Key Elements of the U.S. Tax System

Q. What's the difference between a tax deduction and a tax credit?

A. Deductions reduce taxable income and their value thus depends on the taxpayer's marginal tax rate, which rises with income. Credits reduce taxes directly and do not depend on tax rates. However, the value of credits may depend on the taxpayer's basic tax liability. Non-refundable credits can reduce tax to zero but any credit beyond that is lost.

OVERVIEW

An individual tax filer has the choice of claiming the standard deduction or itemizing deductible expenses from a list that includes state and local taxes paid, mortgage interest, and charitable contributions. In either case, taxable income is decreased by the amount of the allowed deduction.

The deduction reduces tax liability by the amount of the deduction times the filer's marginal tax rate, and is thus worth more to taxpayers in higher brackets. For example, a $10,000 deduction reduces taxes by $1,500 for people in the 15 percent tax bracket, whereas the same deduction cuts taxes by $3,500 for those in the 35 percent tax bracket.

IMPACT OF DEDUCTIONS

Determining the actual tax savings associated with deductions is, however, somewhat more complicated. High-income taxpayers have their itemized deductions reduced by the limitation on itemized deductions, called "Pease" after the Ohio congressman who proposed the provision. In 2017, Pease reduces itemized deductions by 3 percent of the amount by which adjusted gross income exceeds specified thresholds—$261,500 for single filers, $287,650 for heads of household, $313,800 for married couples filing jointly, and half of that for married couples filing separately. The limitation cannot reduce deductions by more than 80 percent, however.

The standard deduction and some itemized deductions are disallowed under the alternative minimum tax (AMT). For example, AMT taxpayers may not deduct state and local tax payments or items in the "miscellaneous" deductions category. The AMT reduces but does not eliminate other deductions.

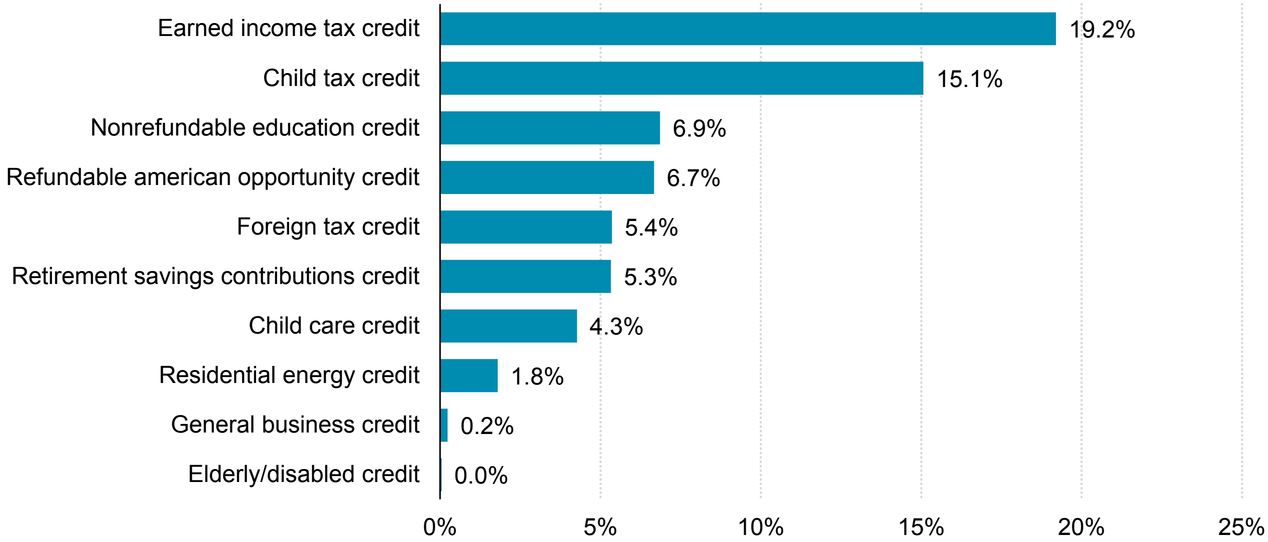
Key Elements of the U.S. Tax System

What's the difference between tax deductions and tax credits?

FIGURE 1

Percentage of All Returns Claiming Selected Credits

2014

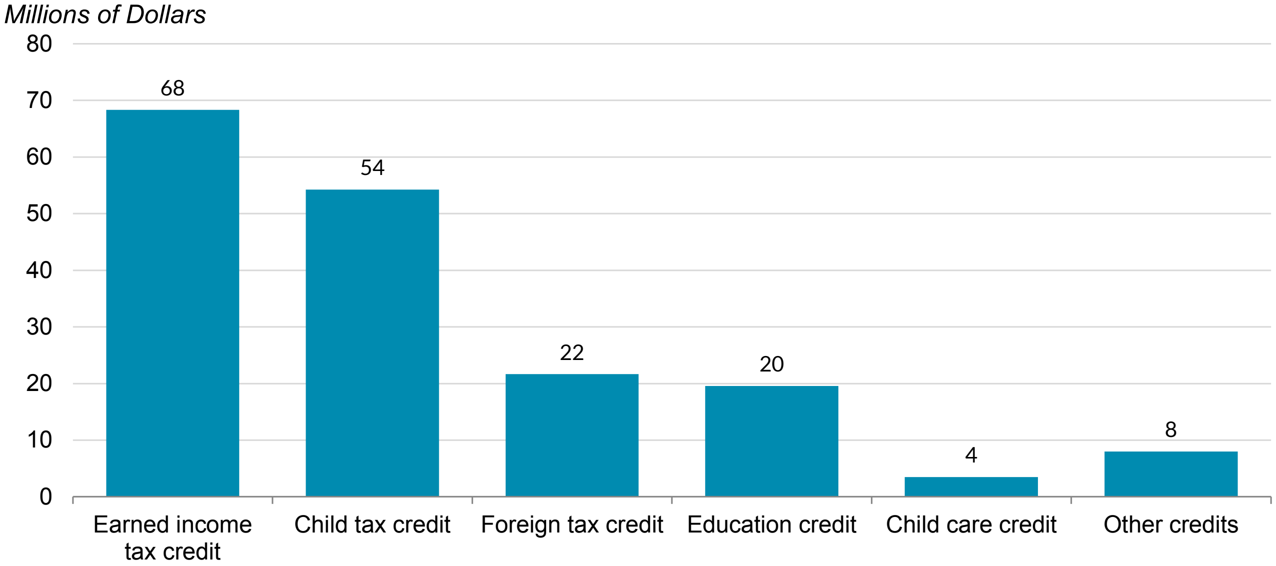


Source: Internal Revenue Service, Statistics of Income, Table A.
Note: .04% of all returns claim elderly/disabled credit.

FIGURE 2

Total Tax Credits by Type

2014



Source: Internal Revenue Service, Statistics of Income, Table A.

Key Elements of the U.S. Tax System

What's the difference between tax deductions and tax credits?

Tax filers may claim some deductions in addition to the standard deduction or itemized deductions. These include deductions for contributions to individual retirement accounts, alimony payments, certain moving expenses, and interest on student loans. The personal exemption ($4,050 each for taxpayers and their dependents in 2017) is also, in effect, a deduction because it reduces taxable income. The value of all of these deductions depends on the taxpayer's marginal tax rate and tax liability.

IMPACT OF CREDITS

Tax credits are subtracted not from taxable income, but directly from a person's tax liability; they therefore reduce taxes dollar for dollar. As a result, credits have the same value for everyone who can claim their full value.

NONREFUNDABLE CREDITS

Most tax credits are nonrefundable; that is, they cannot reduce a filer's tax liability below zero. As a result, low-income filers often cannot receive the full benefit of the credits for which they qualify. For example, the child and dependent care credit is nonrefundable, so a married couple with two children and income under $28,900 in 2017 cannot receive the credit because the family has no income tax liability.

REFUNDABLE CREDITS

Some tax credits, however, are fully or partially refundable: if their value exceeds a person's tax liability, the excess is paid to the filer. The earned income tax credit (EITC) is fully refundable; the child tax credit (CTC) is refundable only if the filer's earnings exceed a $3,000 threshold.

MOST POPULAR CREDITS

The EITC is the most commonly claimed credit, showing up on about 19 percent of 2014 tax returns. The CTC was nearly as popular, claimed on more than 15 percent of 2014 tax returns (figure 1).

The EITC is also the most costly tax credit, totaling about $68 billion in 2014. The child credit was the second largest at roughly $54 billion (figure 2).

Data Sources

Internal Revenue Service. Statistics of Income—2014 Individual Income Tax Returns Publication 1304 (Complete Report). Table A. "All Returns: Selected Income and Tax Items in Current and Constant 1990 Dollars, Tax Years 1990–2014" and Table 3.3. "All Returns: Tax Liability, Tax Credits and Tax Payments, by Size of Adjusted Gross Income, Tax Year 2014."

Urban-Brookings Tax Policy Center. *Statistics.* "Credit Type and Amount."

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Q. How do phaseouts of tax provisions affect taxpayers?

A. Many preferences in the tax code phase out for high-income taxpayers—their value falls as income rises. Phaseouts narrow the focus of tax benefits to low- and middle-income households while limiting revenue costs, but raise marginal tax rates for affected taxpayers.

Many preferences in the tax code are phased out (meaning their value is reduced as income rises) for higher-income taxpayers as a way to target tax benefits on middle- and lower-income households and to limit the loss of revenue. Phaseouts, however, not only claw back these benefits from the more affluent, they also increase the effective marginal tax rate these taxpayers face, decreasing the after-tax gains of earning more income.

Some taxpayers are affected by multiple tax provisions phasing out at the same time, compounding the negative impact on their earning incentives. More broadly, phaseouts complicate the tax code and make it more difficult for taxpayers to understand the taxes they pay.

HOW DO PHASEOUTS WORK?

Phaseouts are structured in different ways and thus have different effects. Some reduce credits and thus have the same impact on all affected taxpayers. Others reduce deductions, in which case their quantitative impact depends on the taxpayer's marginal tax rate: the higher the tax rate, the greater the value of the lost deduction.

Phaseouts reduce tax benefits at different rates depending on their structure and range (table 1). Most phaseouts reduce benefits at a constant rate over an income range; that rate depends on the width of the range. For example, for single tax filers, the American Opportunity Tax Credit phases out evenly over a $10,000 range, so its phaseout rate is 1 percent per $100 in additional income. In contrast, the adoption credit phases out over a $40,000 range, so its phaseout rate is one-fourth as fast—just 0.25 percent per $100.

Some phaseouts, however, reduce benefits by a specified amount for each fixed increment of income. For example, the child tax credit decreases by $50 for every $1,000 or part of $1,000 in additional income above the phaseout threshold. Whether income exceeds the threshold by $1 or by $999, the credit falls by the same $50, so earning a few more dollars could make a taxpayer worse off.

Key Elements of the U.S. Tax System

How do phaseouts of tax provisions affect taxpayers?

TABLE 1

SELECTED PHASE-INS AND PHASEOUTS IN THE 2017 INDIVIDUAL INCOME TAX CODE

Provision	Description	Effect on marginal tax rate	Filing status	Phaseout begins/ends	
		EXEMPTIONS AND DEDUCTIONS			
Personal exemption	Exemption of $4,050 per taxpayer or dependent is reduced 2% for each $2,500 (or part thereof) of AGI above threshold.	Effect depends on total exemptions and taxpayers statutory tax rate.	Single	$261,500*	$384,000*
			HoH	$287,650*	$410,150*
			MFJ	$313,800*	$436,300*
			MFS	$156,900*	$218,150*
Itemized deduction	Itemized deductions reduced 3% of AGI above threshold, up to 80% of deductions.	Increases by 3% of statutory tax rate.	Single	$261,500*	N/A
			HoH	$287,650*	N/A
			MFJ	$313,800*	N/A
			MFS	$156,900*	N/A
		WORK PROVISIONS			
Earned Income Tax Credit	Credit phases in from first dollar of earnings; phaseout threshold based on marital status and number of children. Phase-in and phaseout rates vary with number of children: none - 7.65%, 7.65%; one - 35%, 15.98%; two - 40%, 21.06%, three or more - 45%, 21.06%.	Decreases by credit percentage during phase-in.	Single/HOH		
			No children	$8,340*	$15,010*
			One child	$18,340*	$39,617*
			Two children	$18,340*	$45,007*
			3+ children	$18,340*	$48,340*
		Increases at phaseout	MFJ		
			No children	$13,930*	$20,600*
			One child	$23,930*	$45,207*
			Two children	$23,930*	$50,597*
			3+ children	$23,930*	$53,930*
			MFS	Credit not allowed	
		CHILD PROVISIONS			
Child Tax Credit	Credit of $1,000 per child is reduced by $50 for each $1,000 or part thereof above start of phaseout.	Increases by 5 percentage points throughout phaseout range.	Single/HoH	$75,000	N/A
			MFJ	$110,000	N/A
			MFS	$55,000	N/A
Child and Dependent Care Credit	Credit of up to $3,000 for each of up to two children; credit rate falls from 35% to 20% at rate of 1% for each $2,000 of income above threshold.	Increases by up to 3 percentage points, depending on number of children and spending on child care.	Single/HoH	$15,000	$43,000
			MFJ	$15,000	$43,000
			MFS	Credit not allowed	
Adoption Credit	Credit of up to $13,570 (regardless of the number of children adopted) is reduced evenly over phaseout range.	Increases by up to 32.9 percentage points, depending on expense.	All	$203,540*	$243,540*

Key Elements of the U.S. Tax System

How do phaseouts of tax provisions affect taxpayers?

EDUCATION PROVISIONS					
American Opportunity Credit	Credit of 100% of first $2,000 and 25% of next $2,000 of eligible expenses.	Increases by up to 25 percentage points (12.5 for MFJ) per student, depending on expenses.	Single/HoH MFJ MFS	$80,000* $160,000* Credit not allowed	$90,000* $180,000*
Lifetime Learning Credit	Credit of 20% of eligible expenses up to $10,000.	Increases by up to 20 percentage points (10 for MFJ), depending on expenses.	Single/HoH MFJ MFS	$56,000* $112,000* Credit not allowed	$65,000* $130,000*
Education tuition and fees deduction	Maximum deduction of $4,000 below lower threshold; $2,000 between thresholds; zero above upper threshold.	Large discrete increases at each threshold income value.	Single/HoH MFJ MFS	$65,000 $130,000 Deduction not allowed	$80,000 $160,000
Coverdell Educational Savings Accounts	Maximum contribution of $2,000 is reduced evenly over phaseout range.	No effect on current tax rate, but increases tax rate when funds are withdrawn if distributions are not used for educational purposes or exceed qualified expenses for that year.	Single/HoH MFJ MFS	$95,000 $190,000 $95,000	$110,000 $220,000 $110,000
Student loan interest deduction	Up to $2,500 of qualifying student loan interest is deductable.	Increases by up to 16.7 percent (8.3 for MFJ) of statutory tax rate.	Single/HoH MFJ MFS	$65,000* $135,000* Deduction not allowed	$80,000* $165,000*
Education Savings Bond Program	Interest on qualified savings bonds is tax-free if used for higher education.	Depends on amount of interest on redeemed bonds and statutory tax rate.	Single/HoH MFJ MFS	$77,200* $115,750* $77,200*	$92,200* $145,750* $92,200*
RETIREMENT SAVINGS PROVISIONS					
Saver's Credit	Credit of up to $2,000 per taxpayer; credit rate falls in steps from 50% to 0%.	No effect on current tax rate but increases tax rate when funds are withdrawn.	Single/MFS MFJ HoH	$18,5000* $37,000* $27,750*	$31,000* $62,000* $46,500*
Roth IRA contribution limits	Maximum $5,500 all IRAs.	No effect on current tax rate but increases tax rate when funds are withdrawn.	Single/HoH MFJ MFS (if lived together at all)	$118,000* $186,000* $0	$133,000* $196,000* $10,000
Traditional IRA contribution limits (own)	Maximum $5,500 all IRAs.	Increases by up to 25% of statutory tax rate.	Single/HoH MFJ MFS	$62,000* $99,000* $0	$72,000* $119,000* $10,000
Deductible IRA contribution limits (spouse)	Maximum $5,500 all IRAs.	Increases by up to 25% of statutory tax rate.	MFJ MFS	$186,000* $0	$196,000* $10,000
Taxation of Social Security benefits	Up to 85% of Social Security benefits included in taxable income (50% during phase-in range and 85% beyond it).	Increases by 50% of statutory tax during phase-in; increases by 85% of statutory tax rate above phase-in (subject to income).	Single/HoH MFJ MFS (if lived together at all)	$25,000 $32,000 $0	$34,000 $44,000 $0

Key Elements of the U.S. Tax System

How do phaseouts of tax provisions affect taxpayers?

ALTERNATIVE MINIMUM TAX					
AMT exemption	Exemption reduced by 25 percent of income above phase-out threshold.	Increases by 25% of AMT tax rate if liable for AMT.	Single/HoH MFJ MFS	$120,700 $160,900 $80,450	N/A N/A N/A

Source: Tax Policy Center, 2016. Based on various Internal Revenue Service publications and individual income tax forms.
Notes: AGI = adjusted gross income; HoH = head of household; MFJ = married filing jointly; MFS = married filing separately; N/A = not applicable.
* Indexed for inflation.

Some phaseouts have more pronounced cliffs, so the benefit drops in large increments when income exceeds the threshold. For example, in 201, the limit on the deduction for higher education tuition and fees drops from $4,000 to $2,000 for a single tax filer if income exceeds $65,000 by even $1, and then drops to zero when income tops $80,000. Again, just a few dollars of additional income could leave a taxpayer whose income is near the cliff much worse off.

Many phaseouts are indexed for inflation so that the phaseout ranges remain fixed in real terms. Phaseouts that are not adjusted for inflation affect more taxpayers over time, as inflation raises nominal incomes and thus lifts more taxpayers above the phaseout thresholds.

HOW PHASEOUTS CREATE MARRIAGE PENALTIES AND BONUSES

Many phaseouts create significant marriage penalties—or bonuses—because the phaseout range for married couples is less than twice that for single tax filers. For example, in 2017 the phaseout of personal exemptions begins at $313,800 for married couples filing jointly, less than twice the $261, 500 threshold for single filers. Consider a couple in which each spouse has income of $200,000. The phaseout would not affect either spouse if they were not married—each would have income under the single threshold—but as joint filers they lose 70 percent of their combined $8,100 personal exemptions, increasing their taxable income by nearly $5,700.

Phaseouts can also create marriage bonuses, reducing a couple's combined tax bill. For example, if one spouse has $300,000 of income and the other spouse has none, their combined income would be under the $313,800 threshold for reducing exemptions for joint filers in 2017. If they were single, the high-earning spouse would lose 32 percent of her personal exemption, which would increase her taxable income by nearly $1,300.[1]

Phaseouts also impose marriage penalties on low-income families, and those penalties are often a larger percentage of their income than the marriage penalties caused by phaseouts for higher-income taxpayers.

In 2016, a single mother who earns $17,450 and has one child pays no income tax and receives two refundable credits—a $1,000 child tax credit (CTC) and a $3,373 earned income tax credit (EITC) (table 2).[2] If she marries a man making $40,000—whose 2016 income tax as a single person would be $3,984—she would lose all of her EITC (the couple's income would cause the credit to phase out completely) but would retain her CTC. Losing the EITC means that the couple would pay $2,978 in income tax when married, compared with receiving a net payment of $354 (her $4,349 combined credit minus his $3,995 tax) if they remained single. That difference is a marriage penalty of $3,332, or 5.8 percent of the couple's adjusted gross income.

Key Elements of the U.S. Tax System

How do phaseouts of tax provisions affect taxpayers?

TABLE 2

Marriage Bonus and Penalty Tax Calculator Example

$2016

	Mother	Spouse	Couple
Adjusted gross income	**$17,450**	**$40,000**	**$57,450**
Personal exemptions	$8,000	$4,050	$12,150
Standard deduction	$9,300	$6,300	$12,600
Taxable income	**$50**	**$29,650**	**$32,700**
Tax before credits	$5	$3,984	$3,978
Child Tax Credit	$1,000	$0	$1,000
Earned Income Tax Credit	$3,373	$0	$0
Tax Net of Credits	**-$4,368**	**$3,984**	**$2,978**

Tax as two individuals
-$384
Tax as a married couple
$2,978
Marriage penalty
$3,362
Difference as a percent of couple's AGI
5.9%

Source: Tax Policy Center Marriage Bonus and Penalty Calculator, 2015.

[1] The married couple's bonus would be even larger because, having no income, the nonearner could not benefit from the personal exemption. Filing jointly, the couple would get the full value of both spouses' exemptions.

[2] In 2016, a single mother with one child begins paying income tax (before credits) when her income exceeds $17,450—the sum of her $9,350 standard deduction for a head of household and personal exemptions for herself and her child totaling $8,100.

Data Sources

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———. Child Tax Credit, Publication 972.

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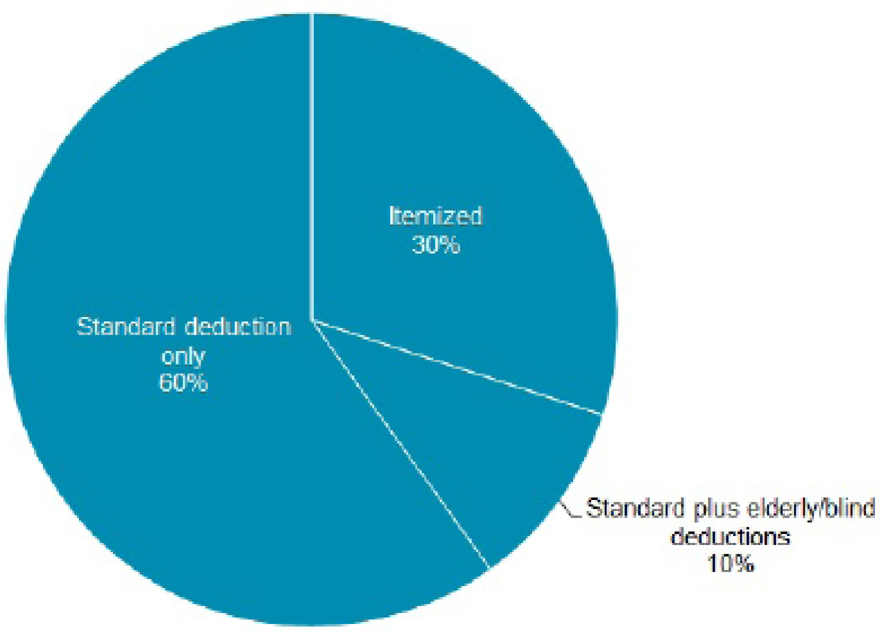
Q. How do the standard and itemized deductions compare?

A. Both reduce taxable income by the amount of the allowed deduction; the tax savings depend on the taxpayer's bracket. About two-thirds of taxpayers claim the standard deduction (figure 1).

FIGURE 1

Two-Thirds of Taxpayers Take the Standard Deduction

Returns by type of deduction, 2014



Source: Internal Revenue Service, Table A.

Tax filers may choose to take the standard deduction or to itemize the actual amounts spent on allowed deductible expenses. The most common itemized deductions are state and local taxes, mortgage interest, charitable contributions, medical and dental expenses, and casualty and theft losses.

Key Elements of the U.S. Tax System

How do the standard and itemized deductions compare?

Most taxpayers choose the standard deduction because it is larger than the deductions they can itemize. Others choose that option because it's easier than identifying and totaling the expenses they could itemize or because they do not realize that itemizing would reduce their tax liability.

In a 2002 study, the Congressional Research Service (CRS) estimated that roughly 950,000 tax filers would have saved more than $470 million on their 1998 tax returns if they had itemized mortgage interest and state and local income taxes instead of claiming the standard deduction. Adding charitable contributions and other taxes to the mix, the CRS found that some 2.2 million taxpayers could have saved nearly $1 billion by itemizing.

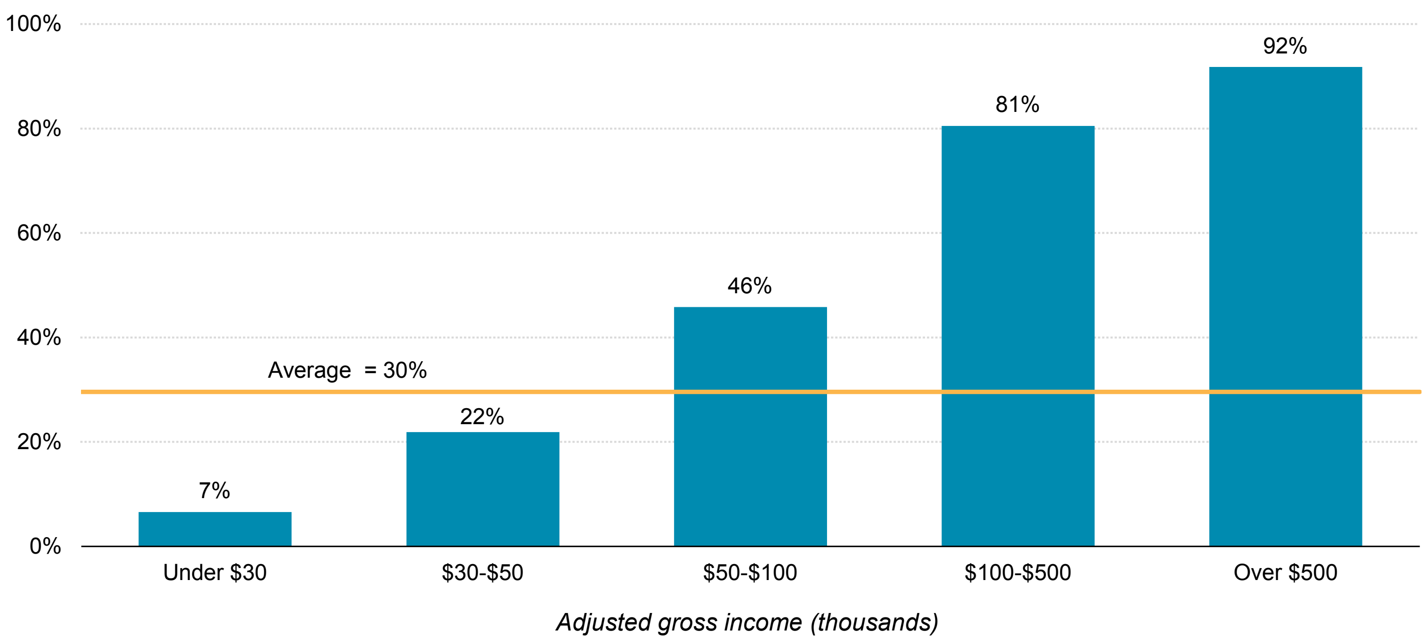
WHO ITEMIZES AND HOW MUCH DO THEY CLAIM?

High-income taxpayers are much more likely to itemize. In 2014, more than 90 percent of tax returns reporting adjusted gross income (AGI) over $500,000 itemized deductions, compared with just under half of those with AGI between $50,000 and $100,000 and less than 10 percent of those with AGI under $30,000 (figure 2).

FIGURE 2

High Income Tax Filers Were More Likely to Itemize Deductions in 2014

Share of tax units claiming itemized deductions



Source: Internal Revenue Service, Table 1.2.

Key Elements of the U.S. Tax System

How do the standard and itemized deductions compare?

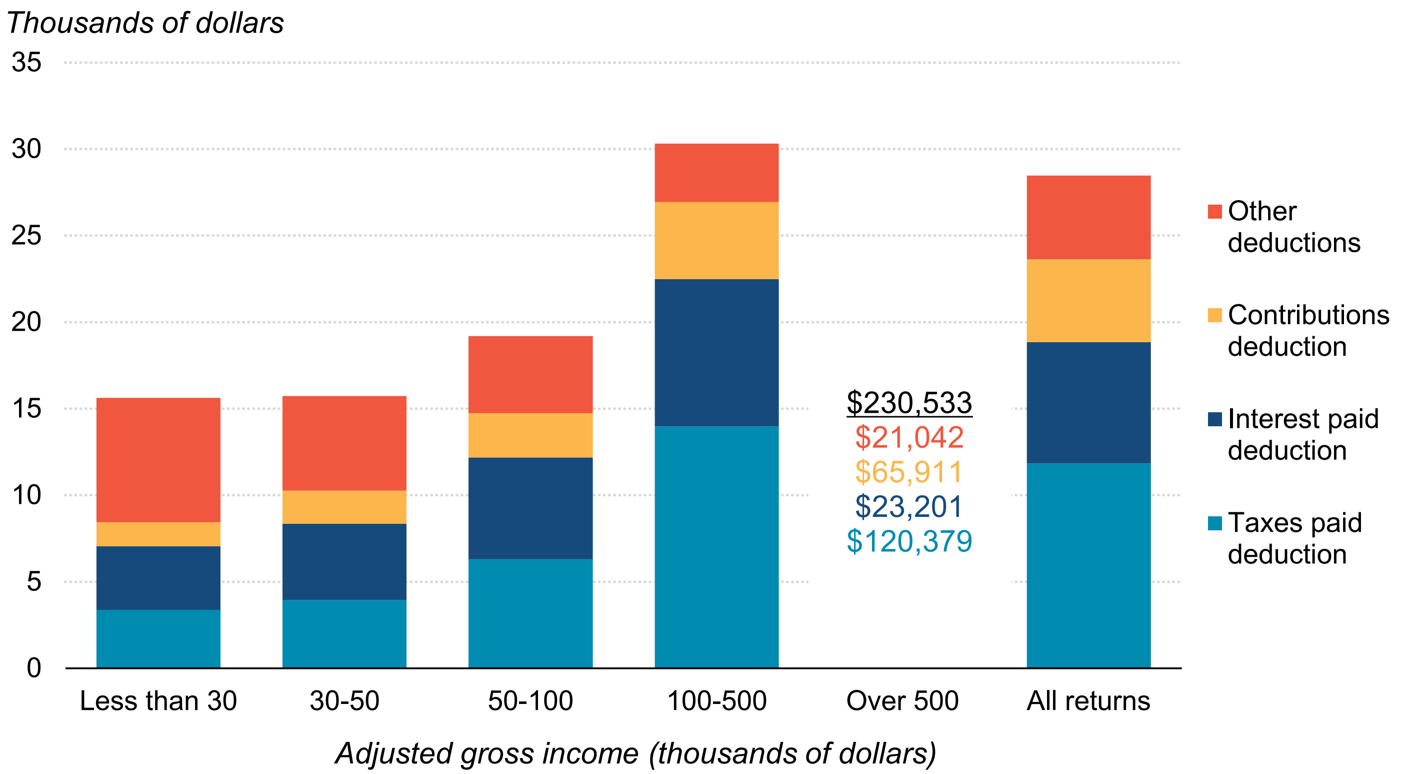
The limitation on itemized deductions (sometimes called "Pease" after the Ohio congressman who proposed it) reduces deductions for high-income taxpayers by 3 percent of the amount by which their AGI exceeds a threshold—$261,500 in 2017 ($287,650 for heads of household, $313,800 for married couples filing jointly, and half of that for married couples filing separately)—but not by more than 80 percent of deductions claimed. The 2001 tax act phased out the limitation and it disappeared entirely from 2010 through 2012 before the American Taxpayer Relief Act of 2012 restored it in its current form.

HOW MUCH AND WHAT EXPENSES DO ITEMIZERS DEDUCT?

Itemized deductions averaged about $27,400 in 2014 for the 44 million tax units claiming them. The amount claimed rises with income, from just under $16,000 for taxpayers with AGI under $50,000 to about $30,000 for those with AGI between $100,000 and $500,000 and more than $230,000 for those with AGI over $500,000 (figure 3).

FIGURE 3

Average Itemized Deductions by Type and AGI
2014



Source: Internal Revenue Service, Table 2.1

Key Elements of the U.S. Tax System

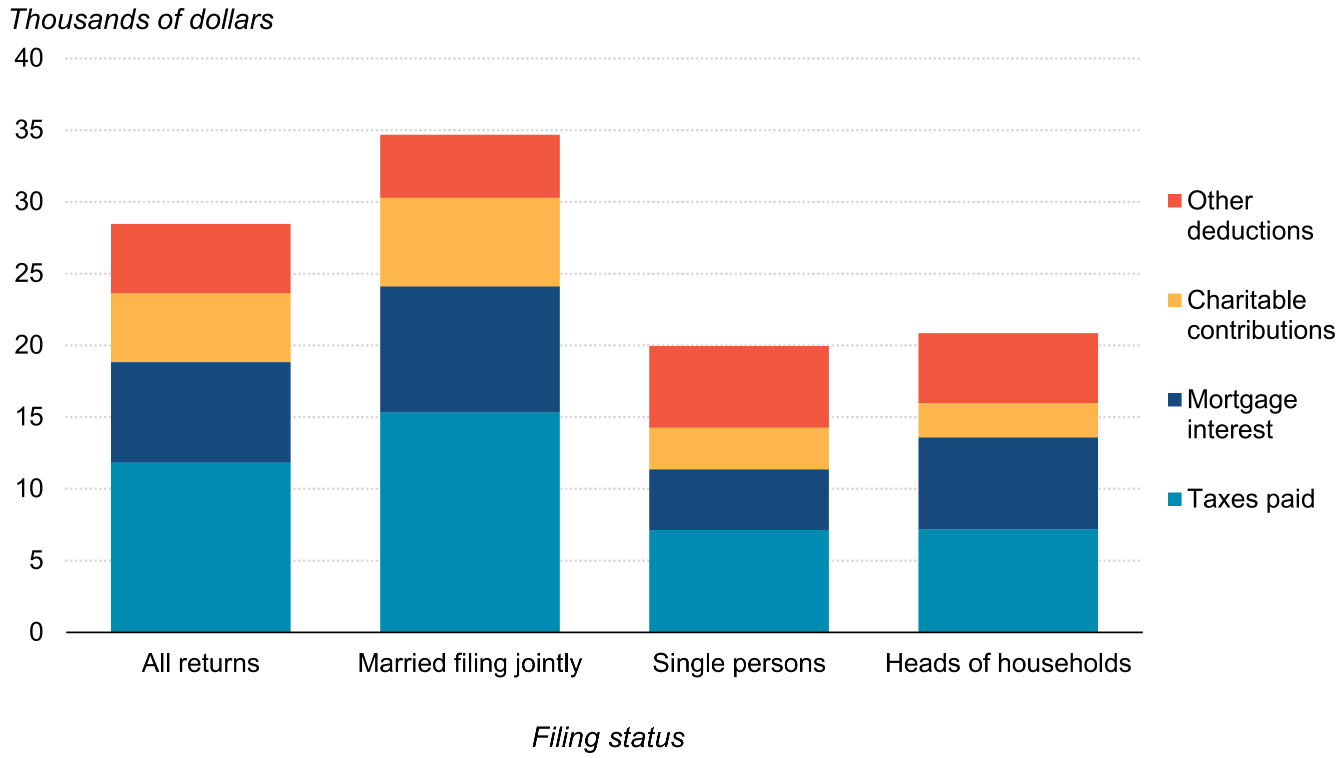
How do the standard and itemized deductions compare?

State and local taxes accounted for over 40 percent of average itemized deductions in 2014, or about $11,800. The mortgage and other interest deductions made up another 25 percent, averaging about $7,000. Charitable contribution and miscellaneous deductions averaged about $4,800 each, or about 17 percent of total itemized deductions (figure 3).

FIGURE 4

Itemized Deductions by Type and Filing Status

2014



Source: Internal Revenue Service, Table 1.3.

Married couples filing jointly typically claim higher deductions, averaging more than $39,000 in 2014. Itemized deductions averaged over $25,000 for single filers and about $26,000 for heads of households. The differences across filing status reflect both the higher standard deduction for joint filers—their itemized deductions must be higher to make itemizing the better choice—and the higher average income of couples relative to unmarried tax filers.

Key Elements of the U.S. Tax System

How do standard and itemized deductions compare?

Data Sources

Internal Revenue Service. Statistics of Income—2014 Individual Income Tax Returns Publication 1304 (Complete Report). Table 1.2. "All Returns: Adjusted Gross Income, Exemptions, Deductions, and Tax Items, by Size of Adjusted Gross Income and by Marital Status, Tax Year 2014"; Table 1.3. "All Returns: Sources of Income, Adjustments, Deductions, Credits, and Tax Items, by Marital Status, Tax Year 2014"; and Table 2.1. "Returns with Itemized Deductions: Sources of Income, Adjustments, Itemized Deductions by Type, Exemptions, and Tax Items by Size of Adjusted Gross Income, Tax Year 2014."

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Q. How are capital gains taxed?

A. Capital gains are profits from the sale of a capital asset, such as shares of stock, a business, a parcel of land, or a work of art. Capital gains are generally included in taxable income, but in most cases are taxed at a lower rate.

A capital gain is realized when a capital asset is sold or exchanged at a price higher than its basis. Basis is an asset's purchase price, plus commissions and the cost of improvements, minus depreciation. Similarly, a capital loss occurs when an asset is sold for less than its basis. Gains and losses (like other forms of capital income and expense) are all measured in nominal terms—that is, not adjusted for inflation.

Capital gains and losses are classified as long term if the asset was held for more than one year, and short term if held for a year or less. Taxpayers in the 10 and 15 percent tax brackets pay no tax on long-term gains on most assets; taxpayers in the 25-, 28-, 33-, or 35-percent income tax brackets face a 15 percent rate on long-term capital gains. For those in the top 39.6 percent bracket for ordinary income, the rate is 20 percent. Short-term capital gains are taxed at the same rate as ordinary income. There also is a 3.8 percent tax on net investment income for single taxpayers with modified adjusted gross income above $200,000 ($250,000 for married couples filing jointly). Note, too, that capital gains in some cases face an effective tax rates above the 23.8 percent statutory rate because of phaseouts in the tax code.

Gains on art and collectibles are taxed as ordinary income up to a maximum 28 percent rate. Taxpayers may realize up to $250,000 of gains on their principal residences tax free (or up to $500,000 for married taxpayers filing jointly). Individuals may exclude up to 50 percent of capital gains on stock held for more than five years in a domestic C corporation with gross assets under $50 million on the date of the stock's issuance. Capital losses may be used to offset capital gains, along with up to $3,000 of other taxable income. The unused portion of a capital loss may be carried over to future years.

The tax basis for an asset received as a gift equals the donor's basis. However, the basis of an inherited asset is "stepped up" to the value of the asset on the date of the donor's death. The step-up provision effectively exempts any gains on assets held until death from income tax.

C corporations pay the regular corporation tax rates on the full amount of their capital gains and may use capital losses only to offset capital gains, not other kinds of income.

Key Elements of the U.S. Tax System

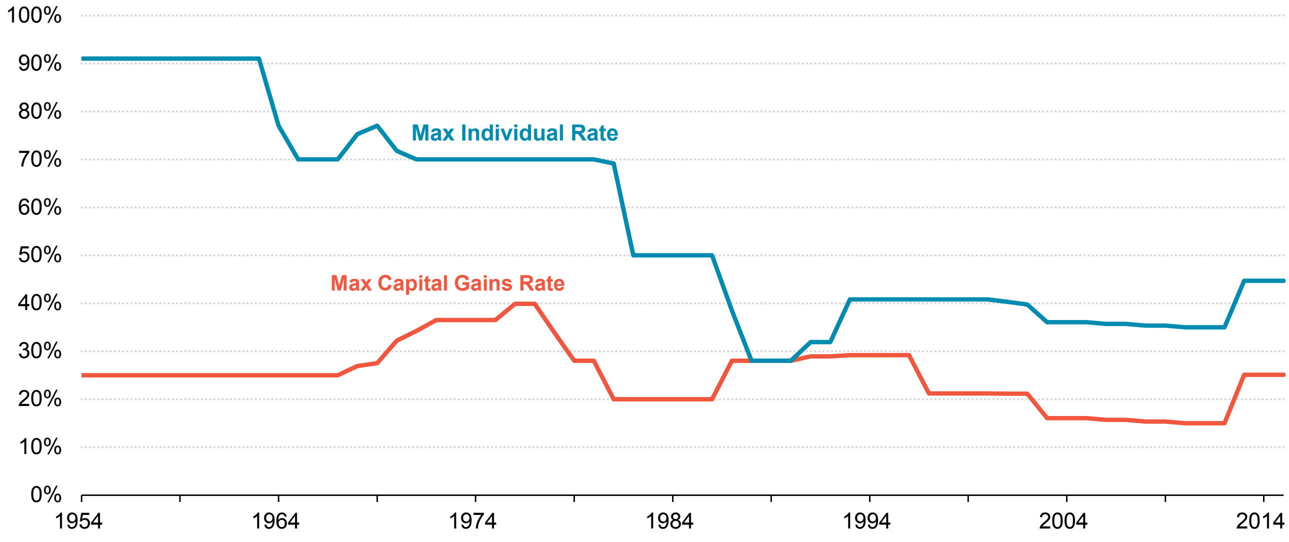
How are capital gains taxed?

For most of the history of the income tax, long-term capital gains have been taxed at lower rates than ordinary income. Since 2003, qualified dividends have also been taxed at the lower rates. Figure 1 below shows how the maximum long-term capital gains tax rate and the maximum ordinary individual income tax rate has changed over the years.

FIGURE 1

Maximum Capital Gains and Individual Tax Rate

1954–2015



Sources: Department of Treasury, Office of Tax Analysis. 2015; Tax Policy Center.
Note: The maximum rate includes the 3.8 percent tax on net investment income (2013-2015) and adjusts for the phaseout of itemized deductions (1991-2009, 2013-2015).

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Q. What is the effect of a lower tax rate for capital gains?

A. It does not appear to spur economic growth significantly. But lower rates certainly do foster tax avoidance strategies and complexity.

Throughout the history of the income tax, capital gains have been taxed at lower rates than ordinary income. Since 2003, qualified dividends have also been taxed at the lower rates. Defenders of the tax preference argue that lower tax rates for capital gains and dividends offset the taxes that have already been paid at the corporate level. Some also claim that lower tax rates for capital gains spur growth, encourage risk-taking and entrepreneurship, offset the effects of inflation, and prevent "lock-in" (the disincentive to sell assets). Critics, for their part, complain that the lower tax rate disproportionately benefits the wealthy and encourages tax sheltering schemes.

The double taxation argument goes only so far. Capital gains from the sale of stock is only about half of all capital gains. And even when a gain arises from the sale of corporate stock, profits have not always been taxed at the corporate level because corporations use various tax preferences, too.

Do lower taxes on capital gains spur economic growth? Figure 1 shows the top tax rates on long-term capital gains along with real economic growth from 1950 to 2015. Of course, many factors determine growth, but the tax rate on capital gains does not appear to be significant.

Capital gains may arise from risky investments, and a lower capital gains tax rate presumably encourages such risk taking. However, taxing gains while allowing deductions for losses on a symmetric basis reduces risk by reducing the after-tax variance of returns. Under current law, taxpayers can use capital losses to offset capital gains and, for noncorporate taxpayers, up to $3,000 of additional taxable income other than capital gains. Noncorporate taxpayers also can carry any remaining capital losses forward to future years indefinitely.

It is true that part of almost any nominal capital gain is due to inflation. But inflation actually affects the returns on assets that are taxed currently (interest, dividends, rents, and royalties) more than it affects capital gains, which are taxed upon disposition.

Meanwhile, the critics are correct that low tax rates on capital gains and dividends accrue disproportionately to the wealthy. The Tax Policy Center estimates that in 2016, three-quarters of the tax benefit of the lower rates were received by taxpayers with incomes over $1 million (table 1).

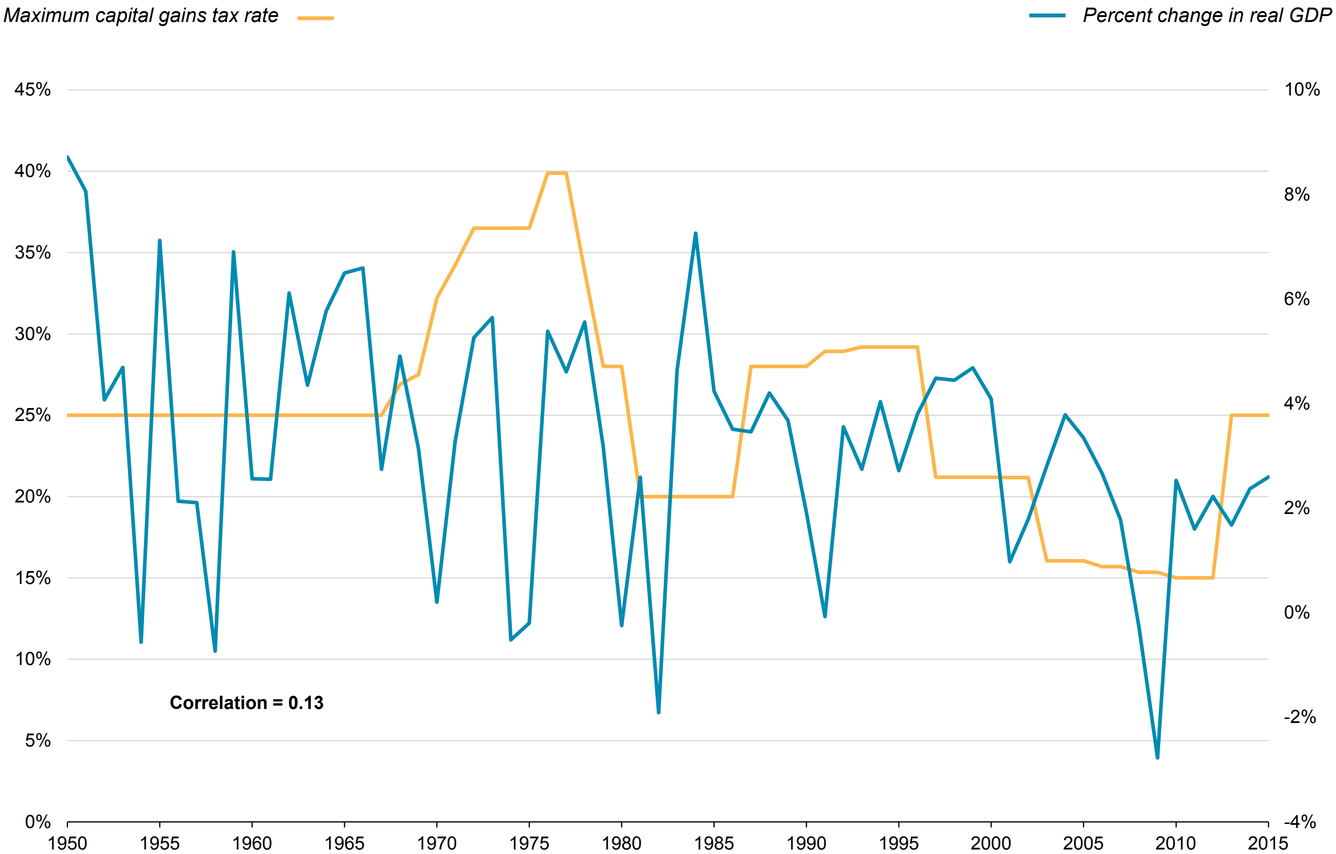
Key Elements of the U.S. Tax System

What is the effect of a lower tax rate for capital gains?

FIGURE 1

Top Capital Gains Tax Rates and Economic Growth

1950–2015



Sources: Citizens for Tax Justice; Bureau of Economic Analysis; Department of the Treasury, Office of Tax Analysis; Tax Policy Center calculations.

Low tax rates on capital gains also play a role in many tax shelters that undermine economic efficiency and growth. These shelters employ sophisticated financial techniques to convert ordinary income (such as wages and salaries) to capital gains. For top-bracket taxpayers, tax sheltering can save 20 cents per dollar of income sheltered. The resources that go into designing, implementing, and managing tax shelters could be used for productive purposes.

Finally, the low rate on capital gains greatly complicates the tax system. A significant portion of tax law and regulations is devoted to policing the boundary between returns on capital assets and ordinary income.

Key Elements of the U.S. Tax System

What is the effect of a lower tax rate for capital gains?

TABLE 1

Benefit of Lower Tax Rates on Long-term Capital Gains

Current law, 2016

Cash income level	Share of returns with benefit	Benefit as share of after-tax income	Share of total federal tax change	Average tax savings
Less than $10,000	0.0%	0%	0%	$0
$10,000–$20,000	0.6%	0%	0%	*
$20,000–$30,000	1.6%	0%	0.1%	$10
$30,000–$40,000	3.2%	0%	0.2%	$10
$40,000–$50,000	5.5%	0.1%	0.3%	$30
$50,000–$75,000	10.4%	0.1%	1.4%	$70
$75,000–$100,000	18.6%	0.2%	2.2%	$170
$100,00–$200,000	26.8%	0.3%	6.8%	$300
$200,000–$500,000	48.6%	0.4%	6.7%	$830
$500,000–$1,000,000	77.5%	1.4%	6.6%	$6,830
More than $1,000,000	88.7%	6.9%	75.7%	$146,050
All	**12.6%**	**1.1%**	**100%**	**$740**

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).
Note: * Non-zero value rounded to zero.

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Q. How might the taxation of capital gains be improved?

A. Taxing capital gains at the same rates as ordinary income would simplify the tax system by removing major incentives for tax sheltering and other attempts to manipulate the system.

The Tax Reform Act of 1986, signed by President Ronald Reagan, raised tax rates on capital gains and lowered rates on ordinary income, but set the same 28 percent top rate for both. The goal: reducing tax planning devoted to converting ordinary income to capital gains. The policy worked—briefly. Successive congresses raised the top rate on ordinary income (now 43.4 percent) and reduced the top rate on capital gains (now 23.8 percent). As the gap between the two rates widened, so did the incentives to manipulate the system. Now might be a good time to once again tax capital gains and ordinary income at the same rate, which would be higher than today's rate on capital gains but lower than the rate on ordinary income.

In the 1980s, taxpayers exploited the ordinary income/capital gain gap by making investments that generated ordinary deductions—such as interest, lease payments and depreciation—to reduce their current income tax liability. These taxpayers got their money back (and presumably more) in the form of long-term capital gains. The '86 act targeted these arrangements by limiting the use of passive loss, interest, and accelerated depreciation deductions. But, most importantly, the '86 act also eliminated the ordinary income/capital gain gap, which removed much of the juice.

With the return of the ordinary income/capital gap, various schemes to convert ordinary income into capital gains have followed. Last year, the Senate investigated basket options, which used the tax alchemy of derivatives to convert short-term into long-term capital gains. Over the last several years, private equity and other investment managers have been compensated with "carried interest," which allow them to claim long-term gains rather than salaries.

These planning opportunities are available only to the well off. More generally, capital assets are held predominantly by the well-off, who derive the most benefit from the capital gains preferences (figure 1).

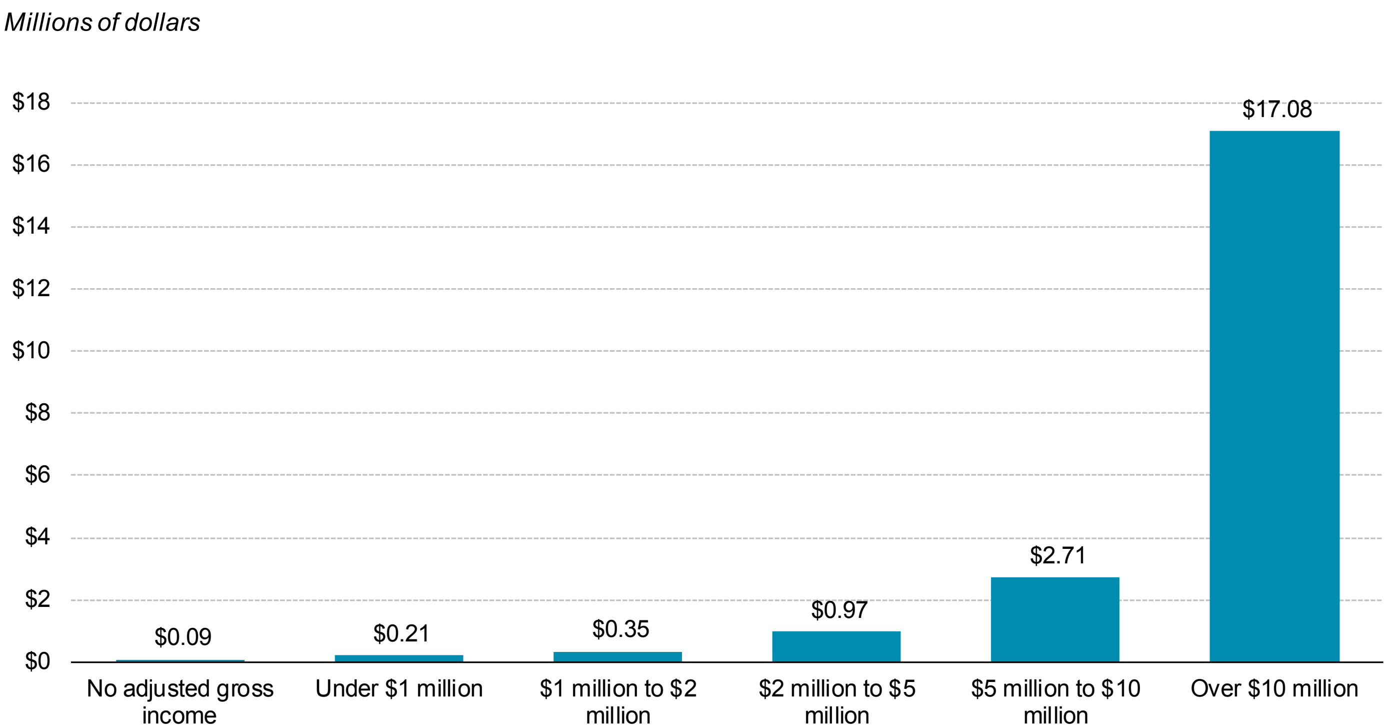
Some may object that reducing the tax rate on capital gains is necessary to prevent "lock in"—holding property to defer tax liability (perhaps until death, when the tax basis of the asset is stepped up to permit heirs to sell without realizing any taxable gains). But if Congress is concerned about the lock-in effect, it could either tax capital gains at death or reinstate the carryover basis so that heirs retain the lower basis. Either step would reduce the tax incentive to keep assets until death—and could raise substantial revenue that would make it possible to reduce tax rates or the deficit.

Key Elements of the U.S. Tax System

How might the taxation of capital gains be improved?

FIGURE 1

Average Taxable Net Capital Gain by Adjusted Gross Income
2014



Source: IRS SOI, Table 1.4

Finally, if Congress is concerned about the potential double taxation of corporate earnings, it might integrate the two levels of taxes on corporate income. That is, Congress could tax corporate earnings only once, taxing the corporation or its shareholders but not both. The US Treasury (1992) has laid out several options for such integration.

Key Elements of the U.S. Tax System

How might the taxation of capital gains be improved?

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Key Elements of the U.S. Tax System

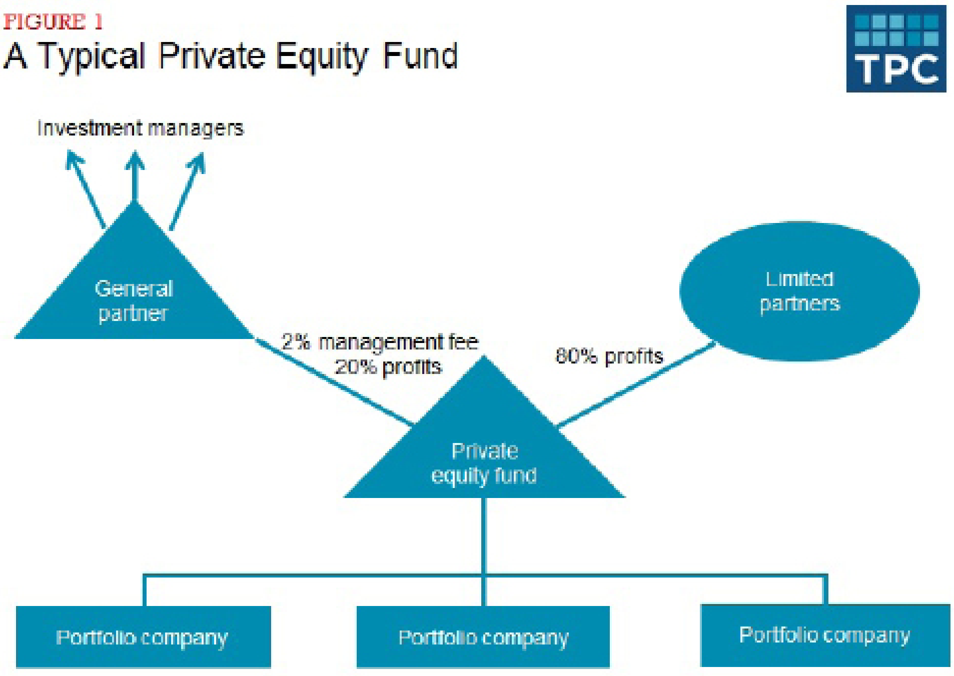
What is carried interest and how should it be taxed?

Q. What is carried interest, and should it be taxed as capital gain?

A. Carried interest, income flowing to the general partner of a private investment fund, is generally treated as capital gains for the purposes of taxation. This tax preference is viewed as an unfair, market-distorting loophole by some but consistent with the tax treatment of other entrepreneurial income by others.

Carried interest is a contractual right that entitles the general partner of a private investment fund (often a private equity fund) to share in the fund's profits (figure 1). A fund typically uses the carried interest to pass through its net capital gains to the general partner which, in turn, passes the gains on to the investment managers. The managers pay a federal personal income tax on these gains at a rate of 23.8 percent (20 percent tax on net capital gains plus 3.8 percent investment tax).

FIGURE 1
A Typical Private Equity Fund



Key Elements of the U.S. Tax System

What is carried interest and how should it be taxed?

The general partner receives its carried interest principally in exchange for its commitment to providing investment management services to the fund. (Typically, the general partner also receives a separate annual fee based on the size of the fund's assets.) The limited partners receive the balance of the fund's profits in exchange for providing predominantly all of the fund's capital. A typical division for a private equity fund is 20 percent of the profits to the general partner and 80 percent to the limited partners.

Private equity funds managed $3.8 trillion in 2014, a massive increase over the $100 billion managed in 1994. They use their capital to buy companies and improve the operations, governance, capital structure, and strategic positions of the companies. Then they sell the companies and pass any profits to the general and limited partners.

Many commentators argue that it would be fairer and more efficient economically for carried interest to be taxed like wage and salary income, which is subject to a top rate of 43.4 percent (39.6 percent plus 3.8 percent). They draw an analogy between the general partners and investment bankers, who pay tax at ordinary rates on their wages, salaries, and bonuses. They also object that most service providers are not able to treat their income as capital gains. Some of these commentators add, if we treat carried interest like wage and salary income for the general partners, we ought to allow ordinary deductions for these payments to the other investors.

But others believe that the general partners are more like entrepreneurs who start a new business and may, under current law, treat part of their return as capital—not as wage and salary income—for their contribution of "sweat equity." Our tax system largely accommodates this conversion of labor income to capital because it cannot measure and time the contribution of the "sweat equity."

Still others defend the current tax treatment of carried interest as a way to mitigate the unfair double taxation of corporate income. Currently, income earned within a partnership is subject only to the individual income tax, whereas income earned within a C corporation is subject to the corporate tax when earned and the individual income tax when realized or distributed.

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Q. What is the AMT?

A. The individual alternative minimum tax (AMT) operates alongside the regular income tax. It requires many taxpayers to calculate their liability twice—once under the rules for the regular income tax and once under the AMT rules—and then pay the higher amount. Ori-gi-nally intended to prevent perceived abuses by a handful of the very rich, it now affects al-most 5 million filers.

In January 1969, Treasury Secretary Joseph W. Barr informed Congress that 155 taxpayers with incomes exceeding $200,000 had paid no federal income tax in 1966. The news created outrage. That year, members of Congress received more constituent letters about the 155 taxpayers than about the Vietnam War. Congress subsequently enacted an "add-on" minimum tax that house-holds paid in addition to regular income tax. It applied to certain income items ("preferences") that were taxed lightly or not at all under the regular income tax. The largest preference item was the portion of capital gains excluded from the regular income tax.

Congress enacted the modern alternative minimum tax (AMT) in 1979 to operate in tandem with the add-on minimum tax. The main preference items, including capital gains, moved from the add-on tax to the AMT. Congress finally repealed the add-on tax, effective in 1983.

The original minimum tax and the AMT affected fewer than 1 million taxpayers annually through the late 1990s. In 2001, Congress passed the Economic Growth and Tax Relief Reconciliation Act (EGTRRA), which substantially reduced regular income taxes but provided only temporary relief from the AMT. Over the following decade, Congress repeatedly passed legislation—often at the last possible moment—to temporarily "patch" the AMT by increasing the AMT exemption amount.

Although the patches prevented an AMT explosion, the number of taxpayers affected by the AMT continued to grow throughout the decade (figure 1) because (1) the regular income tax was indexed for inflation, but the AMT was not; and (2) Congress enacted substantial cuts to the reg-ular income tax.

The American Taxpayer Relief Act of 2012 (ATRA) enacted a permanent AMT fix by establish-ing a higher AMT exemption amount, indexing the AMT parameters for inflation, and allowing specified tax credits under the AMT. As a result, the number of AMT taxpayers fell from 4.6 million in 2012 to about 4.2 million in 2013. That number will grow modestly to 4.8 million in 2017.

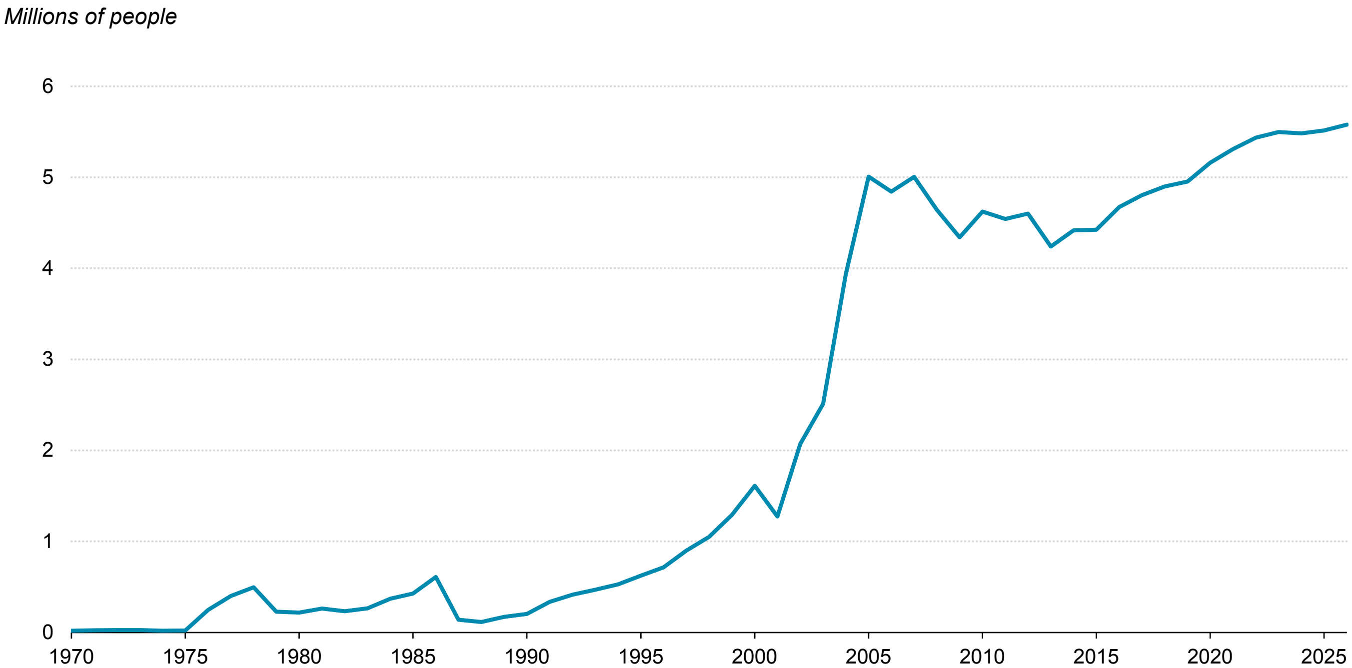
Key Elements of the U.S. Tax System

What is the AMT?

FIGURE 1

Taxpayers Affected by the AMT

1970–2026



Sources: Urban-Brookings Tax Policy Center Microsimulation Model; Harvey and Tempalski (1997); private communication from Jerry Tempalski; and IRS.
Notes: Figures include those who paid the original add-on minimum tax that Congress repealed in 1983. Taxpayers affected by the AMT include those with direct AMT liability on Form 6251 as well as those with lost credits and/or reduced deductions.

STRUCTURE

After calculating their regular income tax, many middle- and upper-income taxpayers must add a number of AMT "preference items" to their taxable income, subtract an AMT exemption amount, and recalculate their tax using the AMT tax rate structure. AMT liability is the excess, if any, of this amount over the amount of tax owed under the regular income tax rules.

AMT preference items include the deduction for state and local taxes (62 percent of all prefer-ences in 2012 according to Treasury data), personal exemptions (21 percent), the deduction for miscellaneous business ex-penses (9.5 percent), and the standard deduction (0.7 percent). The AMT also has special rules for the treat-ment of net operating losses and depreciation.

Because the AMT disallows the state and local tax deduction and dependent exemptions, fami-lies with children who live in high-tax states are among the most likely to owe AMT. Allowing the state and local tax deduction and dependent exemptions for AMT purposes would reduce the number of households affected by the AMT from 4.8 million to just 525,000 in 2017.

Key Elements of the U.S. Tax System

What is the AMT?

The AMT has two tax rates: the first $187,800 of income above the exemption is taxed at a 26-percent rate, and income above that amount is taxed at 28 percent. The AMT exemption begins to phase out at $129,700 for singles and heads of household, $160,900 for married couples filing jointly, and $80,450 for married couples filing separate returns. Because the exemption phases out at a 25-percent rate, it creates a top effective AMT tax rate of 35 percent (125 percent of 28 percent). All dollar values are for 2017 and are indexed annually for inflation (table 1).

TABLE 1
Alternative Minimum Tax Paremeters
Dollars, 2017

AMT Parameters	Single	Married filing jointly	Head of household	Married filing separately
Exemption	54,300	84,500	54,300	42,250
28 percent bracket threshold	187,800	187,800	187,800	93,900
Exemption phaseout threshold	120,700	160,900	120,700	80,450

Source: Internal Revenue Code.
Note: All parameters are indexed annually for inflation.

Data Sources

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Q. Who pays the AMT?

A. The individual alternative minimum tax (AMT) primarily affects well-off households, but not those with the very highest incomes. It is also more likely to hit taxpayers with large families, those who are married, and those who live in high-tax states.

Taxpayers pay the higher of either their tax calculated under regular income tax rules or their tax calculated under the alternative minimum tax (AMT) rules. Because the 39.6 percent top rate un-der the regular income tax is higher than the 28 percent top statutory AMT rate, households with very high incomes who do not attempt to shelter much income typically pay based on the regular income tax system. Households that are not at the very top but still have relatively high incomes face somewhat lower statutory tax rates under the regular tax and are therefore more likely to pay the AMT.

In 2017, 30.9 percent of households with "expanded cash income" (which is a broad measure of income) between $200,000 and $500,000 will be affected by the AMT (table 1). That number rises to 61.8 percent for those with incomes between $500,000 and $1 million. In contrast, only 18.2 percent of households with incomes greater than $1 million will be on the AMT.

TABLE 1

Share of Tax Units Affected by the AMT[a]

Thousands of dollars, 2016

TPC

Expanded cash income[b]	2016	2017	2026
Less than 50	c	c	c
50-75	c	c	c
75-100	0.3	0.3	0.3
100-200	1.9	2.0	2.2
200-500	30.3	30.9	28.5
500-1,000	62.9	61.8	69.1
1,000 and more	20.5	18.2	14.1

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).
(a) Includes AMT liability on Form 6251, lost credits, and the value of reduced deductions. Tax units that are dependents of other tax units are excluded from the analysis.
(b) Tax units with negative adjusted gross income are excluded from their respective income classes but are included in the totals.
(c) Less than 0.05.

Key Elements of the U.S. Tax System

Who pays the AMT?

WHO PAYS?

The regular income tax allows a personal exemption of $4,050 (in 2017, indexed for inflation) for each family member. The AMT exemption varies by filing status but does not increase with family size. As a result, in 2017 families with two children are three times more likely to pay the AMT than those without children (6.3 percent versus 2.1 percent). Families with three or more children (9.0 percent) are more than four times as likely to pay the AMT as those without chil-dren (table 2).

TABLE 2

Share of Tax Units Affected by the AMT[a]

By individual characteristics

Group	2016	2017	2026
By number of children[b]			
0	2.1	2.1	2.2
1	3.7	3.8	4.2
2	6.1	6.3	7.1
3 or more	9.0	9.2	10.4
By state tax level			
High	4.9	5.0	5.4
Middle	2.7	2.8	3.0
Low	2.4	2.4	2.4
By filing status			
Single	0.9	1.0	1.1
Married Filing Joint	6.2	6.4	6.5
Head of Household	2.0	2.1	2.5
Married Filing Separate	6.3	6.0	7.4

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).

(a) Includes AMT liability on Form 6251, lost credits, and the value of reduced deductions. Tax units that are de-pendents of other tax units are excluded from the analysis.

(b) Number of children is defined as number of exemptions taken for children living at home.

Under the regular income tax, many married couples receive a "marriage bonus" because they pay less tax than they would if they were single. This is not true under the AMT. AMT tax brackets are identical for married and single taxpayers, and the AMT exemption for married couples is only about one and a half times as large as the exemption for singles. In contrast, the standard deduction for married couples under the regular income tax is twice that for singles, and the 10 and 15 percent tax brackets for married couples are twice as wide as those for singles. AMT marriage penalties, combined with the fact that married couples often have children and tend to have higher incomes than single individuals, make married couples more than six times as likely as singles to pay the AMT.

Taxpayers can deduct state and local taxes under the regular income tax but not the AMT. Thus, in 2017 taxpayers in high-tax states are more than twice as likely to be on the AMT as those in low-tax states.

Who pays the AMT?

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Key Elements of the U.S. Tax System

Q. How much revenue does the AMT raise?

A. About $35 billion in 2017, or about 2.2 percent of all individual income tax revenue. By 2026, AMT revenue will total $57 billion, or 2.3 percent of all individual income tax reve-nue.

Congress enacted the original minimum tax in 1969. It was an "add-on" tax that households paid in addition to any regular income tax they owed. It applied to certain income items ("preferences") that were taxed relatively lightly or not at all under the regular income tax. The largest preference item was the portion of capital gains excluded from the regular income tax. Revenue from the add-on tax grew from $122 million (0.14 percent of aggregate individual income tax revenue) in 1970 to $1.5 billion (0.84 percent) by 1978.

Congress enacted the modern individual alternative minimum tax (AMT) in 1979 to operate alongside the add-on minimum tax. The main preference items, including capital gains, moved from the add-on tax to the new AMT. As a result, revenue from the add-on tax plummeted to $300 million in 1979. Congress subsequently repealed the add-on tax, effective in 1983. Revenue from the new AMT climbed rapidly from $870 million (about 0.4 percent of all individual income tax revenue) in its inaugural year of 1979 to $6.7 billion (2.0 percent) in 1986.

The Tax Reform Act of 1986 (TRA) changed both the regular income tax and the AMT. The TRA eliminated much tax sheltering activity and thus shifted much of the AMT base to the regular income tax system. In particular, the TRA eliminated the partial exclusion of capital gains, which had accounted for 85 percent of total AMT preferences in 1985. As a result, AMT revenue fell to $1.7 billion in 1987, back to the same 0.4 percent of aggregate individual income tax revenue that it had raised in 1979.

Unlike the regular income tax system, Congress did not index the AMT for inflation. Each year, the standard deduction, personal exemptions, and tax bracket thresholds in the regular income tax would rise to keep pace with inflation. In contrast, the AMT exemption and brackets stayed fixed. Thus, over time, as a taxpayer's income rose with inflation, AMT liability rose relative to regular income tax liability. Because taxpayers paid the larger of the two taxes, inflation pushed more people onto the AMT, and AMT revenue increased steadily after 1987.

In 2001, Congress passed the Economic Growth and Tax Relief Reconciliation Act (EGTRRA), which substantially reduced regular income taxes but provided only temporary relief from the AMT. Over the following decade, Congress repeatedly passed legislation—known as the AMT "patch"—to prevent an explosion in the number of AMT payers. Despite the annual patches, AMT revenue continued to grow, reaching $36.6 billion in 2012.

Key Elements of the U.S. Tax System

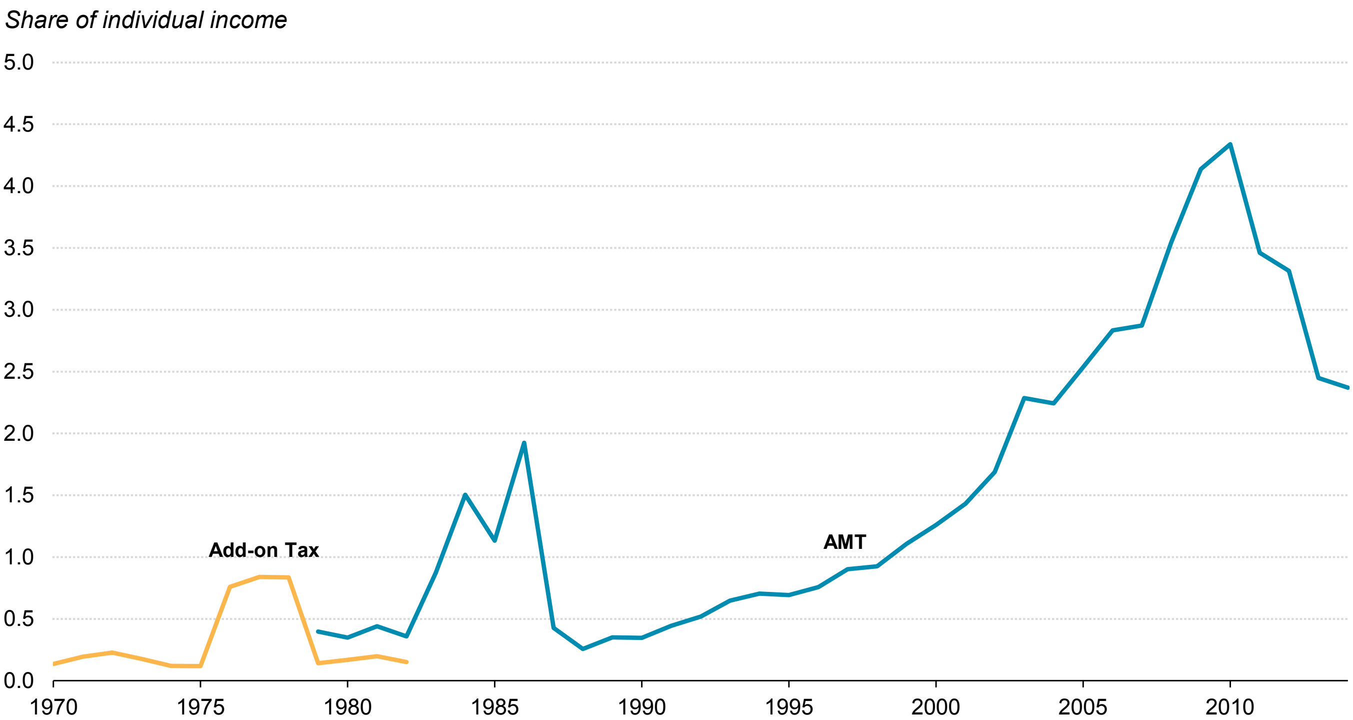
How much revenue does the AMT raise?

The American Taxpayer Relief Act of 2012 (ATRA) finally enacted a permanent AMT "fix" by establishing a higher AMT exemption, indexing the AMT parameters for inflation, and allowing certain tax credits under the AMT. Combined with the fact that ATRA raised regular income taxes on high-income taxpayers, the permanent AMT fix reduced AMT revenue to $28.4 billion in 2013.

FIGURE 1

Individual AMT Revenue as a Share of Individual Income Tax Revenue

1970-–2016



Source: Urban-Brookings Tax Policy Center Microsimulation Model (versions 0304-3, 1006-1, 0308-7, 0309-1, 0509-2, 0411-1, and 0516-1); Harvey and Tempalski (1997); private communication from Jerry Tempalski; and IRS.

PROJECTIONS

In 2017, the AMT is expected to generate $35.1 billion, or about 2.2 percent of individual income tax revenue. Despite ATRA's permanent fix to the AMT, real income growth over the coming decade will push more taxpayers into the income ranges hit by the tax. Thus, AMT revenue is projected to grow to $56.6 billion by 2026 (figure 2), even though the AMT's share of total individual income tax revenue will remain roughly constant.

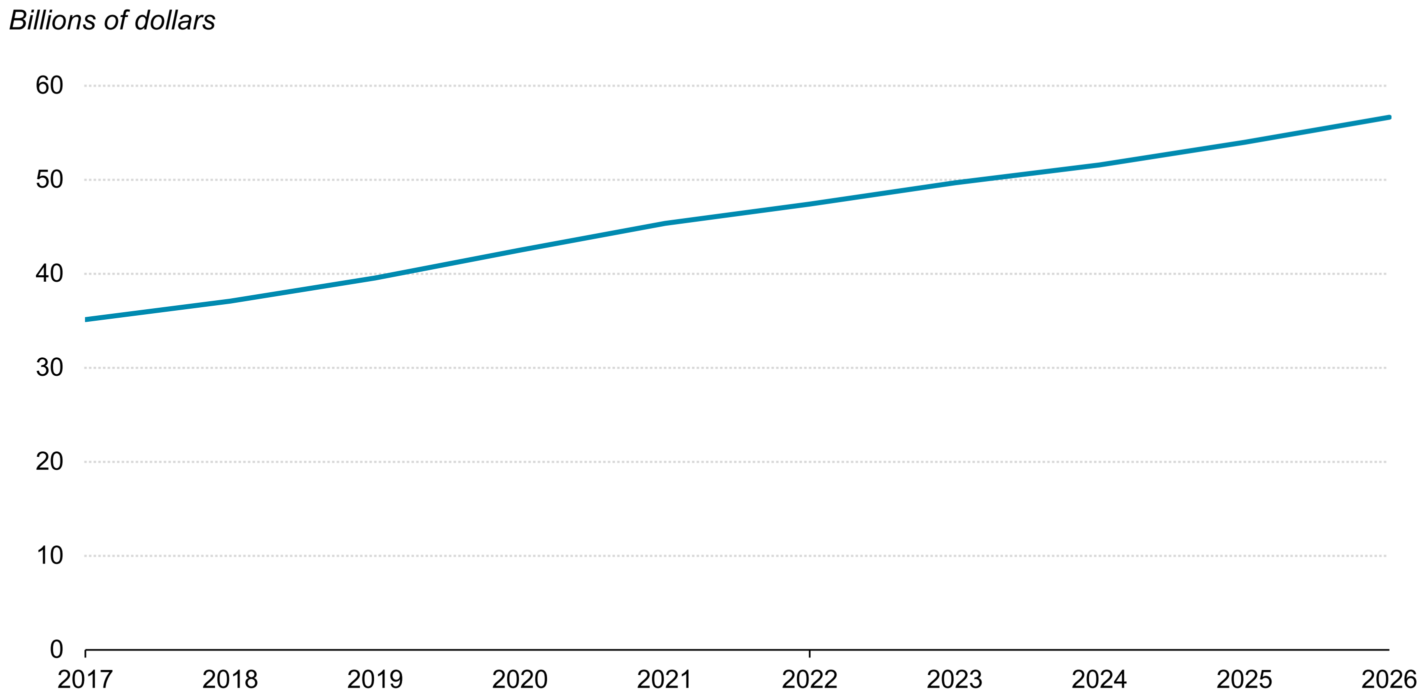
Key Elements of the U.S. Tax System

How much revenue does the AMT raise?

FIGURE 2

Projected AMT Revenue

2017–26



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).

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Did the American Taxpayer Relief Act of 2012 (ATRA) fix the AMT?

Q. Did ATRA fix the AMT?

A. The American Taxpayer Relief Act of 2012 (ATRA) prevented an explosion in the number of tax filers ensnared by the AMT. Nonetheless, some 4.8 million will pay the AMT in 2017.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) substantially cut the regular individual income tax through 2010, but provided only limited and temporary relief from the individual alternative minimum tax (AMT) through 2004. The lack of a permanent solution required Congress to revisit the AMT every year or two and pass a short-term fix or "patch" to prevent the tax from ensnaring tens of millions of households. The patches typically limited the AMT's reach by raising the exemption level and allowing certain personal credits to be used under the AMT.

The American Taxpayer Relief Act of 2012 (ATRA) made permanent most of the tax cuts enacted over the previous decade and finally created a permanent AMT fix. In addition to raising the AMT exemption, ATRA indexed the AMT parameters for inflation and permanently allowed certain tax credits—such as the child tax credit and credits for postsecondary education expenses—to be used under the AMT. The Joint Committee on Taxation estimated the 10-year cost of the AMT relief in ATRA at more than $1.8 trillion.

Under ATRA, the number of taxpayers affected by the AMT is expected to increase from 4.8 million in 2017 to 5.6 million by 2026 (figure 1). If ATRA had not included an AMT fix, 46.6 million taxpayers would have faced the AMT in 2017. That number would have increased to 79.1 million by 2026.

Under ATRA, AMT revenue is projected to increase from $35.1 billion in 2017 to $56.6 billion in 2026 (figure 2). Without the ATRA fix, the tax would have generated $215.4 billion in 2017, increasing to $475.1 billion by 2026.

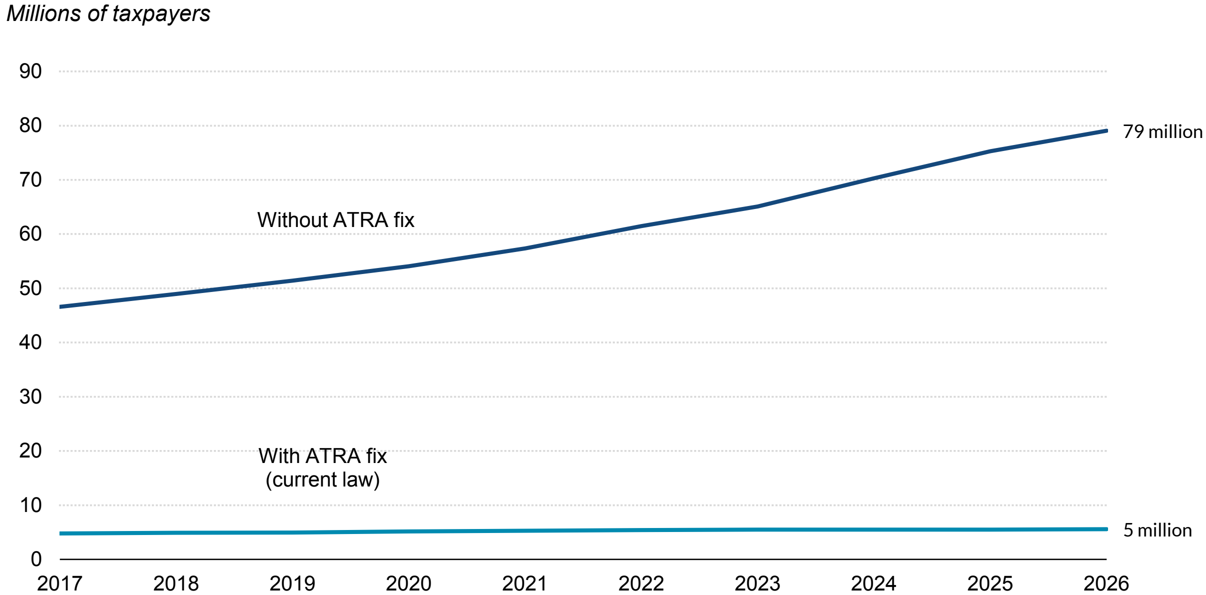
Although ATRA prevented an AMT explosion, it did not completely eliminate the problems associated with the tax. The original purpose of the minimum tax, the precursor to today's AMT, was to prevent high-income households from sheltering significant amounts of income and to ensure that those households paid at least some income tax. The current version of the AMT strays from that original goal.

Most taxpayers find themselves on the AMT not because they engage in egregious tax sheltering but because they are married, have large families, or live in high-tax states. Data from the Treasury Department show that in 2012, the largest differences between taxable income under the regular income tax and under the AMT result from the AMT's disallowance of the state and local tax deduction (62 percent of difference) and personal exemptions (21 percent) (figure 3). Allowing those items under the AMT would reduce the number of taxpayers affected by the tax in 2017 from 4.8 million to 525,000.

Key Elements of the U.S. Tax System

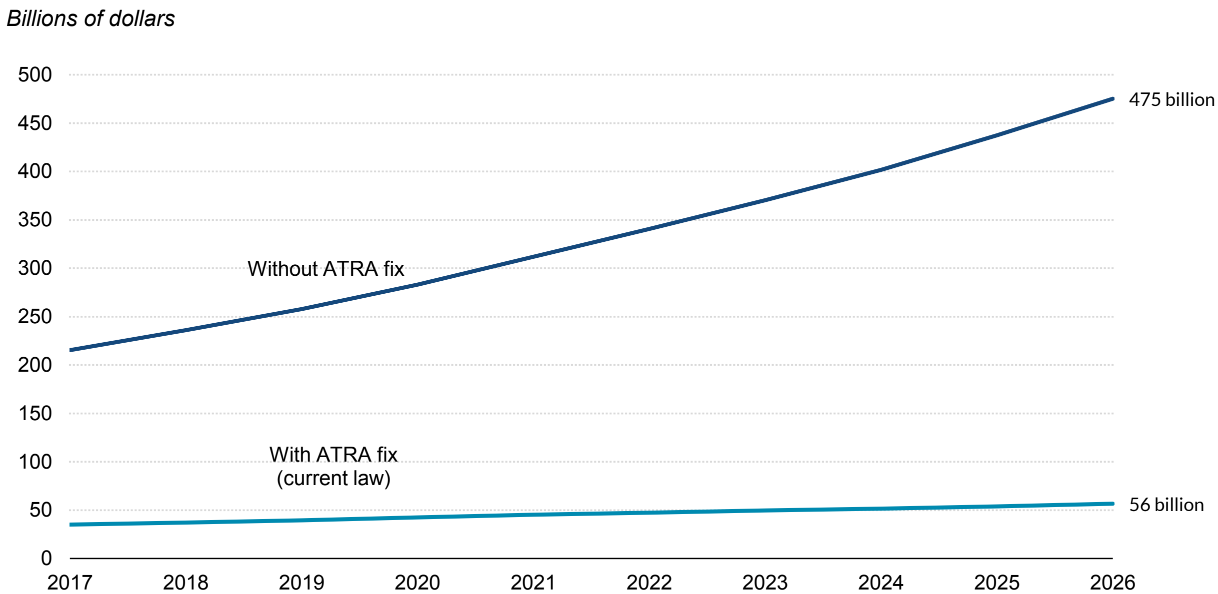
Did the American Taxpayer Relief Act of 2012 (ATRA) fix the AMT?

FIGURE 1
Effect of ATRA Fix on Number of AMT Payers
2017-26



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).
Notes: AMT payers include those with direct AMT liability on Form 6251 as well as those with lost credits and/or reduced deductions.

FIGURE 2
Effect of ATRA Fix on AMT Revenue
2017-26

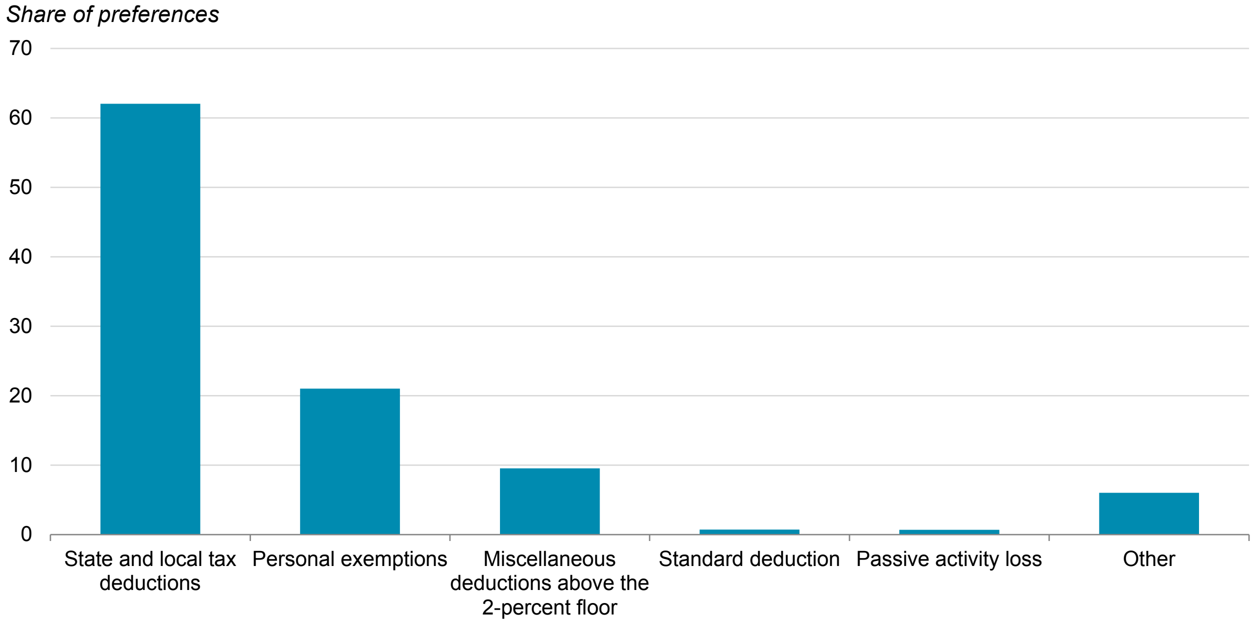


Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).
Notes: AMT payers include those with direct AMT liability on Form 6251 as well as those with lost credits and/or reduced deductions.

Key Elements of the U.S. Tax System

Did the American Taxpayer Relief Act of 2012 (ATRA) fix the AMT?

FIGURE 3
AMT Preference Items as a Share of Total Positive Preferences
2012



Source: Office of Tax Analysis, Department of the Treasury (unpublished tabulations).
Notes: Regular tax net operating losses (NOLs) represent 3.0 percent of positive preferences but are partially offset by AMT NOLs, which are a negative preference.

A true AMT "fix" would likely involve either retargeting the tax to hit aggressive tax sheltering or broadening the base of the regular income tax to eliminate the need for an alternative tax in the first place.

Data Sources

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Q. Should the AMT replace the regular income tax?

A. The notion that taxpayers should not have to calculate their tax liability twice—once for the regular tax and again for the alternative minimum tax (AMT)—has merit. It is less clear that making the AMT the only income tax in town would improve the tax system's efficiency, simplicity, or fairness.

TWO RATES OR FOUR?

The regular income tax has seven statutory tax rates ranging from 10 percent to 39.6 percent. The AMT has only two: 26 percent and 28 percent. But the AMT is not as flat as it seems. It actually imposes four marginal tax rates, not two, because the AMT exemption phases out as income rises (figure 1).

The AMT exemption falls by 25 cents for each dollar by which alternative minimum taxable income exceeds a threshold ($160,900 for married couples and $120,700 for singles in 2017; those amounts are indexed annually for inflation). Thus, over the income range where the exemption phases out, taxpayers actually face a marginal rate 25 percent higher than the statutory rate. This increase applies not only to an additional dollar of ordinary income, but also to any increase in long-term capital gains or qualified dividends. So although the AMT is advertised as preserving the preferential rates on gains and dividends, over certain income ranges it actually taxes those income sources more heavily than the regular income tax.

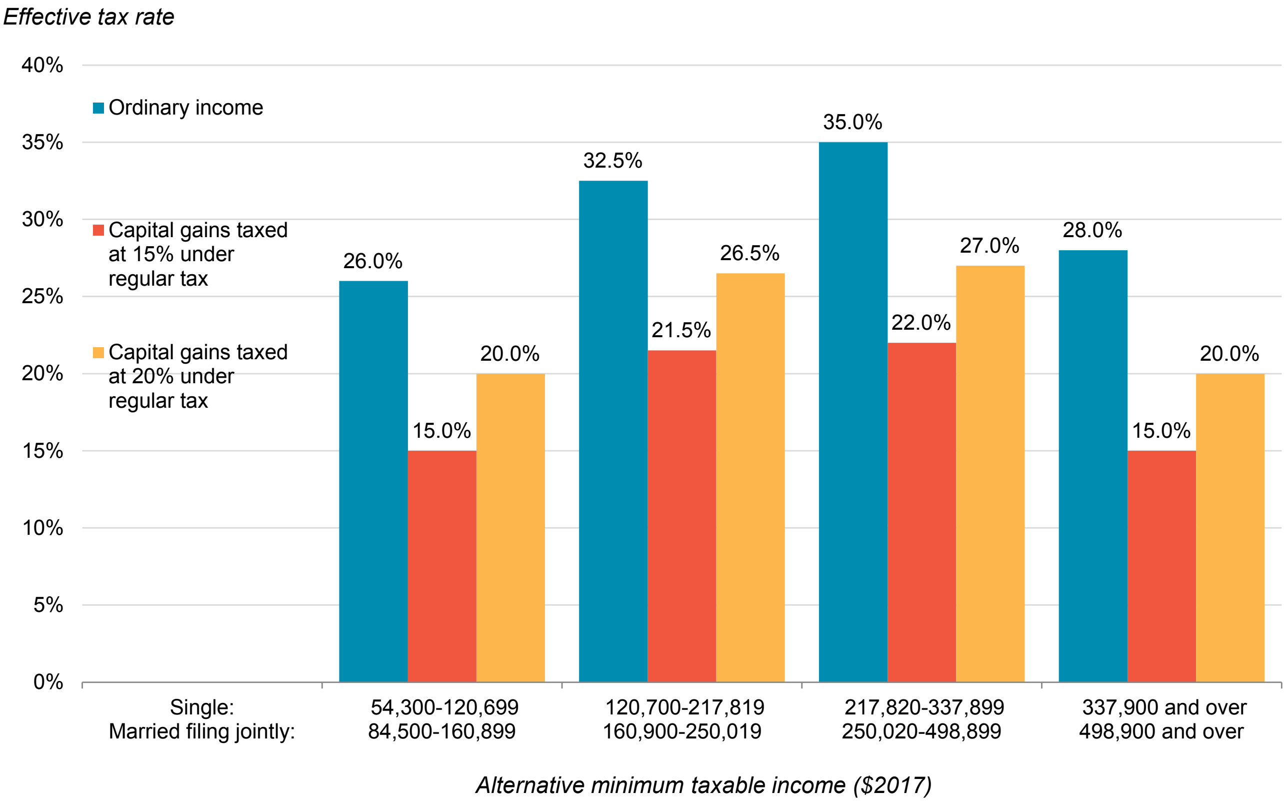
Key Elements of the U.S. Tax System

Should the AMT replace the regular income tax?

FIGURE 1

Effective AMT Rates on Ordinary Income and Capital Gains

2017



Sources: Internal Revenue Code and author's calculations.
Notes: Under the regular income tax, the maximum tax rate is 20 percent on any amount of adjusted net capital gain that otherwise would be taxed at a 39.6 percent rate. Any gain otherwise taxed at a 10- or 15-percent rate is taxed at a zero-percent rate. Gains otherwise taxed at rates greater than 15-percent but less than 39.6 percent are taxed at a 15-percent rate. All rates in this analysis exclude the potential effects of the 3.8 percent surtax on net investment income.

LOWER RATES ON A BROADER BASE?

The notion that the AMT taxes a broader income base at a lower rate than the regular income tax is not true for most AMT payers. In 2017, about 79 percent of households on the AMT actually face a higher effective marginal tax rate than they would if they were on the regular income tax (table 1).

In addition, the AMT provides a large exemption of $84,500 for married couples and $54,300 for singles in 2017; those amounts are indexed annually for inflation. This means that the amount of income taxed under the AMT is often less than under the regular income tax. In 2017, about 69 percent of taxpayers affected by the AMT would have had more income subject to tax under the rules of the regular system than under the AMT.

Key Elements of the U.S. Tax System

Should the AMT replace the regular income tax?

TABLE 1

Income Subject to Tax and Effective Marginal Tax Rates Under the Regular Income Tax and AMT

By share of AMT taxpayers, 2017[a]

Expanded cash income (thousands of 2016$)[b]	Percent with More Income Subject to Tax Under: [c]		Percent with a Higher Marginal Tax Rate Under: [d]	
	Regular Tax	AMT	Regular Tax	AMT
Less than 75	n/a	n/a	n/a	n/a
75-100	93.6	6.4	1.8	97.3
100-200	90.5	9.5	1.2	95.6
200-500	79.1	20.9	11.8	87.3
500-1,000	15.6	84.4	59.6	40.0
More than 1,000	11.7	88.3	67.8	28.7
All	**68.8**	**31.3**	**19.4**	**79.3**

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).

Notes: n/a = not applicable (insufficient number of AMT taxpayers in this income range.

(a) Calendar year. AMT taxpayers include those with AMT liability from Form 6251, with lost credits, and with reduced deductions.

(b) Tax units with negative adjusted gross income are excluded from their respective income class but are included in the totals. Includes both filing and non-filing units but excludes those that are dependents of other taxpayers. For a description of expanded cash income, see http://www.taxpolicycenter.org/TaxModel/income.cfm.

(c) Income subject to tax for the regular income tax is taxable income; for the AMT it is AMTI net of the AMT exemption.

(d) The marginal tax rate for each return is calculated by adding $1,000 to wages, recomputing income tax net of refundable credits, and dividing the resulting change in tax liability by 1,000.

SIMPLER AND FAIRER?

Making the AMT the only income tax would certainly reduce the hassle involved in calculating taxes twice. But the AMT as a stand-alone tax would still retain much of the complexity of the current regular tax system, particularly with respect to the definition and treatment of business and capital income.

In addition, the AMT imposes significant marriage penalties. Under the regular tax the standard deduction for married couples is twice that for singles, and the 10- and 15-percent tax brackets for married couples are twice as wide as those for singles. In contrast, AMT tax brackets are identical for married and single taxpayers, and the AMT exemption for married couples is only about one and a half times as large as the exemption for singles.

The regular income tax allows a personal exemption of $4,050 (in 2017, indexed for inflation) for each family member. The AMT exemption varies by filing status, but does not increase with family size. As a result, compared with the regular income tax, the AMT places a higher burden on large families.

Finally, because the tax rate on the highest incomes under the AMT is only 28 percent—significantly less than the regular tax's top statutory rate of 39.6 percent—the AMT places a lighter burden on those with the greatest ability to pay.

Key Elements of the U.S. Tax System

Should the AMT replace the regular income tax?

Data Sources

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Q. How might we improve the AMT?

A. Congress could retarget the AMT to its original purpose or enact a major overhaul of the income tax system, eliminating the need for an alternative tax.

REFORM OPTIONS

The Family Fix

The regular income tax allows a personal exemption of $4,050 (in 2017, indexed for inflation) for each family member. The individual alternative minimum tax (AMT) exemption varies by filing status but does not increase with family size. One possible reform option, a "family fix," would allow dependent exemptions under the AMT. To mitigate marriage penalties, the proposal would also set the AMT exemption, 28 percent bracket threshold, and exemption phase-out threshold for married couples at twice the value for singles. This option would cost $172.7 billion over 10 years (figure 1) and would reduce the number of AMT taxpayers by more than 3.5 million (figure 2).

The Deduction Fix

Another option, a "deduction fix," would allow state and local taxes, miscellaneous expenses above the 2 percent of adjusted gross income floor, and the standard deduction to be allowable under the AMT. This reform option would cost $352.6 billion over 10 years and would reduce the number of AMT taxpayers to about 400,000.

Taxing Capital Gains

Under current law, capital gains and qualified dividends generally receive the same preferential treatment under the AMT and the regular income tax. A third option would tax capital gains and qualified dividends at the same rate as ordinary income under the AMT. This option would generate $268 billion over 10 years and would increase the number of AMT taxpayers by about 1 million annually.

A major AMT overhaul combining all three of the above options would cost $229.5 billion over 10 years, and would decrease the number of AMT taxpayers to about 500,000.

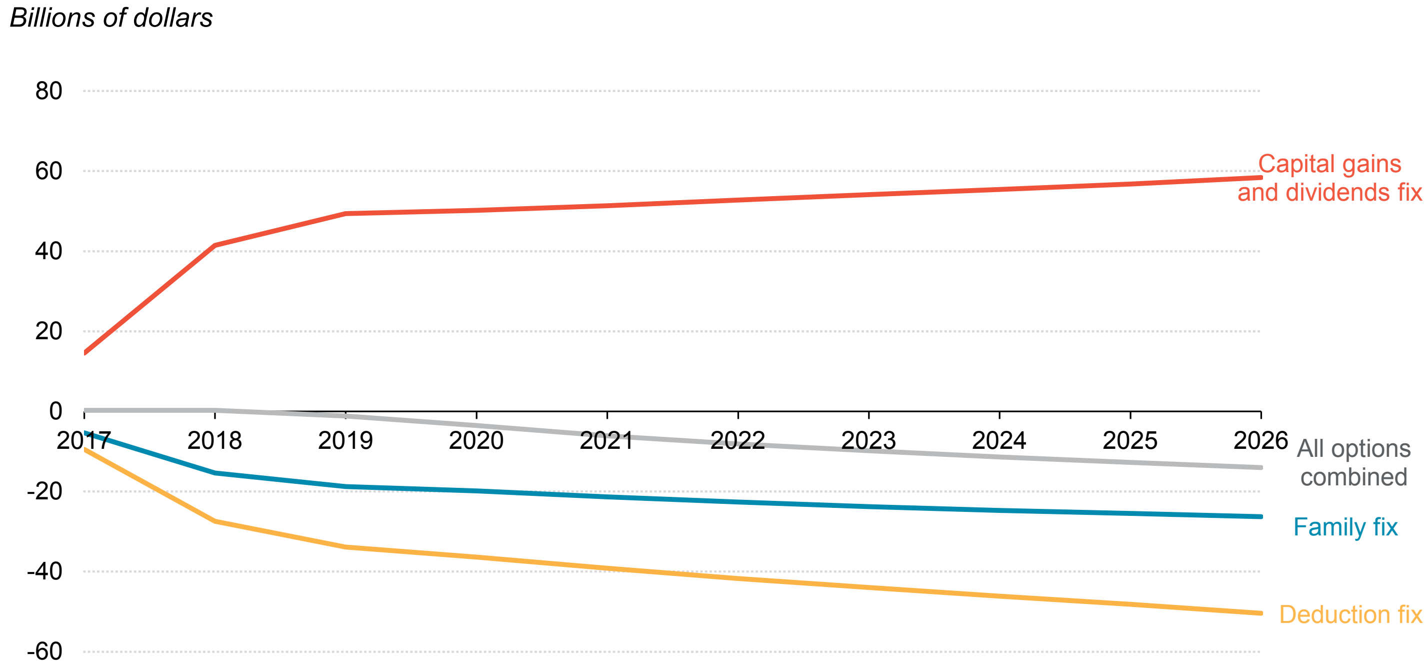
Key Elements of the U.S. Tax System

How might we improve the AMT?

FIGURE 1

Impact of Reform Options on Tax Revenue

FY2017-26



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).
Notes: Baseline is current law. Proposals are effective 01/01/2016. Estimates include a microdynamic behavioral response. Estimates assume a 40-60 fiscal split, i.e. fiscal year revenue is estimated to be 60 percent of revenue from the previous calendar year plus 40 percent of revenue from the current calendar year.

Overhaul

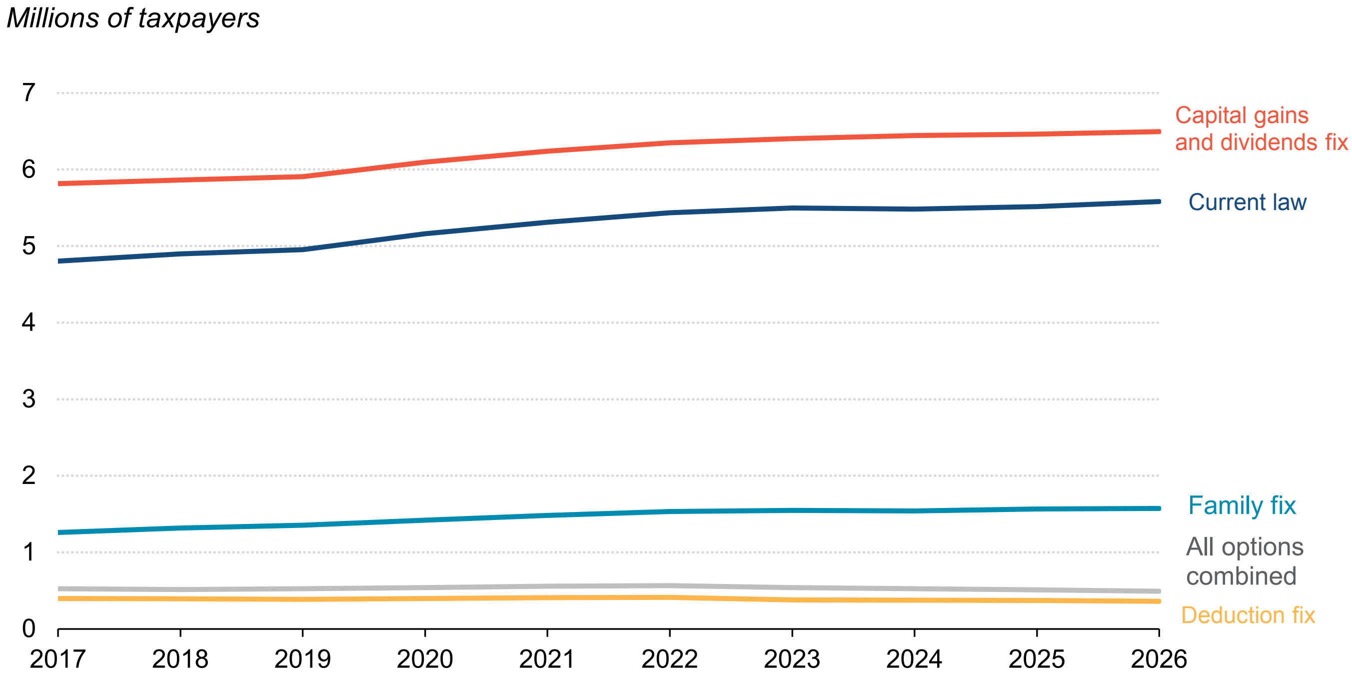
An alternative to this sort of incremental reform would be to combine the AMT's repeal with a major reform of the individual income tax that would prevent the sheltering behavior that the minimum tax was originally designed to prevent. Stand-alone repeal of the AMT would cost $388.9 billion over the next 10 years.

Key Elements of the U.S. Tax System

How might we improve the AMT?

FIGURE 2

Impact of Reform Options on Number of AMT Payers
2017-26



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).
Note: AMT payers include those with direct AMT liability on Form 6251, lost credits, and reduced deductions.

Data Sources

Urban-Brookings Tax Policy Center. "Microsimulation Model, version 0516-1."

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Key Elements of the U.S. Tax System

Q. What is the personal exemption?

A. Personal exemptions for both taxpayers and dependents provide that only a person's income above some defined basic level is subject to tax. This helps ensure that the poorest households are not subject to the income tax. In 2017, the personal exemption is $4,050.

In 2014, tax filers reported $9.7 trillion in adjusted gross income (AGI) and claimed $1.1 trillion in personal exemptions (although, as explained below, not all exemptions could be fully utilized to reduce tax liability).

In 1913, the personal exemption was set at $3,000 (worth more than $70,000 in today's dollars), so that very few persons were expected to pay tax. The 2017 personal exemption, at $4,050, is substantially lower both in real terms and relative to average incomes. But the tax code has added other features since 1913, such as the standard deduction and various tax credits that have partly offset the exemption's decline in value.

The value of the personal exemption depends on an individual's marginal tax rate. Think of it as a first tax bracket at a zero rate. For instance, a single taxpayer who would otherwise owe 15 percent on his or her first $4,000 of income saves $600, whereas a single taxpayer in a 35 percent bracket saves $1,400. Thus, under a progressive income tax, exemptions are worth more to high-income filers than to low-income filers. The rate structure itself can, however, be adjusted to compensate for that effect and achieve any desired degree of progressivity.

The personal exemption also links tax liability to household size. For instance, it implies that a household of four with $116,200 of taxable income (before subtracting personal exemptions) and a household of two with $108,100 of taxable income (before subtracting personal exemptions) are deemed to have the same ability to pay tax—in this case on $100,000.

Since 1990, the personal exemption has been phased out at higher income levels. In 2017, the phaseout begins for single filers at $261,500 and married filing jointly taxpayers at $313,800. It phases out completely at $384,000 for single filers and $436,300 for married filing jointly taxpayers. Under the American Taxpayer Relief Act of 2012, the thresholds are indexed for inflation.

The alternative minimum tax (AMT) denies taxpayers the use of personal exemptions. This feature is the second-largest source of tax increase in the AMT. As a result, larger families are more likely to owe AMT than smaller families.

Key Elements of the U.S. Tax System

What is the personal exemption?

Data Sources

Internal Revenue Service. 2016. Statistics of Income—Individual Income Tax Returns Publication 1304 (Complete Report). Washington, DC: Internal Revenue Service.

Further Reading

Carasso, Adam, and C. Eugene Steuerle. 2003. "Personal Exemption Not What It Used to Be." *Tax Notes*, April 28.

Q. Has the personal exemption kept up with prices and incomes?

A. Both the relative and the real value of the personal exemption have fallen since its creation in 1913, although other tax credits have helped offset its reduction. The personal exemption is now indexed to inflation.

As the federal government expanded in the postwar era, individual income taxes rose, and the personal exemption, which was fixed in nominal dollars, failed to keep pace with changes in personal income. Lawmakers increased it only occasionally before finally indexing it to increases in prices, beginning in 1981.

The personal exemption in 1948 was $600. Had it been indexed to prices beginning in 1948, its value in 2015 would have been $5,900 rather than the actual $4,000 (figure 1). Setting the exemption at that higher level would, however, reduce revenues by about $60 billion.

Had the personal exemption been indexed to personal income per capita since 1948, it would have been $19,800 in 2015, almost five times what it actually is, and annual revenues would fall more than $298 billion below current levels.

Congress has partially offset the erosion of the personal exemption with other changes to the tax code. Most importantly, it created the child tax credit and the earned income tax credit, both of which have helped to hold down taxes for larger, low- and middle-income households that are most affected by the falling real value of the exemption.

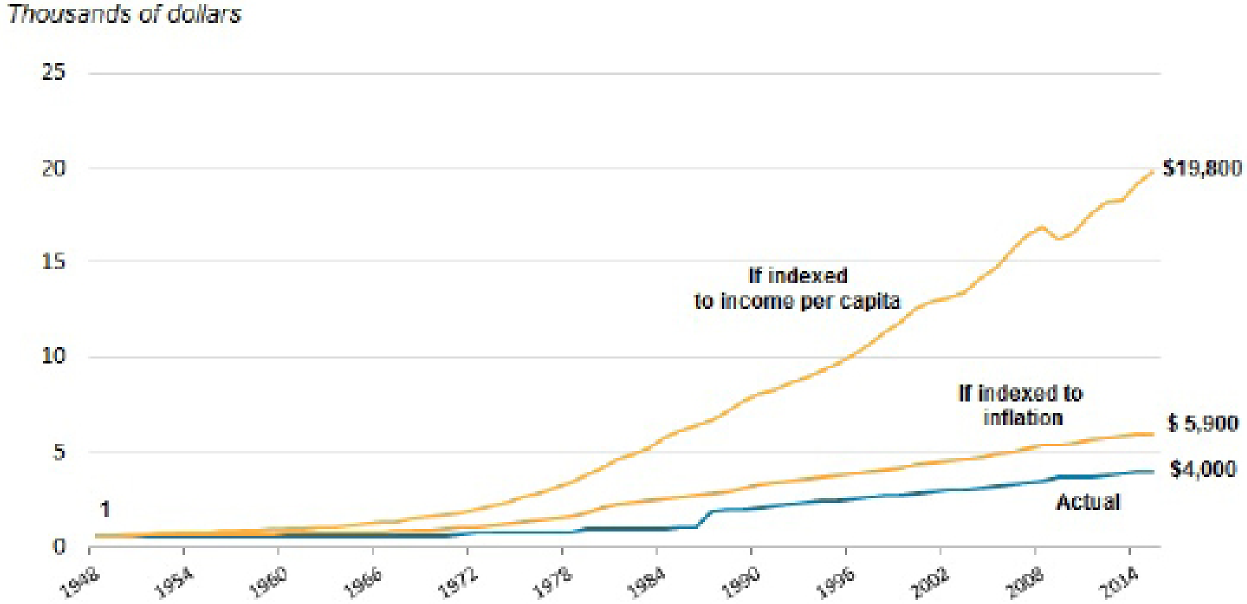
Key Elements of the U.S. Tax System

Has the personal exemption kept up with prices and income?

FIGURE 1

Growth of the Personal Exemption

Actual and with indexing, 1948-2015



Source: Urban-Brookings Tax Policy Center; Internal Revenue Service; Bureau of Economic Analysis, National Income and Product Accounts, table 2.1.

Key Elements of the U.S. Tax System

Has the personal exemption kept up with prices and income?

TABLE 1

Distribution of Federal Tax Change by Expanded Cash Income Percentile, 2015[1]

Percentages and 2015 Dollars

Expanded Cash Income Percentile[3,4]	Increase Personal Exemption to $5,900[1]			Increase Personal Exemption to $19,800[2]		
	Percent of Tax Units with Tax Cut[5]	Average Federal Tax Change ($)	Percentage Point Change in Average Federal Tax Rate[6]	Percent of Tax Units with Tax Cut[5]	Average Federal Tax Change ($)	Percentage Point Change in Average Federal Tax Rate[6]
Lowest Quintile	13.9	(20)	(0.2)	14.0	(60)	(0.5)
Second Quintile	57.7	(170)	(0.5)	57.8	(760)	(2.2)
Middle Quintile	86.6	(430)	(0.7)	86.7	(2,120)	(3.5)
Fourth Quintile	97.1	(750)	(0.7)	97.2	(4,310)	(4.1)
Top Quintile	75.8	(910)	(0.3)	76.6	(3,800)	(1.2)
All	53.7	(380)	(0.5)	53.9	(1,830)	(2.2)
Addendum						
80-90	95.9	(1,160)	(0.7)	96.2	(5,380)	(3.2)
90-95	83.9	(1,050)	(0.4)	85.4	(3,540)	(1.5)
95-99	29.7	(280)	(0.1)	31.0	(820)	(0.2)
Top 1 Percent	0.5	-	-	0.6	(10)	-
Top 0.1 Percent	0.2	-	-	0.2	(20)	-

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-2).

(1) Calendar year. Proposal would increase the personal exemption amount to $5,900.
(2) Calendar year. Proposal would increase the personal exemption amount to $19,800.
(3) Includes both filing and non-filing units but excludes those that are dependents of other tax units. Tax units with negative adjusted gross income are excluded from their respective income class but are included in the totals. For a description of expanded cash income, see http://www.taxpolicycenter.org/resources/income-measure-used-distributional-analyses-tax-policy-center.
(4) The income percentile classes used in this table are based on the income distribution for the entire population and contain an equal number of people, not tax units. The breaks are (in 2016 dollars): 20% $23,800; 40% $46,800; 60% $81,000; 80% $140,900; 90% $204,900; 95% $291,000; 99% $688,900; 99.9% $3,408,600.
(5) Includes tax units with a change in federal tax burden of $10 or more in absolute value.
(6) Average federal tax (includes individual and corporate income tax, payroll taxes for Social Security and Medicare, the estate tax, and excise taxes) as a percentage of average expanded cash income.

Data Sources

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Key Elements of the U.S. Tax System

Q. What is the child tax credit?

A. The child tax credit (CTC) provides a credit of up to $1,000 per child under age 17. If the CTC exceeds taxes owed, families may receive some or all of the credit as a re-fund, known as the additional child tax credit (ACTC) or refundable CTC.

HOW THE CTC WORKS TODAY

Taxpayers can claim a tax credit of up to $1,000 for each child under age 17. The credit is reduced by 5 percent of adjusted gross income over $75,000 for single parents ($110,000 for married couples). If the credit exceeds taxes owed, taxpayers can receive some or all of the balance as a refund, known as the additional child tax credit (ACTC) or refundable CTC. The ACTC is limited to 15 percent of earnings above $3,000.

FIGURE 1
Child Tax Credit for One Child

Source: Tax Policy Center.
Note: Assumes all income comes from earning and child is under 17 and meets all tests to be a CTC qualfiying child.

Key Elements of the U.S. Tax System

What is the child tax credit (CTC)?

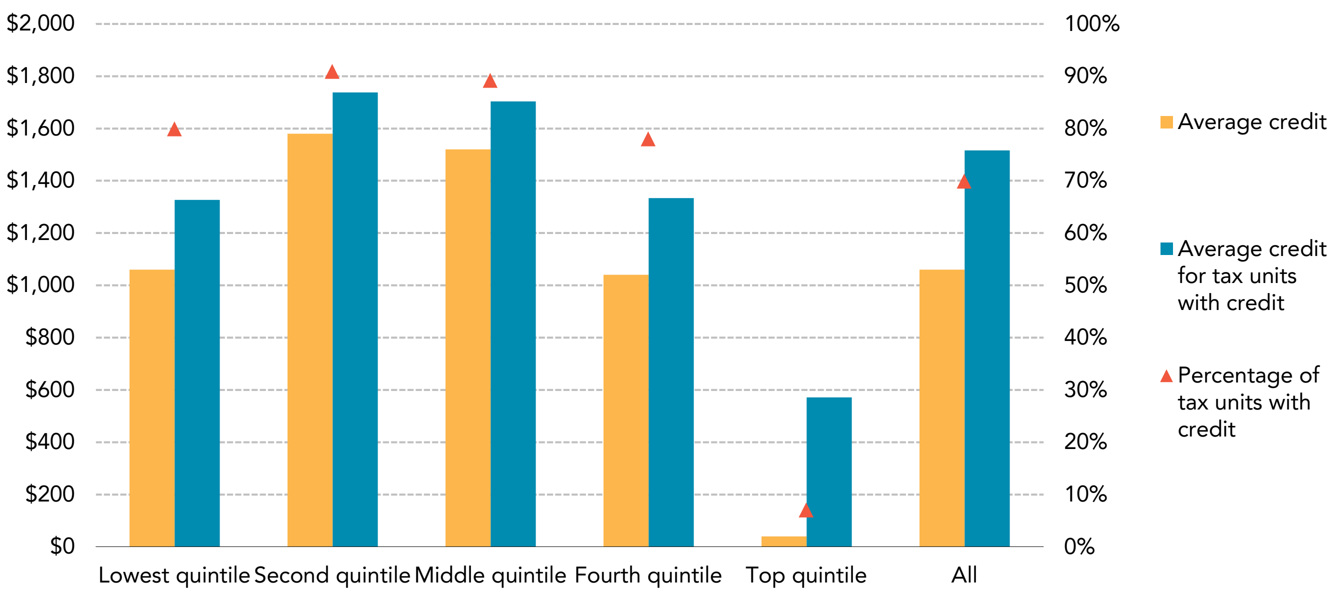
IMPACT OF THE CTC

Families in all income groups benefit from the CTC. However, the percentage of families receiving the credit and the average credit received is higher among moderate- and middle-income families. In 2016, 70 percent of families with children will receive an average CTC of $1,060. About 90 percent of families with children in the second and third income quintiles receive CTC benefits (each quintile contains 20 percent of the population ranked by household income). The proportion of families with children receiving a credit drops to 80 percent in the fourth quintile, while only 7 percent of families with children in the highest income quintile receive the credit (figure 2).

FIGURE 2

Distribution of and Percentage of Tax Units with Children and Child Tax Credit

2016



Source: Urban-Brookings Tax Policy Center Microsimulation Model, (version 0516-1).

If the CTC (including the refundable portion) were counted in the official estimate of poverty, 2.8 million fewer people would fall below the poverty threshold in 2015, including about 1.6 million children. Counting the credit would have also reduced the severity of poverty for an additional 13.3 million people, including 6.6 million children (Center on Budget and Policy Priorities 2016).

What is the child tax credit (CTC)?

RECENT HISTORY OF THE CREDIT

The American Taxpayer Relief Act of 2012 (ATRA) permanently increased the CTC from $500 per child, its pre-2001 level, to $1,000 per child. It also temporarily extended the provisions of the American Recovery and Reinvestment Act of 2009 (the anti-recession stimulus package) that reduced the earnings threshold for the refundable CTC from $10,000 (adjusted for inflation starting after 2002) to $3,000 (not adjusted for inflation). The Bipartisan Budget Act of 2015 made the $3,000 refundability threshold permanent.

The refundable CTC was originally designed in 2001 to coordinate with the earned income tax credit (EITC). Once earnings reached $10,020 for families with two children in 2001, there was no further increase in the EITC. The earnings threshold for the refundable CTC was set at $10,000 so families could now receive a subsidy for earnings in excess of that amount. Like the earned income amount for the EITC, the $10,000 earnings threshold was indexed for inflation. When the earnings threshold for the refundable CTC was reduced—first to $8,500 in 2008 and then to $3,000 in 2009—that link between the phase in of the refundable CTC and the EITC was broken.

Data Sources

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Q. What is the adoption tax credit?

A. The tax code provides an adoption credit of up to $13,570 of qualified expenses (in 2017) for each child adopted, whether via public foster care, domestic private adoption, or international adoption. The tax expenditure on the credit in 2015 totaled approximately $300 million.

CREDIT AMOUNT

Taxpayers can receive a tax credit for all qualifying adoption expenses up to $13,570 in 2017. The maximum credit is indexed for inflation. Taxpayers may also exclude from income qualified adoption expenses that are paid or reimbursed by an employer, up to the same limit as the credit. Taxpayers can use the tax credit and the income exclusion but cannot claim the same expenses for both.

"Special needs" adoptions automatically qualify for the maximum credit regardless of actual out-of-pocket expenses. For purposes of the credit, a child has special needs if a state's welfare agency determines that the child cannot or should not be returned to his or her parents' home and that the child probably will not be adoptable without assistance provided to the adoptive family. This provision is designed to encourage parents to adopt children who would otherwise be hard to place, even if most of the adoption expenses are covered by someone else (such as a public foster care program).

ELIGIBILITY

The adoption credit is available to most adoptive parents, with some exceptions. The credit is not available to taxpayers whose income exceeds certain thresholds. The thresholds are indexed for inflation. In 2017 the credit begins to phase out at $203,540 of modified adjusted gross income and phases out entirely at income of $243,540. The credit also is not available for adoptions of stepchildren.

REFUNDABILITY

The adoption tax credit is nonrefundable but can be carried forward for up to five years. The credit is thus of little or no value to low-income families who pay little or no income tax over a period of years. The Patient Protection and Affordable Care Act of 2010 made the adoption tax credit refundable for 2010 and 2011. Concerned about the potential for fraud, the Internal Revenue Service (IRS) stepped up compliance efforts. The result, according to the National Taxpayer Advocate, was substantial delays for taxpayers, with 69 percent of all adoption credit claims filed in 2012 selected for audit. The IRS ultimately disallowed only 1.5 percent of claims, and 20 percent of those savings were spent on interest owed to taxpayers with delayed refunds. The credit reverted to nonrefundability in 2012.

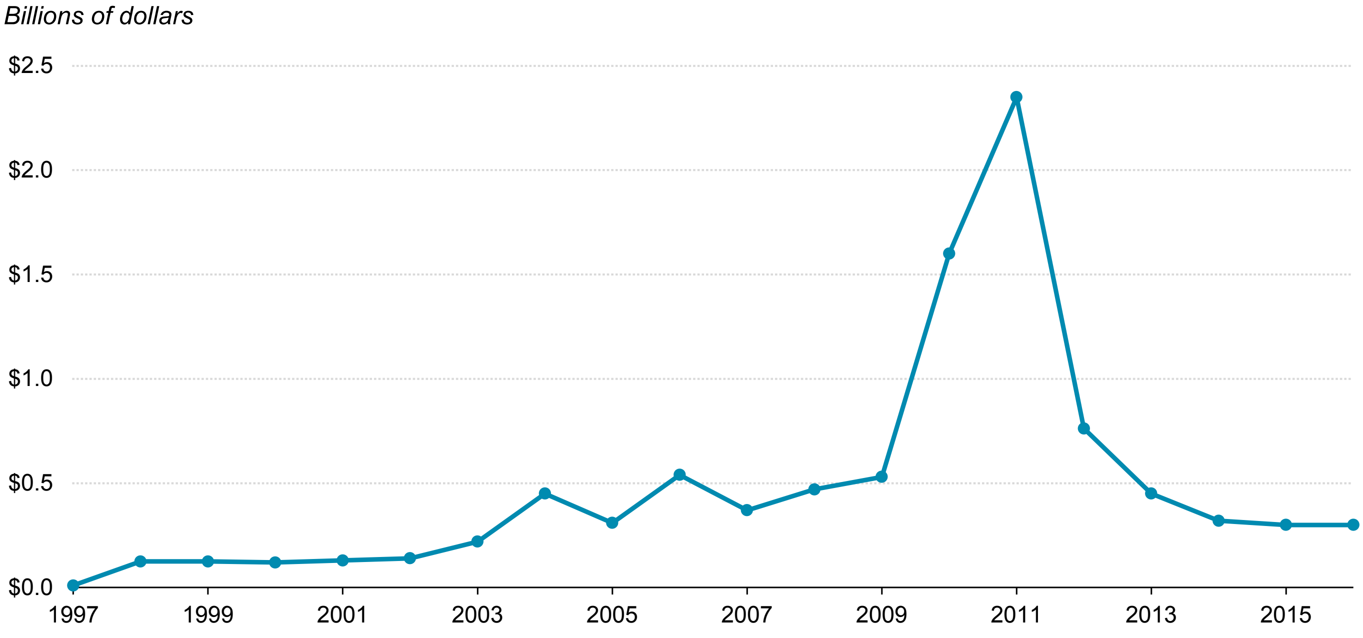
Key Elements of the U.S. Tax System

What is the adoption tax credit?

FIGURE 1

Tax Expenditures for Adoption

Fiscal years 1997–2016



Source: Treasury Tax Expenditure Budget, various years.
Notes: Includes outlay (refundable) portion in years 2010-12. Tax Expenditure estimate includes the value of tax-free employer adoption programs, which are likely 1-2 percent of the total.

TAX EXPENDITURE

The credit has been repeatedly expanded, from an initial maximum value of $5,000 in 1997 to $13,570 in 2017. In fiscal year 2015, credit claims reduced tax liability by $300 million, according to the US Department of Treasury (figure 1). The temporary availability of a refundable credit pushed the tax expenditure up to the dramatically higher figures of $1.6 billion in 2010 and $2.35 billion in 2011 (including the refundable portion).

WHO GETS IT

The distribution of the credit across income groups ranges from small amounts for low- and moderate-income households (because of their minimal tax liability and the credit's non-refundability) and the highest-income households (because of the income cap) to substantial amounts to those with upper-middle incomes. For example, in 2014, the credit for those with incomes between $50,000 and $75,000 (almost 30 percent of claimants) averaged $2,529 per adoption, while the average credit for households with incomes between $100,000 and $200,000 (about 36 percent of claimants) was $8,015 per adoption (table 1).

The most recent year with data available by adoption type (2004) indicates that nearly half of adoptions for which the credit was claimed were for domestic children without special needs, with only 18 percent classified as special needs and the remainder reflecting international adoptions.

Key Elements of the U.S. Tax System

What is the adoption tax credit?

TABLE 1
Distribution of Adoption Tax Credit
By total income, 2014

Total income (dollars)	Number of returns with adoption expenses	Total tax benefit (thousands of dollars)	Mean credit (dollars)
Less than 30,000	1,011	718	710
30,000 – under 50,000	10,098	12,327	1,221
50,000 – under 75,000	22,099	55,883	2,529
75,000 – under 100,000	12,973	65,591	5,056
100,000 – under 200,000	26,391	211,520	8,015
200,000 and over	1,379	9,073	6,579
All	73,951	355,110	4,802

Source: IRS, Statistics of Income Division. SOI Tax Stats—Individual Income Tax Returns Publication 1304 (Complete Report). Table 3.3

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Q. What is the earned income tax credit?

A. The earned income tax credit subsidizes low-income working families. The credit equals a fixed percentage of earnings from the first dollar of earnings until the credit reaches its maximum. The maximum credit is paid until earnings reach a specified level, after which it declines with each additional dollar of income until no credit is available.

HOW THE EITC WORKS

The earned income tax credit (EITC) provides substantial support to low- and moderate-income working parents, but very little support to workers without qualifying children (often called childless workers). Workers receive a credit equal to a percentage of their earnings up to a maximum credit. Both the credit rate and maximum credit vary by family size, with larger credits available to families with more children. After the credit reaches its maximum, it remains flat until earnings reach the phaseout point. Thereafter, it declines with each additional dollar of income until no credit is available (figure 1).

By design, the credit only benefits working families. Families with children receive a much larger credit than workers without qualifying children.[1] In 2017, the maximum credit for families with one child is $3,400, while the maximum credit for families with three or more children is $6,318.

In contrast to the substantial credit for workers with children, childless workers can receive a maximum credit of only $510. Moreover, the credit for childless workers phases out at much lower incomes. Also, childless workers must be at least 25 and not older than 64 to qualify for a subsidy—restrictions that do not apply to workers with children. As a result of these tighter rules, 97 percent of benefits from the credit go to families with children.

IMPACT OF THE EITC

Research shows that the EITC encourages single people and primary earners in married couples to work (Dickert, Houser, and Sholz 1995; Eissa and Liebman 1996; Meyer and Rosenbaum 2000, 2001). The credit, however, appears to have little effect on the number of hours they work once employed. Although the EITC phaseout could cause people to reduce their hours (because credits are lost for each additional dollar of eanings, which is effectively a surtax on earnings in the phaseout range), there is little empirical evidence of this happening (Meyer 2002).

Key Elements of the U.S. Tax System

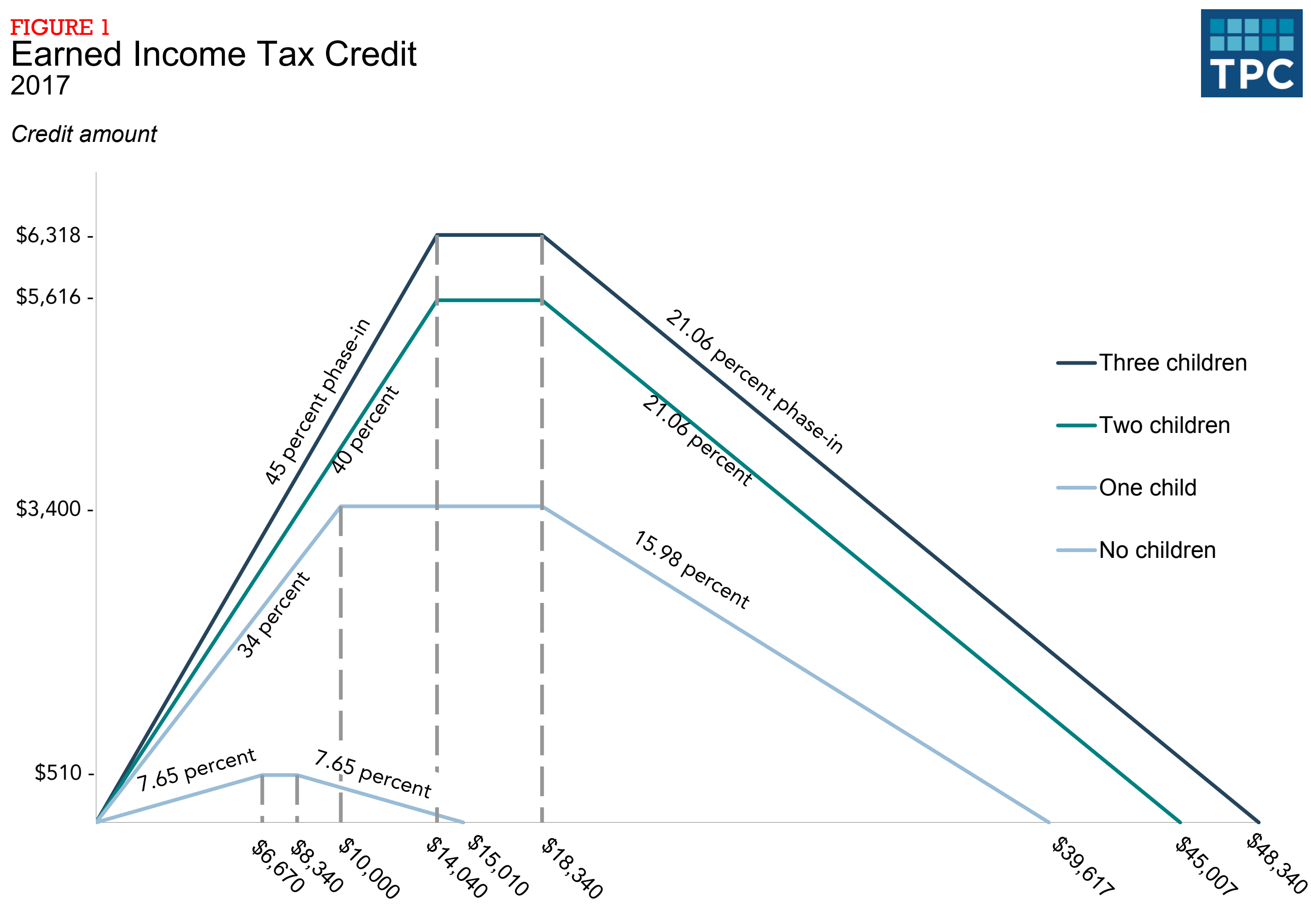
What is the earned income tax credit (EITC)?

The one group of people that may reduce hours of work in response to the EITC incentives are the lower-earning spouses in a married couple (Eissa and Hoynes 2006). On balance, though, the increase in work resulting from the EITC dwarfs the decline in participation among second earners in married couples.

If the EITC were treated like earnings, it would have been the single most effective antipoverty program for working age people, lifting about 6.5 million people out of poverty, including 3.3 million children (CBPP 2016).

Benefits from the EITC are concentrated among the lowest earners, with almost all benefits going to families in the bottom three quintiles of the distribution (figure 2). (Each quinitle contains 20 percent of the population, ranked by household income.)

FIGURE 1
Earned Income Tax Credit
2017



Source: Tax Policy Center, IRS Rev. Proc. 2016-55.
Note: Assumes all income comes from earnings. Amounts are for taxpayers filing a single or head-of-household tax return. For married couples filing a joint tax return, the credit begins to phase out at income $5,590 higher than shown.

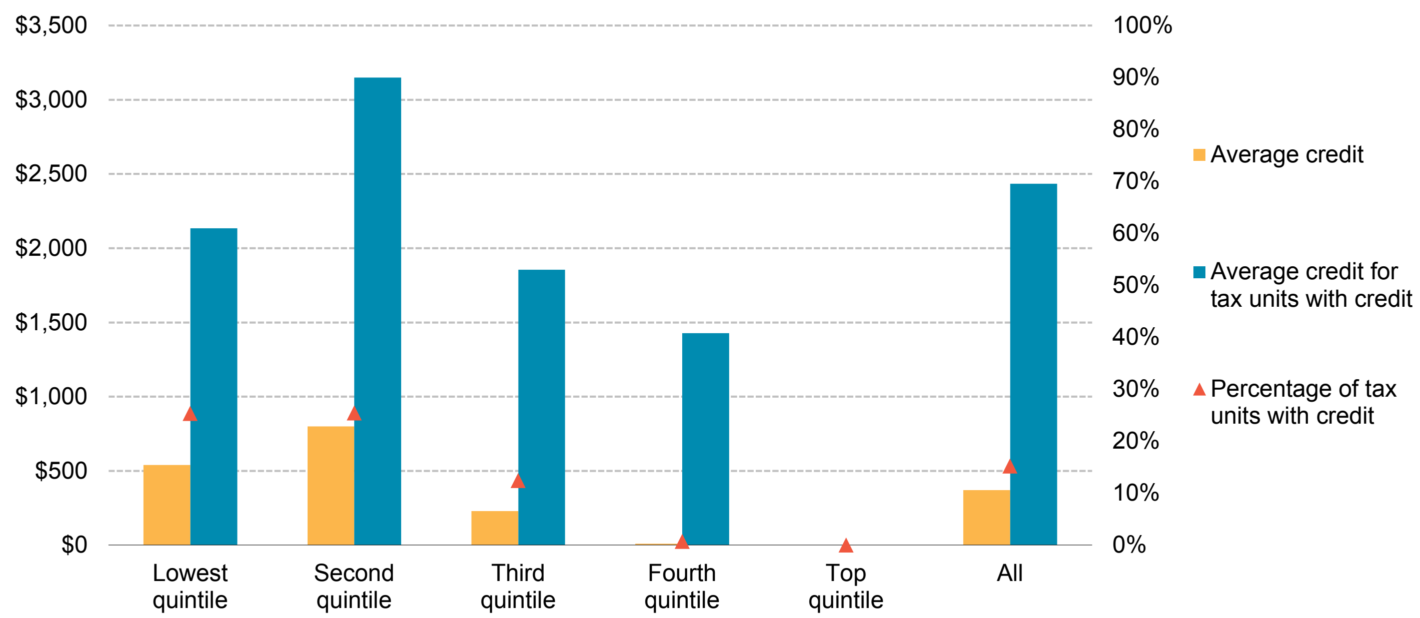
Key Elements of the U.S. Tax System

What is the earned income tax credit (EITC)?

FIGURE 2

Distribution of and Percentage of Tax Units with EITC

2016



Source: Urban-Brookings Tax Policy Center Microsimulation Model, (version 0516-1).

RECENT CHANGES

As a result of legislation enacted in 2001, the EITC phases out at higher income levels for married couples than for single individuals. That threshold was increased as part of the American Recovery and Reinvestment Act of 2009 (ARRA). The same act increased the maximum EITC for workers with at least three children. The American Taxpayer Relief Act of 2012 made the 2001 EITC changes permanent ($3,000 higher threshold for married couple phaseout, indexed) but extended the ARRA changes ($5,000 higher threshold for married couple phaseout, indexed, and higher credit maximum for workers with at least three children) through the end of 2017. The Protecting Americans from Tax Hikes Act of 2015 made these changes permanent.

PROPOSALS FOR REFORM

President Obama and members of the Republican congressional leadership have proposed EITC amendments to provide a substantial credit for childless workers. These proposals typically involve expanding the eligible age limits for the childless EITC—lowering the age of eligibility from 25 to 21 and increasing the age of eligibility from 64 to 67—increasing the maximum credit, and expanding the income range over which the credit is available. A more far-reaching approach to reform that would still expand benefits to childless workers would be to separate the credit into two pieces—one focused on work and one focused on children. Examples of this type of reform have been proposed by many, including the Bush Tax Reform Panel of 2005, the Bipartisan Policy Center, and Maag (2015b).

Key Elements of the U.S. Tax System

What is the earned income tax credit (EITC)?

ERROR RATES AND THE EITC

The EITC likely delivers more than a quarter (28.5 percent) of all payments in error, according to a recent IRS compliance study. The largest source of error was determining whether a child claimed for the EITC actually qualified (Internal Revenue Service 2014). The child must live with the parent (or other relative) claiming the EITC for more than half of the year in order to qualify. The IRS receives no administrative data that can verify where a child resided for the majority of the year, making it difficult for the agency to monitor compliance. Attempts to use administrative data from other programs to verify child residence have not proven successful (Pergamit et al. 2014). In an attempt to reduce fraud, the Protecting Americans from Tax Hikes Act of 2015 (PATH Act) requires the IRS to delay tax refunds for taxpayers who claim an earned income tax credit (EITC) or additional child tax credit (ACTC) on their returns until at least February 15.

[1] A qualifying child must meet requirements based on relationship, age, residency, and tax filing status. See: Qualifying Child Rules.

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Key Elements of the U.S. Tax System

What is the earned income tax credit (EITC)?

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Q. How does the tax system subsidize child care expenses?

A. Working parents are eligible for two tax benefits to offset child care costs: the child and dependent care tax credit and the exclusion for employer-provided child care.

THE CHILD AND DEPENDENT CARE TAX CREDIT

The child and dependent care tax credit (CDCTC) provides a credit worth between 20 and 35 percent of child care costs up to $3,000 for a child under age 13 or any dependent physically or mentally incapable of self-care. Eligible child care expenses are limited to $6,000 per family. Higher credit rates apply to families with lower adjusted gross incomes (AGIs). Families with incomes below $15,000 qualify for the full 35 percent credit. That rate falls by 1 percentage point for each additional $2,000 of income (or part thereof) until it reaches 20 percent for families with incomes of $43,000 or more. The credit is nonrefundable so it can only be used to offset income taxes owed—in other words, any excess credit beyond taxes owed is forfeited. As a result, low-income families who owe little or no income tax get little benefit from the credit (table 1).

To qualify for the CDCTC, a parent must be working or in school. For married couples, both adults must be working or attending school. In general, allowable expenses are capped at the earnings of the lower-earning spouse. Special rules allow individuals who were students or disabled to have their earned income assumed to be $250 per month ($500 if there is more than one qualifying child).

The Urban-Brooking Tax Policy Center estimates that, in 2016, 12.7 percent of families with children benefited from the CDCTC. Some families with children will not benefit because they do not have child care expenses or, in the case of married couples, only one partner works or goes to school. Among families with children who benefit from the CDCTC, taxes will be reduced by an average of $551. The only income quintile in which families average substantially different benefits is the lowest. (Each quintile contains 20 percent of the population ranked by household income.) Not only are their child care expenses likely to be lower than those of families in higher-income quintiles, they are typically unable to benefit from the credit because the CDCTC is nonrefundable (figure 1).

Key Elements of the U.S. Tax System

How does the tax system subsidize child care expenses?

TABLE 1

Child and Dependent Care Credit

2017

Adjusted gross income (dollars)	Credit rate (percent)	Maximum Credit (dollars)	
		One child	Two or more children
15,000 or less	35	1,050	2,100
15,001–17,000	34	1,020	2,040
17,001–19,000	33	990	1,980
19,001–21,000	32	960	1,920
21,001–23,000	31	930	1,860
23,001–25,000	30	900	1,800
25,001–27,000	29	870	1,740
27,001–29,000	28	840	1,680
29,001–31,000	27	810	1,620
31,001–33,000	26	780	1,560
33,001–35,000	25	750	1,500
35,001–37,000	24	720	1,440
37,001–39,000	23	690	1,380
39,001–41,000	22	660	1,320
41,001–43,000	21	630	1,260
43,000 and over	20	600	1,200

Sources: Internal Revenue Service; Tax Policy Center.

EMPLOYER EXCLUSION: FLEXIBLE SPENDING ACCOUNTS

Employer-provided child and dependent care benefits include amounts paid directly for care, the value of care in a daycare facility provided or sponsored by an employer, and, more commonly, contributions made to a dependent care flexible spending account (FSA).

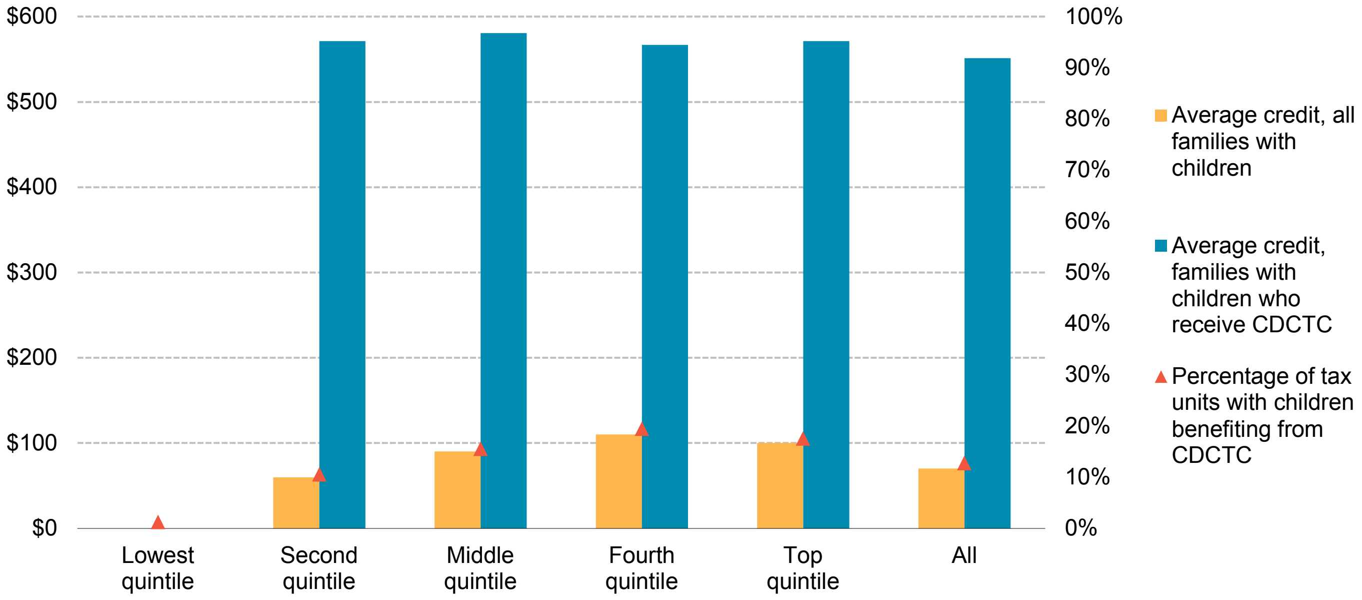
Employees can set aside up to $5,000 per year of their salary (regardless of the number of children) in an FSA to pay child care expenses. (FSAs are also available for health care expenses). The money set aside in an FSA is not subject to income or payroll taxes. Unlike the CDCTC, though, which requires both partners in a married couple to work to claim benefits, only one parent must work to claim a benefit from an FSA. In 2014, 39 percent of civilian workers had access to a dependent care FSA (Bureau of Labor Statistics 2014). Lower earners are less likely to have access to an FSA than higher earners (Stoltzfus 2015).

How does the tax system subsidize child care expenses?

FIGURE 1

Child and Dependent Care Tax Credit for Families with Children, Average Benefits and Participation

2016



Source: Urban-Brookings Tax Policy Center Microsimulation Model, (version 0516-1).

INTERACTION OF CDCTC AND FSAS

If a family has child care expenses that exceed the amount set aside in a flexible spending account, the family may qualify for a CDCTC. Families first calculate their allowable CDCTC expenses ($3,000 per child under age 13, up to $6,000 per family). If this calculation exceeds the amount of salary set aside in an FSA, a parent may claim a CDCTC based on the difference. For example, a family with two or more children can qualify for up to $6,000 of expenses to apply toward a CDCTC. If that family excluded $5,000 from salaries to pay for child care expenses in an FSA, it may claim the difference between the two ($1,000) for a CDCTC.

Higher-income families generally benefit more from the exclusion than from the credit because the excluded income is free from both income and payroll taxes. Most higher-income families with child care expenses qualify for a credit of 20 percent of their eligible expenses. Because the combined tax saving from each dollar of child care expenses excluded from income exceeds $0.20, the exclusion is worth more than the credit. The exclusion, however, is only available to taxpayers whose employers offer FSAs.

Neither the CDCTC nor the FSA are indexed for inflation. Thus, each year, the real (inflation-adjusted) value of benefits from the two provisions erodes.

Key Elements of the U.S. Tax System

How does the tax system subsidize child care expenses?

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Q. What tax benefits exist for K–12 education?

A. While the vast majority of education tax benefits target higher education, two types of federal tax breaks are aimed at K–12 education: tax credit bonds for school construction and reimbursement to teachers for school-supply expenses.

TAX CREDIT BONDS FOR SCHOOL CONSTRUCTION

Created in 1997, the Qualified Zone Academy Bond (QZAB) program provides funds for renovations to existing buildings, equipment, curricula development, and training. The program was expanded in 2009 by the American Recovery and Reinvestment Act (the fiscal stimulus package), which also introduced the Qualified School Construction Bond (QSCB) program. Like the QZAB, the QSCB program funds renovations, but it also supports new construction.

Under these programs, the bonds cost the school or the school district issuing them little or nothing because bond holders are paid in federal tax credits in lieu of interest. In both 2009 and 2010, the QZAB and QSCB programs allocated $1.4 billion and $11 billion, respectively, to fund payments on qualifying bonds. Since 2010, QZAB annual allocations have returned to their initial levels of $400 million annually. The 2010 Hiring Incentives to Restore Employment (HIRE) Act introduced a direct pay option in which the federal government makes payments directly to certain bond issuers under QZAB and QSCB to cover bond interest, rather than providing credits to the bond holders.

What tax benefits exist for K-12 education?

EDUCATOR EXPENSE DEDUCTION

Teachers can deduct up to $250 annually ($500 for married couples where both spouses are teachers) for unreimbursed expenses on supplies. The deduction covers expenses on books, computer equipment, supplementary materials, and other school supplies and will cost an estimated $210 million in 2017.

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Q. What tax incentives exist to help families save for college?

A. Three tax-favored saving instruments encourage families to save for college: Coverdell savings accounts, qualified tuition programs (commonly known as 529 plans), and the education savings bond program. Because of their characteristics, the first two direct most of the benefit to higher-income families.

Tax-favored accounts encourage families to save for college expenses by reducing or eliminating the tax normally owed. But there's a catch: to reap significant benefits, families must invest in sheltered college savings accounts years before they know whether their children will attend college. While these funds can be redirected toward another person's educational expenses if the child does not go to college, savers must pay penalties to divert the money for other non-education purposes. The resulting uncertainty is greatest for low-income families because their children are least likely to attend college.

Higher-income families benefit more from tax-favored accounts because they avoid more taxes for each dollar contributed to a sheltered account. All families must pay income tax and a 10 percent penalty on money withdrawn from an account if the funds are used for purposes other than permitted educational expenses. However, even after paying the penalties, high-income families can still come out ahead because the accounts let them shift ownership to their children, who typically face lower income tax rates. That benefit, of course, does not extend to low-income families, who are likely to be in the same tax bracket as their children.

COVERDELL ACCOUNTS

In 2017 families with adjusted gross income (AGI) below $110,000 ($220,000 if filing a joint return) can deposit up to $2,000 per beneficiary in a Coverdell account on an after-tax basis. Funds grow untaxed and may be withdrawn tax free if used to pay educational expenses. Coverdell account funds can be used for K–12 expenses as well as higher education.

QUALIFIED TUITION PROGRAMS (529 PLANS)

Anyone, regardless of income, may contribute to a 529 plan for a designated beneficiary. A donor may contribute up to $14,000 annually for each beneficiary without triggering a gift tax, with the option of making up to five years of contributions in a single payment so long as no additional gifts are made during the five-year period. Income in 529 plans accumulates untaxed.

Key Elements of the U.S. Tax System

What tax incentives exist to help families save for college?

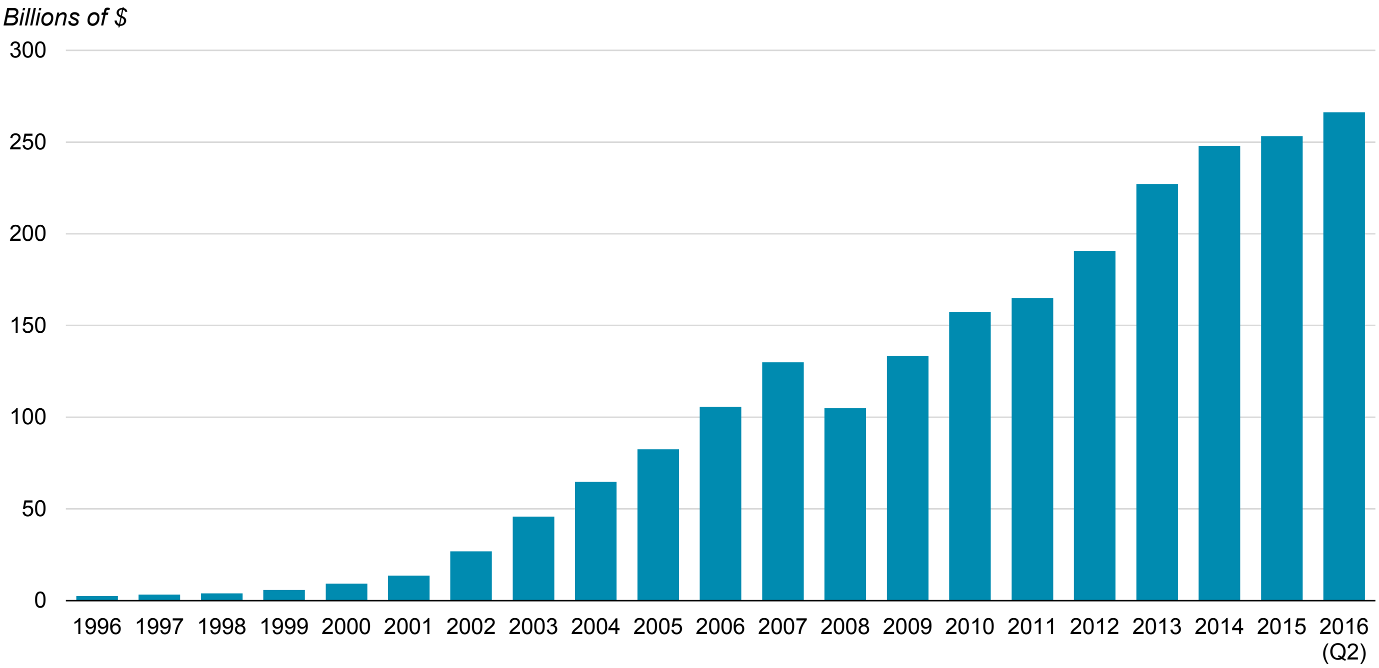
Since passage of the Economic Growth and Tax Relief Reconciliation Act of 2001, funds are not taxed when withdrawn from 529s, provided they are used to pay for postsecondary education. Donors retain ownership of the accounts, but may use the funds to pay educational expenses only for the named beneficiary. The donor may, however, change beneficiaries as long as the new beneficiary is a member of the same family as the old beneficiary.

Assets in 529 plans have grown considerably in the last two decades. In 1996, only 500,000 accounts existed and contained only $2.4 billion. As of June 2016, there were 12.7 million 529 plan accounts containing $266 billion in assets (figure 1).

FIGURE 1

Growth of 529 College Savings Plan Account Assets

1996-2016



Source: College Savings Plan Network, "529 Report," September 2016.

Every state except Wyoming sponsors a 529 plan (but Wyoming residents receive preferred treatment in the Colorado 529 plan). In states with a personal income tax, residents investing in their state-sponsored 529 plans often receive a state tax break for at least part of their investment. Families can choose to invest in plans from other states, which may be the best option for them—especially when contributions are not tax deductible. A number of states, moreover, provide matching funds for contributions to 529 accounts. Beyond the state plans, there is also a separate private college 529 plan.

Key Elements of the U.S. Tax System

What tax incentives exist to help families save for college?

EDUCATION SAVINGS BOND PROGRAM

The federal government allows buyers to exclude interest on designated government bonds from income tax if the money is used to pay for postsecondary education. In 2017, however, families can only cash in these bonds tax free if their AGI is less than $93,150 ($147,250 if filing a joint return). The income limits are indexed for inflation. This program is substantially smaller than the Coverdell and 529 programs.

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Q. What tax incentives exist to help families pay for college?

A. Rapidly rising college expenses in the 1990s spurred the 1997 enactment of tax incentives for higher education, which currently include the American opportunity tax credit, the lifetime learning credit, and deductions for tuition and fees and for student loan interest.

AMERICAN OPPORTUNITY TAX CREDIT

The American opportunity tax credit (AOTC) provides a credit up to $2,500 per student during the first four years of undergraduate postsecondary school. Students receive a credit of 100 percent against the first $2,000 of tuition, fees, and books, and a 25 percent credit against the next $2,000. Up to $1,000 of the AOTC is refundable; in order to qualify for the credit, students must be enrolled at least half-time for one or more academic periods during the year. AOTC credits, it should be noted, are not indexed for inflation. The AOTC was enacted as part of the fiscal stimulus package and then made permanent in 2015 under the Protecting Americans from Tax Hikes (PATH) Act. The AOTC replaced the Hope credit and is available for more years of schooling (four versus two years), covers more expenses, and is partly refundable.

For 2017 tax returns, the maximum benefit for the AOTC begins to phase out when modified adjusted gross incomes (MAGI) reaches $80,000 and is completed phased out at MAGI of $90,000. For married couples the phaseout range begins at MAGI of $160,000 and the credit is completely phased out at MAGI of $180,000. The phaseout thresholds are not indexed for inflation.

LIFETIME LEARNING CREDIT

The lifetime learning credit (LLC) equals 20 percent of tuition and fees for any postsecondary education expense, up to a maximum annual credit of $2,000 per taxpayer. That maximum applies to the combined expenses of all students in the household claiming the credit and is reached when total qualifying expenses equal $10,000. The maximum benefit for the LLC phases out for MAGI between $56,000 and $66,000 in 2017 (and between $112,000 and $132,000 for married couples). The phaseout thresholds for the lifetime learning credit are adjusted annually for inflation. The LLC is nonrefundable, so only people who owe income tax can benefit.

Key Elements of the U.S. Tax System

What tax incentives exist to help families pay for college?

TUITION AND FEES DEDUCTION

The deduction for tuition and fees allows taxpayers (parents, students, or spouses—whoever pays) to reduce taxable incomes by up to $4,000. To qualify in 2016, a family's modified adjusted gross income may not exceed $65,000 for single, head of household, or qualifying widower filers or $130,000 for married filers. Single, head of household, or qualifying widower filers with AGIs between $65,000 and $80,000 or married filers with AGIs between $130,000 and $160,000 can deduct up to $2,000 of expenses. After that, a family is no longer eligible for the deduction. Since the provision is a deduction, it has value only to students and their families with taxable income. The tuition and fees deduction was extended for 2015 and 2016 but is set to expire in 2017 unless extended again.

STUDENT LOAN INTEREST DEDUCTION

The student loan interest deduction allows taxpayers with qualified student loans (loans taken out solely to pay qualified higher education expenses) to reduce taxable income by $2,500 or the interest paid during the year, whichever is less. The loan cannot be from a relative or made under a qualified employer plan, and the student must be a taxpayer, a spouse, or a dependent; only those enrolled at least half-time in a degree program qualify.

Qualified expenses include tuition and fees; room and board; books, supplies and equipment; and other necessary expenses such as transportation. To qualify in 2017, a taxpayer's AGI may not exceed $80,000 for single, head of household, or qualifying widower filers, or $165,000 for married filers. After that, a family is no longer eligible for the deduction. The deduction is, of course, only valuable to people with taxable income. The student loan interest deduction will cost an estimated $1.97 billion in 2017.

HOW THESE TAX INCENTIVES AFFECT STUDENTS

Before Congress created the AOTC, many observers argued that existing tax subsidies had minimal impact on college enrollment because those subsidies went mostly to people who would have attended college even without the additional aid. Many low-income students who might have been the most influenced by reduced college costs received little or no benefit from the Hope and LLC credits because they were nonrefundable and thus could only offset income taxes owed.

In response, the AOTC was made refundable, allowing lower-income families to receive the credit. Even so, students with incomes below $50,000 receive more aid from the Pell grant than from the tax credits. And even with the changes to the tax credits, it remains unclear whether tax credits increase college enrollment (figure 1).

Using the tax system to subsidize higher education has two primary advantages over using traditional spending programs: (1) Students don't have to fill out the daunting Free Application for Federal Student Aid (FAFSA) form to receive benefits; and (2) Every student who qualifies receives the full benefit for which they appear entitled. However, providing aid through the tax system also has disadvantages—notably, the delay in funds being received (up to 15 months after tuition was paid), a lack of transparency about why taxes went down, and potential mismatches in that the person receiving the credit or deduction may not be the student.

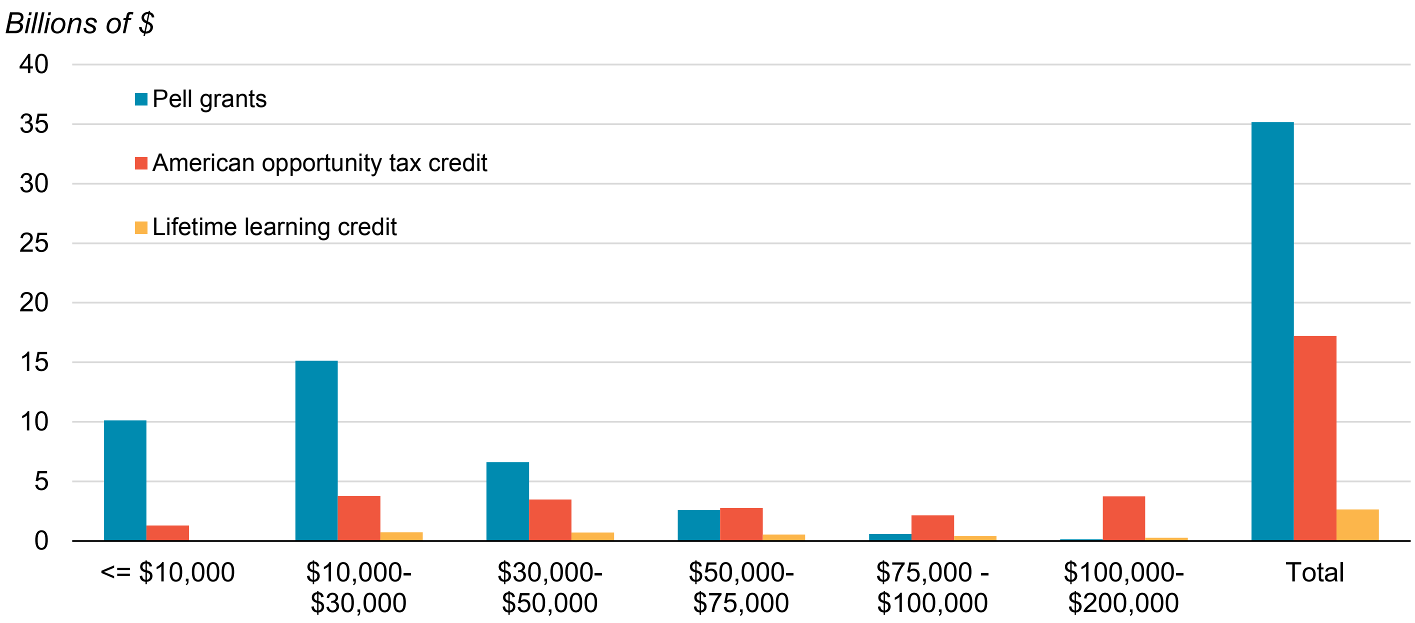
Key Elements of the U.S. Tax System

What tax incentives exist to help families pay for college?

FIGURE 1

Amount of Pell Grants, AOTC, and LLC

All Students, 2017



Source: Tax Policy Center, Table T16-0246, 2016.

OPTIONS FOR REFORM

- Even though some books are eligible expenses under the American opportunity tax credit, additional assistance could be provided by broadening coverage to include other expenses such as room and board.
- Providing benefits directly to schools when students enroll—not months later when their families file tax returns—could help students cover college costs when they are obliged to make payments. Benefit amounts would be based on estimates of the previous year's taxes.
- Consolidating the credits into a single credit would make the process more transparent for students.
- Rather than offering a deduction for student loan interest, providing incentives for students to enroll in income-contingent repayment programs would reduce hardship in student debt repayment.

Key Elements of the U.S. Tax System

What tax incentives exist to help families pay for college?

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Key Elements of the U.S. Tax System

What are marriage penalties and bonuses?

Q. What are marriage penalties and bonuses?

A. A couple incurs a marriage penalty if the two pay more income tax filing jointly as a married couple than they would pay if they were single and filed as individuals. Conversely, a couple receives a marriage bonus if they pay less tax filing jointly than they would if they were single.

CAUSES OF MARRIAGE PENALTIES AND BONUSES

Under a progressive income tax, marriage penalties and bonuses arise because the household rather than the individual is the unit of taxation. Tax provisions that phase in or out with income also produce penalties or bonuses. Couples receiving bonuses greatly outnumber those incurring penalties.

Marriage penalties and bonuses result from the combination of progressive tax rates and taxing married couples as single units. With progressive taxes (which impose higher rates on higher incomes) and tax brackets that are not twice as wide for couples as for individuals, some married couples' income is taxed at higher rates than if each spouse's income was taxed separately. The 10 and 15 percent brackets for joint filers are twice as wide as those for single filers, but the higher rate brackets are less than twice as wide. Note, moreover, that a couple is not obliged to file a joint tax return, but their alternative—filing separate returns as a married couple—almost always results in greater tax liability.

MARRIAGE PENALTIES

Couples in which spouses have similar incomes are more likely to incur marriage penalties than couples in which one spouse earns most of the income, because combining incomes in joint filing can push both spouses into higher tax brackets.

Consider parents of two children where each parent earns $100,000 and the family has itemized deductions totaling $40,000 (table 1). Filing jointly, their taxable income is $144,000, on which their 2015 income tax liability is $27,588; they would get no child credit because their combined income is too high to qualify. If they could file separately, one as single and the other as the head of a household with two children, the single filer would owe a tax of $14,794 and the head-of-household filer would owe $11,323 minus a child credit of $750, or $10,573, yielding a total tax of $25,366. Their joint tax bill is thus $2,221 higher than the sum of their hypothetical individual tax bills, imposing on them a marriage penalty equal to 1.1 percent of their pretax income.

Key Elements of the U.S. Tax System

What are marriage penalties and bonuses?

TABLE 1

Calculation of the Marriage Penalty for a Hypothetical Couple with Two Children

2015

Item	Couple Filing Separately[a]		Couple filing jointly
	Spouse one	Spouse two	
Adjusted gross income	$100,000	$100,000	$200,000
Less personal exemptions	$4,000	$12,000	$16,000
Less 20 percent for itemized deductions[b]	$20,000	$20,000	$40,000
Equals taxable income	$76,000	$68,000	$144,000
Of which:			
Taxable at 10 percent	$9,225	$13,150	$18,450
Taxable at 15 percent	$28,225	$37,050	$56,450
Taxable at 25 percent	$38,550	$17,800	$69,100
Taxable at 28 percent	$0	$0	$0
Regular tax liability	$14,794	$11,323	$27,588
Alternative minimum tax	$0	$0	$0
Child tax credit	$0	$750	$0
Tax liability after credits	$14,794	$10,573	$27,588
Final tax liability	**$25,366**		**$27,588**
Marriage penalty (difference in tax liabilities)		**$2,221**	
As share of adjusted gross income		**-1.1%**	

Source: Tax Policy Center calculations.

Note: Detail may not sum to totals because of rounding.

(a) When the couple files separately, spouse one files as single and spouse two as head of household with two children.

(b) Itemized deductions are state and local taxes (10 percent of AGI), mortgage interest (5 percent of AGI), and charitable contributions (5 percent of AGI).

MARRIAGE BONUSES

Couples in which one spouse earns all of the couple's income never incur a marriage penalty and almost always receive a marriage bonus because joint filing shifts the higher earner's income into a lower tax bracket.

Consider a couple with two children and $200,000 in total earnings, all earned by spouse two (table 2). Under 2015 tax law, they will receive a marriage bonus of more than $9,000 as a result of three factors. First, filing jointly, the couple can claim $16,000 in personal exemptions, a third again what they could claim if spouse two filed a head-of-household return claiming two children and spouse one filed a single return—with no earnings, spouse one could not claim an exemption. Second, because tax brackets for joint returns (other than the 10 percent and 15 percent brackets) are wider than those for head-of-household returns, much of the couple's income is taxed at lower rates under joint filing than the 28 percent marginal rate the spouse two would pay filing separately. Finally, spouse two would fall under the alternative minimum tax (AMT) filing separately, boosting taxes by an additional $4,942. In combination, the three factors yield a marriage bonus of $9,229, or 4.6 percent of their adjusted gross income. More than half of that bonus would result from the difference in AMT liability.

Key Elements of the U.S. Tax System

What are marriage penalties and bonuses?

TABLE 3

Calculation of the Marriage Bonus for a Hypothetical Couple with Two Children

2015

Item	Couple Filing Separately[a]		Couple filing jointly
	Spouse one	Spouse two	
Adjusted gross income	$0	$200,000	$200,000
Less personal exemptions	$4,000	$12,000	$16,000
Less 20 percent for itemized deductions[b]	$0	$40,000	$40,000
Equals taxable income	$0	$148,000	$144,000
Of which:			
Taxable at 10 percent	$0	$13,150	$18,450
Taxable at 15 percent	$0	$37,050	$56,450
Taxable at 25 percent	$0	$79,400	$69,100
Taxable at 28 percent	$0	$18,400	$0
Regular tax liability	$0	$31,875	$27,588
Alternative minimum tax	$0	$4,942	$0
Child tax credit	$0	$0	$0
Tax liability after credits	$0	$36,817	$27,588
Final tax liability	**$36,817**		**$27,588**
Marriage bonus (difference in tax liabilities)		**$9,229**	
As share of adjusted gross income		**4.6%**	

Source: Tax Policy Center calculations.
Note: Detail may not sum to totals because of rounding.
(a) When the couple files separately, spouse one files as single and spouse two as head of household with two children.
(b) Itemized deductions are state and local taxes (10 percent of AGI), mortgage interest (5 percent of AGI), and charitable contributions (5 percent of AGI).

EFFECT OF RECENT TAX CUTS ON MARRIAGE PENALTIES

Before the 2001 tax act, married couples were already significantly more likely to receive bonuses than to pay penalties. The Congressional Budget Office (1997) estimated that 51 percent of married couples received marriage bonuses totaling nearly $33 billion in 1996, and 42 percent incurred marriage penalties totaling almost $29 billion.

Tax legislation since 2001 has substantially reduced marriage penalties and increased marriage bonuses. That year, Congress raised the standard deduction for couples to twice that for single filers and set the income ranges for couples in the 10 and 15 percent tax brackets to twice the corresponding ranges for individuals. The 2001 tax act temporarily raised the starting point of the earned income tax credit (EITC) phaseout range for married couples by $3,000 above that for single filers. The 2009 American Recovery and Reinvestment Tax Act temporarily boosted the increase to $5,000 and indexed it for inflation, and the American Taxpayer Relief Act of 2012 extended that increase through 2017. Before the increase expired, however, the Protecting Americans from Tax Hikes Act of 2015 made the $5,000 increase for married couples permanent.

Key Elements of the U.S. Tax System

What are marriage penalties and bonuses?

Despite the recent reductions, many aspects of the tax code perpetuate penalties. Joint filer brackets for tax rates above 15 percent are less than twice as wide as single brackets; therefore, combining income for joint filing can lead to higher tax rates. In fact, the 35 percent bracket in 2015 starts at the same income level for single and joint filers and heads of household, and thus imposes significant marriage penalties on high-income couples. In addition, income limits on some tax subsidies are less than twice as high for couples as for single filers. For example, the child tax credit starts to phase out for unmarried filers when adjusted gross income exceeds $75,000; for married couples filing jointly, the threshold is $110,000. Because that is less than twice the single filer's threshold, it can impose marriage penalties on some taxpayers. Finally, AMT parameters for couples are less than twice those for unmarried individuals. For example, the 2015 AMT exemption for joint filers is $83,400, less than twice the $53,600 exemption for single filers.

MARRIAGE PENALTIES AND THE EARNED INCOME TAX CREDIT

Taxpayers who might qualify for the EITC can suffer particularly large marriage penalties if the income of one spouse disqualifies the couple. However, marriage can increase the EITC if a nonworking parent files jointly with a low-earning worker.

TABLE 3

Calculation of the Marriage Penalty for a Low-Income Hypothetical Couple with Two Children

2015

Item	Couple Filing Separately[a]		Couple filing jointly
	Spouse one	Spouse two	
Adjusted gross income	$20,000	$20,000	$40,000
Less personal exemptions	$4,000	$12,000	$16,000
Less standard deduction	$6,300	$9,250	$12,600
Equals taxable income	$9,700	$0	$11,400
Of which:			
Taxable at 10 percent	$9,225	$0	$11,400
Taxable at 15 percent	$475	$0	$0
Regular tax liability	$994	$0	$1,140
Alternative minimum tax	$0	$0	$0
Child tax credit	$0	$2,000	$2,000
Earned income tax credit (EITC)	$0	$5,150	$2,100
Tax liability after credits	$994	-$7,150	-$2,960
Couple's final tax liability	**-$6,156**		**-$2,960**
Marriage penalty (difference in tax liabilities)		**$3,196**	
As share of adjusted gross income		**8.0%**	

Source: Tax Policy Center calculations.
Note: Detail may not sum to totals because of rounding.
(a) When the couple files separately, spouse one files as single and spouse two as head of household with two children.

Key Elements of the U.S. Tax System

What are marriage penalties and bonuses?

Consider a couple with two children and $40,000 in total earnings, split evenly between husband and wife (table 3). Two factors will cause them to incur a marriage penalty of more than $3,000 under 2015 tax law. First, if they were not married, the wife could file as head of household with two children and the husband would file as single. Filing In that way, their combined standard deductions would be $15,550, $2,950 more than the $12,600 standard deduction available on a joint return (although that is offset by their losing $1,250 of their combined deductions because the wife's deduction cannot reduce her taxable income below zero). At the couple's marginal tax rate of 10 percent, those effects increase their tax liability by $170 (10 percent of $1,700). Second—and more significant—filing separate returns, the wife could claim an earned income tax credit (EITC) of $5,150 and a $2,000 child credit; the husband would get neither tax credit. On net, the wife would receive a payment of $7,250 and the husband would pay $994, yielding a joint tax refund of $6,156. Filing jointly, the couple will get a smaller EITC of $2,100 plus the $2,000 child tax credit. Thus, filing jointly, the couple will receive a payment of $2,960, $3,196 less than the $6,156 they would have gotten if they could have filed separately; the $3,196 difference equals 8.0 percent of their adjusted gross income.

Marriage penalties are not confined to the tax system. Married couples often receive lower benefits from government programs than they would if they had not married. Moreover, the interaction of a tax penalty and a program eligibility penalty can create effective marginal tax rates that approach 100 percent.

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Key Elements of the U.S. Tax System

Q. How does the federal tax system affect low-income households?

A. Most low-income households do not pay federal income taxes, typically because their incomes are lower than the combination of their allowed standard deduction and their personal and dependent exemptions, or because they receive substantial rebates via refundable tax credits. However, nearly all low-income workers are subject to the payroll tax.

WHAT FEDERAL TAXES DO LOW-INCOME HOUSEHOLDS PAY?

Low-income households typically pay some federal tax. The Tax Policy Center estimates that, on average in 2017, households in the lowest income quintile (the bottom fifth) will owe federal taxes equal to 3.7 percent of their incomes, much lower than the average 20.1 percent tax rate for all households.

But the income tax is not the reason these households owe federal taxes. In fact, TPC estimates that in 2017, households in the lowest income quintile have a negative average income tax rate thanks to refundable credits—namely the earned income tax credit (EITC) and the child tax credit (CTC). That is, the payments they receive from refundable credits exceed any income tax they owe.

In contrast, the average payroll tax rate for households in the lowest income quintile is 6.1 percent (very similar to the average rate of 6.9 percent for all households). The payroll tax is by far the most significant federal tax for households in the lowest income quintile, in terms of how much they pay.

Of course, low-income households pay federal excise taxes on their purchase of specific products, including cigarettes, alcohol, and gasoline. Low-income households also indirectly pay some corporate income tax, to the extent that corporations pass tax burdens back to workers' wages.

WHAT SHARE OF LOW-INCOME HOUSEHOLDS OWE FEDERAL INCOME OR PAYROLL TAX?

Only 12.1 percent of households in the bottom income quintile will pay federal income tax in 2017. In contrast, 57.4 percent of households in the lowest income quintile will owe payroll taxes. Combined, 58.7 percent of households in the lowest income quintile will owe federal income or payroll taxes.

Key Elements of the U.S. Tax System

How does the federal tax system affect low-income households?

In many cases, low-income households owe no income tax. That's because they can deduct a standard deduction and personal exemptions from their taxable income. In 2017, a married couple with two children will be able to exempt $28,900 from income using the standard deduction ($12,700) and personal exemptions ($4,050 per person).

WHY DO LOW-INCOME HOUSEHOLDS FACE NEGATIVE AVERAGE FEDERAL INCOME TAX RATES?

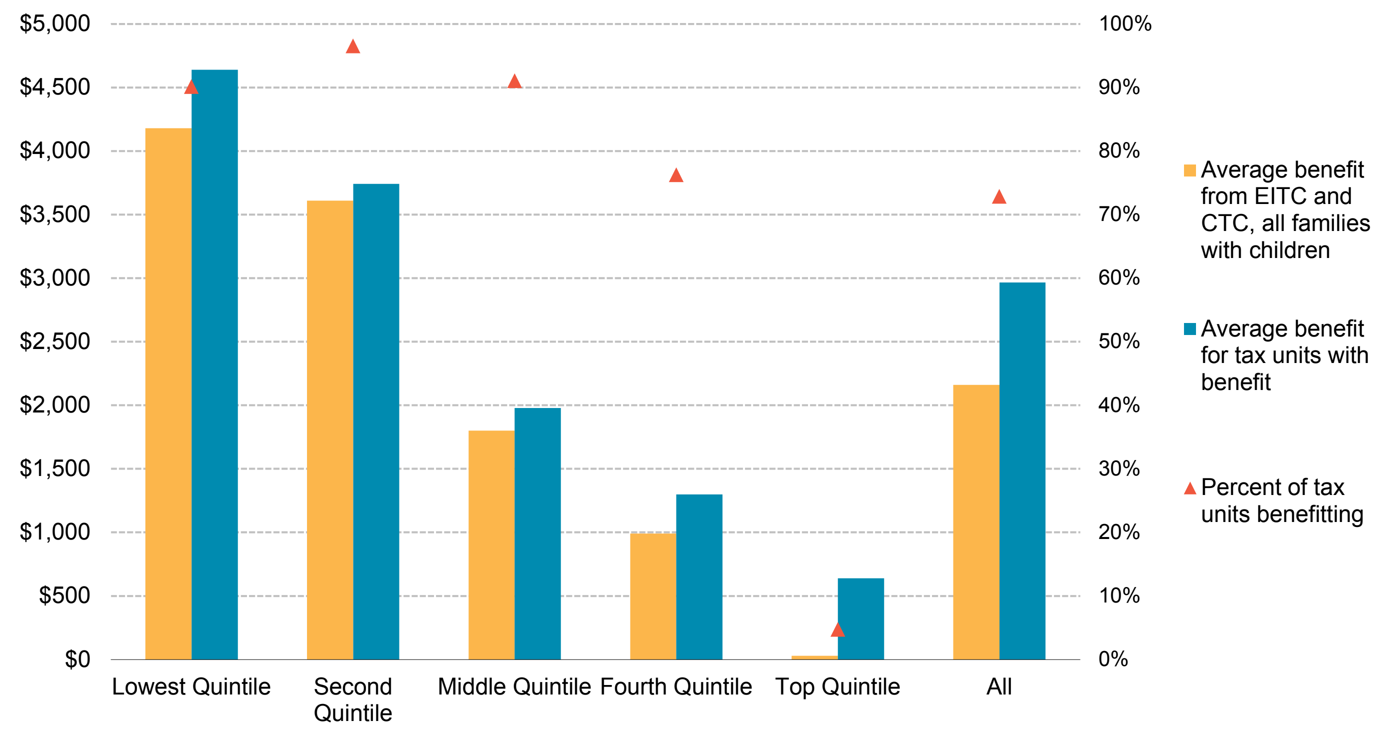
The EITC is a refundable credit that subsidizes earnings, particularly for workers with children. The CTC is partially refundable, providing up to $1,000 per child under age 17 for workers with children. Together, these credits deliver substantial assistance to low-income families with children. (A relatively small EITC is also available to childless workers.) The net refunds created by these credits show up as negative average tax rates.

Together, the Tax Policy Center estimates that in 2017, the CTC and the EITC will provide tax-filing parents in the lowest income quintile an average refund of around $4,600. The credits will benefit 90.1 percent of these households (figure 1).

FIGURE 1

Average Benefits and Participation in the Earned Income Tax Credit and Child Tax Credit

2017



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).

Key Elements of the U.S. Tax System

How does the federal tax system affect low-income households?

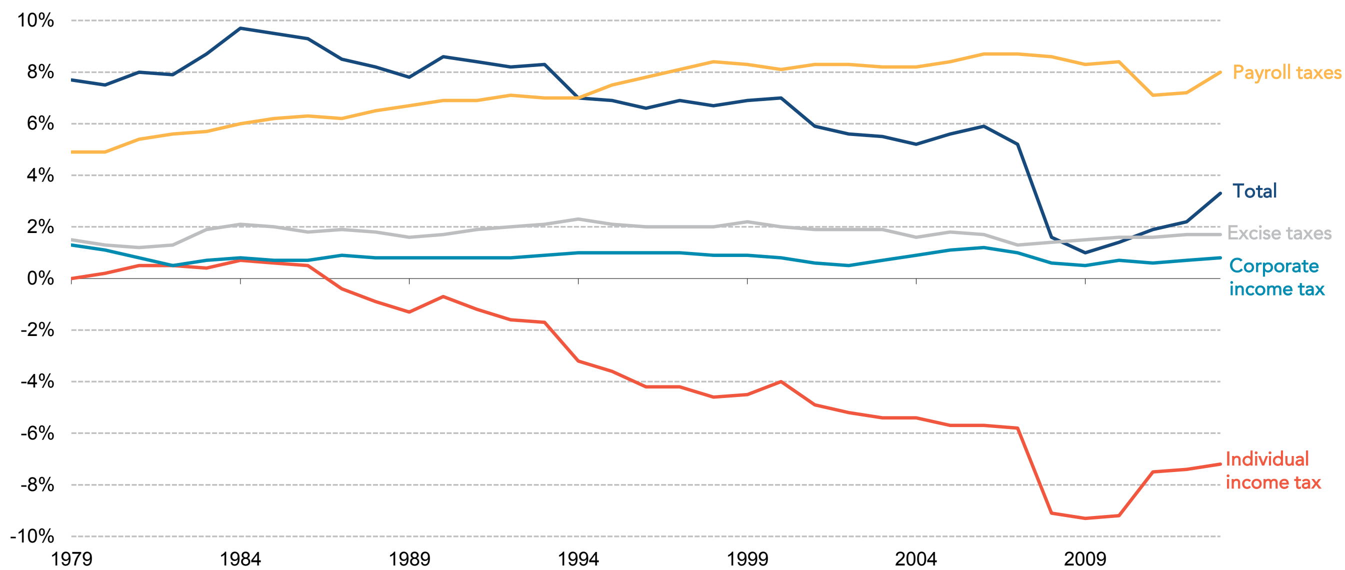
HOW HAVE EFFECTIVE TAX RATES FOR LOW-INCOME HOUSEHOLDS CHANGED OVER TIME?

Average tax rates for low-income households have changed markedly over the past quarter-century (see figure 2). Creation of the CTC and expansion of the EITC both lowered the effective individual income tax rate for these households from about 0.5 percent in the early 1980s to its negative value today. In contrast, the effective payroll tax rate for households in the lowest income quintile increased by more than half over the same period (setting aside the temporary payroll tax reduction in 2011 and 2012). The effective corporate income tax rate borne by low-income households has also fallen since 1979, while the effective excise tax rate rose slightly.

FIGURE 2

Average Federal Tax Rates for Households in the Lowest Income Quintile

1979-2013



Source: Congressional Budget Office, "The Distribution of Household Income and Federal Taxes 2013," June 2016.

Key Elements of the U.S. Tax System

How does the federal tax system affect low-income households?

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Q. What is the difference between refundable and nonrefundable credits?

A. Taxpayers subtract both refundable and nonrefundable credits from the taxes they owe. If a refundable credit exceeds the amount of taxes owed, the difference is paid as a refund. If a nonrefundable credit exceeds the amount of taxes owed, the excess is lost.

REFUNDABLE VERSUS NONREFUNDABLE TAX CREDITS

The maximum value of a nonrefundable income tax credit is capped at a taxpayer's income tax liability. In contrast, taxpayers receive the full value of their refundable tax credits. The amount of a refundable tax credit that exceeds tax liability is refunded to taxpayers.

Most tax credits are nonrefundable. Notable exceptions include the fully refundable earned income tax credit (EITC), the premium tax credit for health insurance (PTC), the refundable portion of the child tax credit (CTC) known as the additional child tax credit (ACTC), and the partially refundable American Opportunity Tax Credit (AOTC) for higher education. With the EITC, PTC, and ACTC, taxpayers calculate the value of these credits and receive the credit first as an offset to taxes owed, with any remainder paid out as a refund.

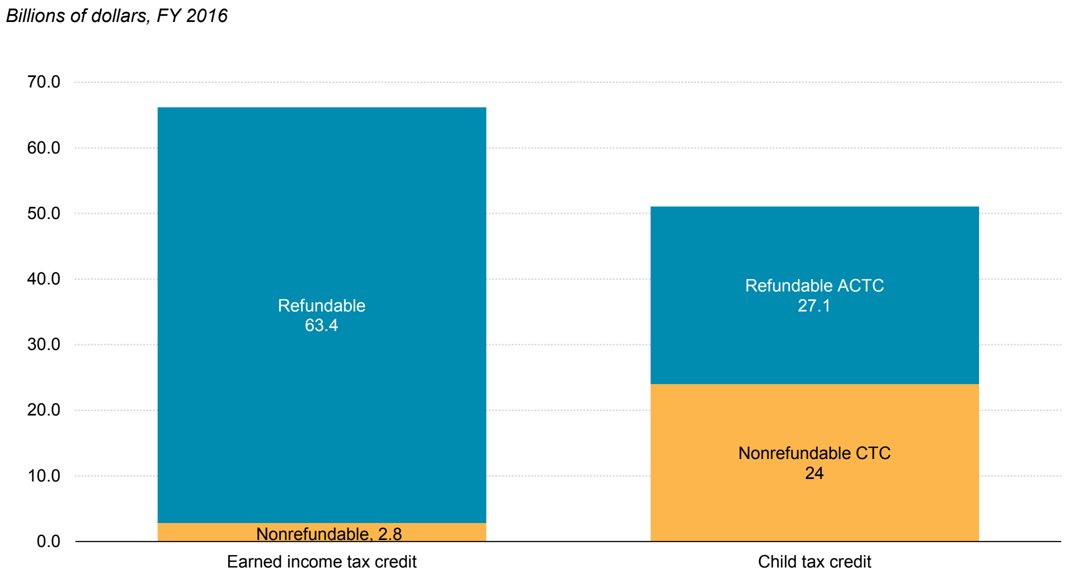
BUDGET TREATMENT OF REFUNDABLE VERSUS NONREFUNDABLE TAX CREDITS

The federal budget distinguishes between the portion of a tax credit that offsets tax liability and the portion that is refundable, classifying the latter as an outlay. Most of the EITC—an estimated $63.1 billion of the FY 2016 total of $65.4 billion—will be refunded. Much less of the child tax credit ($27.0 billion out of $51.3 billion) will be refunded. (figure 1).

Key Elements of the U.S. Tax System

What is the difference between refundable and nonrefundable credits?

FIGURE 1
Refundable and Nonrefundable Shares of EITC and the Child Tax Credit



Source: Office of Management and Budget. "Analytical Perspectives, Budget of the United States Government, Fiscal Year 2017: Tax Expenditures," Table 14–1.

ADVANTAGES AND DISADVANTAGES OF REFUNDABLE CREDITS

Proponents of refundable credits argue that only by making credits refundable can the tax code effectively carry out desired social policy. This is especially true for the EITC and the CTC: if the credits were not refundable, low-income households most in need of assistance would not benefit from them. Furthermore, allowing credits only against income tax liability ignores the fact that most low-income families also incur payroll taxes.

Opponents of refundable credits, for their part, raise a host of objections:
- The tax system should collect taxes, not redistribute income.
- The government should not use the tax system to carry out social policies.
- Everyone should pay some tax as a responsibility of citizenship,
- Refundable credits increase administrative and compliance costs, and encourage fraud.

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Q. Can poor families benefit from the child tax credit?

A. The child tax credit (CTC) provides a credit of up to $1,000 per child under age 17. If the CTC exceeds taxes owed, families are eligible to receive all or part of the balance as a refund, known as the additional child tax credit (ACTC) or refundable CTC. The credit is reduced by 5 percent of adjusted gross income over $75,000 for single parents and over $110,000 for married couples.

HOW THE CTC WORKS

Taxpayers can claim a child tax credit of up to $1,000 per child under age 17. The credit is reduced by 5 percent of adjusted gross income over $75,000 for single parents ($110,000 for married couples). If the credit exceeds taxes owed, taxpayers can receive some or all of the balance as a refund, known as the additional child tax credit (ACTC) or refundable CTC. The ACTC is limited to 15 percent of earnings above $3,000.

Families at nearly all income levels benefit from the CTC – with the largest average benefits (about $1,500) going to families with children in the second and third income quintiles. Families in the highest income quintile receive the smallest average benefits because the credit phases out for workers once adjusted gross income reaches $75,000 (single parents) or $110,000 (married parents).

Neither the credit amount nor the phaseout point is indexed for inflation. Over time, the value of the credit will decline and as incomes grow, more people will be subject to the credit's phase out.

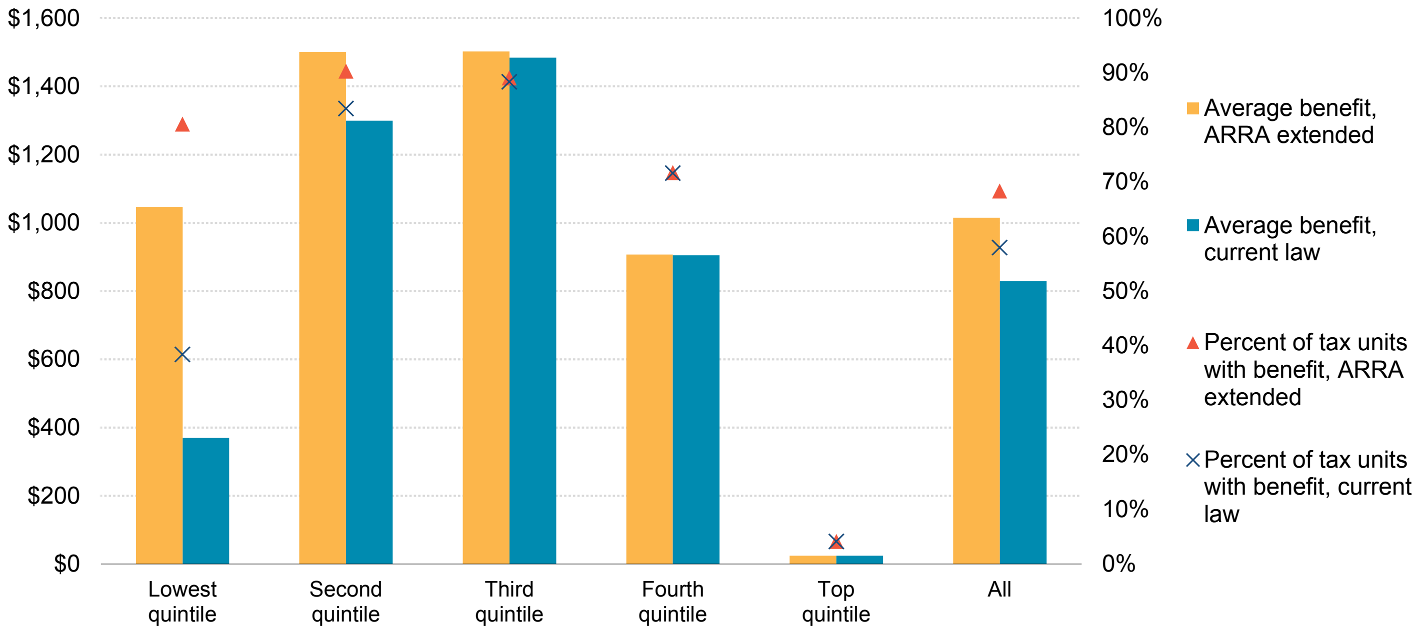
Key Elements of the U.S. Tax System

Can poor families benefit from the child tax credit?

FIGURE 1

Average CTC Benefit for Families with Children under Current Law and with $3,000 Refundability Threshold Extended

2018



Source: Urban-Brookings Tax Policy Center Microsimulation Model, (version 0515-1).

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Q. Why do low-income families use tax preparers?

A. Many low-income families owe no income tax but still must file a tax return to receive refundable tax credits, including the earned income tax credit (EITC). Those who do file often need help, which nearly always comes from a paid preparer. The cost of that help erodes the net value of the EITC and other refundable credits. That cost might be worth bearing if preparers helped their clients claim tax benefits that otherwise might be missed, but many don't.

TAX PREPARATION FOR LOW-INCOME FAMILIES

Most people fill out their tax returns with assistance from paid preparers. In 2010, 56.8 percent of all returns were completed this way. That proportion is slightly lower for lower-income families, 54.5 percent for returns with adjusted gross incomes below $30,000 (table 1). A very small proportion of low-income families reported using Volunteer Income Tax Assistance (VITA) clinics.

TABLE 1
Tax Preparation Method
By adjusted gross income, 2010

AGI (thousands of dollars)	Tax returns (millions)	Tax Preparation Method				
		No identified preparer	Paid preparer	IRS-prepared	Volunteer-income tax assistance	Tax counseling for the elderly
Under 30	65.7	41.8%	54.5%	0.2%	1.7%	1.7%
30–50	25.6	42.3%	55.7%	0.1%	0.9%	1.0%
50–100	30.7	40.9%	58.2%	0.0%	0.4%	0.5%
Over 100	18.2	36.6%	63.2%	0.0%	0.1%	0.1%
Total	142.8	40.9%	56.8%	0.1%	1.0%	1.1%

Source: Tax Policy Center tabulations of 2010 Statistics of Income Public Use File.

Why do low-income families use tax preparers?

DO PAID PREPARERS FILL OUT MORE ACCURATE RETURNS?

Except in a handful of states, paid preparers are not regulated. The Government Accountability Office (GAO) found that returns completed by preparers were not more accurate than self-prepared returns and included errors in calculating a tax filer's EITC – a problem specific to low- and moderate-income families.

In a small sampling performed by the GAO, only 2 of 19 returns showed the correct refund amount. On 13 tax returns in the sample, preparers overestimated the total refund by $100 or more (GAO 2014). A larger-scale study of IRS data showed that paid preparers had a higher estimated error rate—60 percent—than returns prepared by taxpayers themselves. Some of these errors are made by the preparer; some are the result of the taxpayer providing incorrect or incomplete information (GAO 2014).

These latter results were not limited to low-income families' returns. When it comes to returns with the EITC, a recent study showed that unenrolled return preparers were more likely to make errors than other paid preparers. An unenrolled return preparer is someone other than an attorney, CPA, or an enrolled agent—agents licensed by the IRS. Unenrolled preparers completed 43 percent of the EITC returns made by paid preparers, while national tax preparation firms completed 35 percent of these returns (Internal Revenue Service 2014).

One clear benefit of paid preparation: an earlier study of low-income workers showed that if someone already knows about the EITC, they are more likely to receive it if they use a paid preparer to manage the paperwork than if they fill out their returns themselves (Maag 2005). Moreover, some preparers not only inform their low-income clients of their EITC eligibility, but further help them by identifying other forms of assistance for which they might qualify, and some even assist in the application process.

USE OF REFUND ANTICIPATION LOANS AND REFUND ANTICIPATION CHECKS

Prior to 2012, low-income tax filers who used paid preparers could get their tax refunds faster with a refund anticipation loan (RAL). RALs were relatively high-cost immediate cash loans from private lenders, backed by the tax refunds the borrowers claimed on their prepared returns (Theodos 2011). RALs proliferated after 1999 when the IRS reinstituted the debt indicator program, which disclosed whether a tax refund would be redirected by the Internal Revenue Service to pay debts.

The IRS has since discontinued use of the debt indicator, essentially eliminating the RAL market. However, most consumers who formerly received a RAL now appear to be using a similar product, the refund anticipation check (RAC). The RAC appears to cost less than the RAL but it can still be quite expensive. RACs are temporary bank accounts opened by paid preparers, where tax filers direct their refunds. Tax filers are allowed to pay fees out of their RACs. When the IRS deposits the refund, the paid preparer subtracts fees from the account, and then the tax filer can access the remainder.

In 2014, the National Consumer Law Center reported that more than 21 million consumers obtained RACs. Unlike RALs, RACs do not allow consumers faster access to anticipated refunds (Wu 2015). The vast majority of RAC consumers—about 83 percent—have low incomes. In fact, about half are EITC recipients (Wu 2015).

Key Elements of the U.S. Tax System

Why do low-income families use tax preparers?

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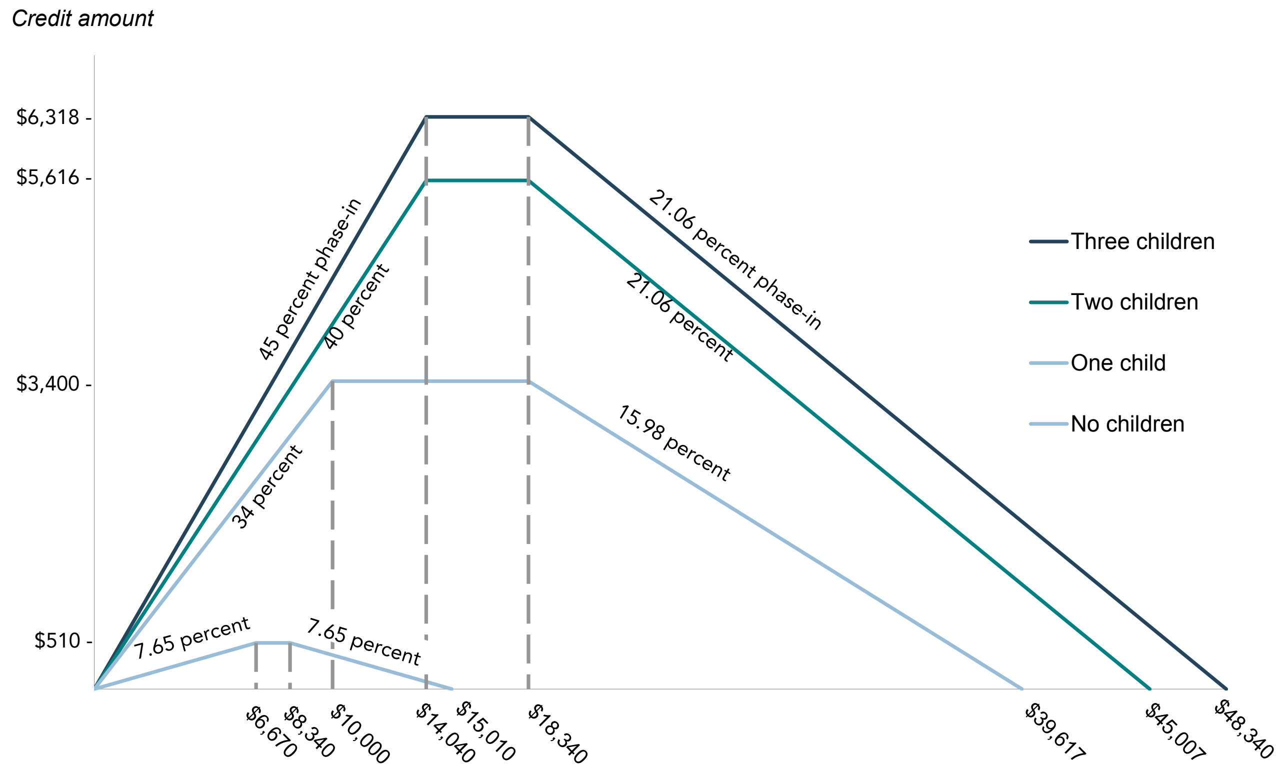
Key Elements of the U.S. Tax System

Q. How does the EITC affect poor families?

A. The EITC is the single most effective federal antipoverty program for working age households — providing additional income and boosting employment for low-income workers.

In 2017, the earned income tax credit (EITC) will provide credits ranging from $510 for workers with no children to $6,318 for workers with at least three children (figure 1).

FIGURE 1
Earned Income Tax Credit
2017



Source: Tax Policy Center, IRS Rev. Proc. 2016-55.
Note: Assumes all income comes from earnings. Amounts are for taxpayers filing a single or head-of-household tax return. For married couples filing a joint tax return, the credit begins to phase out at income $5,590 higher than shown.

How does the EITC affect poor families?

POVERTY AND THE EITC

Official estimates of poverty compare the before-tax cash income of families of various sizes and compositions with a set of thresholds. Many social transfer programs use the poverty thresholds to determine program eligibility. The official poverty measure excludes the effect of federal tax and noncash transfer programs on resources available to the family. Thus, although the EITC adds income to poor households, it does not change the official number of those living in poverty.

To understand how the social safety net changes resources, the US Census Bureau has developed a supplemental poverty measure (SPM) that includes additional resources available to families (and additional expenses) not captured in the official measure (Renwick and Fox 2016). To determine how well off a family is, the SPM compares resources available to resources needed, taking into account regional differences.

Resources needed include not only basic items such as food and housing, but also taxes and expenses such as those associated with work and health care. Resources available include government transfers, including noncash transfers, and refundable tax credits such as the EITC. Official Census publications show that together, the child tax credit (CTC) and the EITC lifted 9.2 million people out of poverty in 2015 (Renwick and Fox 2016). The Center on Budget and Policy Priorities separates the effects of the EITC and the CTC and calculates that the EITC was responsible for lifting 6.5 million people out of poverty (CBPP 2016). This makes the EITC the single most effective program targeted at reducing poverty for working-age households.

REDUCING POVERTY BY ENCOURAGING WORK

Substantial research confirms that the EITC encourages single people and primary earners in married couples to work (Dickert, Houser, and Sholz 1995; Eissa and Liebman 1996; Meyer and Rosenbaum 2000, 2001). The credit, however, appears to have little effect on the number of hours people work once they are employed. Although the EITC phaseout could cause people to reduce their work hours (because credits are lost for each additional dollar of earnings, effectively a surtax on earnings in the phaseout range), there is little evidence that this actually happens. (Meyer 2002).

The most recent relevant study found that a $1,000 increase in the EITC led to a 7.3 percentage point increase in employment and a 9.4 percentage point reduction in the share of families with aftertax and transfer income in poverty (Hoynes and Patel 2015). If this employment effect were included in census estimates of poverty reduction (rather than just the dollars transferred through the credit), the number of people lifted out of poverty would be much greater.

How does the EITC affect poor families?

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Q. What are error rates for refundable credits and what causes them?

A. The IRS estimates two types of error rates for the earned income tax credit (EITC): the improper payment rate and the over-claim rate. The former includes IRS enforcement activities while the latter does not. The IRS has estimated an EITC improper payment rate of between 22 and 26 percent of EITC payments and an over-claim rate of between 28 and 39 of claims.

IMPROPER PAYMENTS IN THE EITC

Extrapolating from the IRS's National Research Program compliance study of individual income tax returns for tax year 2009, the Treasury Department projected that in fiscal year 2013 between 22.1 percent and 25.9 percent of total EITC program payments were improper (US Department of the Treasury 2013). The Office of Management and Budget identified the earned income tax credit (EITC) as having the highest improper payment rate and the second-highest improper payment amount among 13 "high-error" programs.

Errors can stem from intentional fraud or innocent mistakes made by taxpayers—the latter, a likely result of complex rules associated with the EITC. Studies by Treasury analysts indicate that only a minority of improper payments stem from fraudulent actions (Holtzblatt and McCubbin 2002).

The estimated 22.1–25.9 percent range is likely higher than the actual error rate. A 2004 study by the Taxpayer Advocate found that, in 2002, among 67,000 people who sought reconsideration of their audit results, 43 percent were owed the entire or almost entire EITC claim that had initially been denied.

EITC OVER-CLAIMS

A more recent IRS study of returns claiming the EITC found that from 2006 to 2008, between 28.5 and 39.1 percent of all EITC claims represented over-claims totaling between $14.0 billion and $19.3 billion (IRS 2014). The largest source was error in classifying children as "qualified." Roughly 75 percent of all tax returns with qualifying-child errors violated the requirement that children live with the taxpayer in the United States for more than six months of the year (IRS 2014).

What are error rates for refundable credits and what causes them?

IRS RESPONSE

The IRS is combating improper payments by implementing due diligence requirements for paid preparers (IRS 2015). The IRS has tried to strengthen paid-preparer regulation before, but the courts ruled in 2012 that the agency had overstepped its authority and would not be allowed to require competency tests of some preparers (Taxpayer Advocate 2013).

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Q. How do IRS audits affect low-income families?

A. The IRS audits a disproportionate (but still small) share of tax returns that include EITC claims. The agency has found that average discrepancies between taxes owed and taxes paid are smaller on EITC returns than on all returns.

IRS AUDITS OF EITC RETURNS

In FY 2015, the IRS audited 1.4 million of the almost 192 million returns filed, less than 1 percent of the total. Returns claiming an EITC were audited at a rate more than twice that of all individual income tax returns: 1.7 percent compared with 0.8 percent. Almost all these audits (92 percent) were correspondence audits, meaning the tax filer was no-tified and could respond by mail.

For all individual income tax returns audited in FY 2015, the IRS recommended higher taxes on 89 percent. For EITC returns, the agency recommended higher taxes on a slightly higher 91 percent. The average amount of money the IRS attempted to collect on all audited returns was $10,022. The average amount on audited EITC returns was $4,917. The IRS recommended additional refunds on 3.2 percent of all individual income tax returns versus 1.2 percent of EITC returns. The average recommended refund on all returns was $27 compared to $5 for EITC returns.

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Q. What kind of tax-favored retirement accounts are there?

A. Tax-favored retirement accounts can be sliced and diced in various ways. There are three big differences, though: who sponsors them, who bears the risk, and when Uncle Sam takes his cut.

Defined-benefit plans generally distribute funds on a regular basis during retirement according to formulas that account for employees' years of work and earnings. In defined-contribution plans, of which the 401(k) plan is the most common, balances depend on the size of past employee and employer contributions and on the investment returns accumulated on those contributions.

Accounts established by individuals include two types of individual retirement accounts (IRAs): traditional IRAs and Roth IRAs. Like 401(k)s, traditional IRAs allow taxpayers to deduct their contributions, up to a preset limit, from taxable income. Tax liability is only triggered when funds are distributed to the account owners. By contrast, contributions to Roth IRAs and Roth 401(k)s yield no tax breaks when they are made, but distributions to retirees, including accumulated investment income, are tax-free.

Employers are not required to offer retirement benefits to their employees, and only about half of all workers receive them. Employees of large companies are more likely to receive employer-sponsored retirement benefits than their counterparts in small firms. In 2015, about two-thirds of workers at medium-size and large firms received retirement benefits, compared with about one-third of workers at small firms. In 2015, almost all government employees (89 percent) received retirement benefits of one sort or another.

Participation in retirement accounts initiated by individuals rather than employers is less common. In 2013, only around 14 percent of households contributed to any type of IRA.

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Q. How large are the tax expenditures for retirement savings?

A. The expenditures are very large, indeed. They topped $158 billion in 2015 and will likely exceed $1 trillion over the 2015–19 period.

Tax expenditures are revenue losses attributable to special exclusions, exemptions, deductions, credits, and other provisions in the tax code. Congress's Joint Committee on Taxation (JCT) calculates the tax expenditure for retirement savings as the sum of the revenue loss due to the tax-exclusion for current-year contributions and earnings on account balances, minus the revenue from taxation of current-year pension and IRA distributions (table 1).

TABLE 1

Tax Expenditures for Retirement Savings

Billions of dollars, 2015–19

Plan type	2015	2015-19
Pension plans	**129.4**	**881.5**
Defined benefit plans	48.6	315.6
Defined contribution plans	72.8	504.8
Keogh plans	8.0	61.1
Individual retirement plans	**28.0**	**116.7**
Traditional IRAs	20.9	77.2
Roth IRAs	7.1	39.5
Credit for elective deferrals and contributions	**1.2**	**6.0**
Total expenditures	**158.6**	**1,004.2**

Source: Joint Committee on Taxation, 2015.

The White House Office of Management and Budget (OMB) publishes tax expenditure estimates calculated in a similar fashion by the Treasury's Office of Tax Analysis (OTA). OMB also publishes alternative estimates that take into account the deferral of tax payments on pension and IRA contributions and earnings. That calculation is the sum of the immediate revenue loss due to retirement savings contributions, plus the "present value" of revenue loss that occurs as a result of the tax exemption for accrued earnings on that contribution in future years, minus the present value of the revenue due upon future withdrawals (table 2).

Key Elements of the U.S. Tax System

How large are the tax expenditures for retirement savings?

TABLE 2

Present Value of Tax Expenditures for Retirement Savings

Billions of dollars, 2015

Plan type	2015
Employer plans	**97.1**
Defined benefit plans	25.0
Defined contribution plans	67.2
Self-employed plans	5.0
Individual retirement plans	**6.5**
IRA contributions and earnings	1.4
Roth earnings and distributions	4.7
Non-deductible IRA earnings	0.4

Source: Office of Management and Budget (2016).

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Q. What are defined-benefit retirement plans?

A. Lifetime annuities promised by employers and, in most cases, partially guaranteed by the federal government.

RISKS

In contrast to other types of retirement accounts, the risk in a defined-benefit plan is borne mostly by the employer. If retired employees live longer than anticipated, or if the investments financing the employees' pensions fail to meet expectations, it is the employer's responsibility to increase contributions to make good on the promised benefits. Defined-benefit plans are thus more likely to be offered by large employers, who are better suited to bear the risk and to spread fixed administrative costs across larger numbers of participants.

However, not all the risk falls on employers. Defined-benefit plans are insured by the Pension Benefit Guarantee Corporation, a federal entity which ensures that retired employees receive at least some of their benefits if their employers are unable to pay the promised sums in full.

TRENDS

Defined-benefit plans have been falling in popularity (at least among employers) over the past few decades. From 1991 to 2003, the share of full-time employees at medium-size and large establishments with defined-benefit plans fell from 59 percent to 33 percent. Over the next 12 years, that share fell to just 25 percent. Defined-benefit plans, however, are still the most common type of plan for government employees.

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Key Elements of the U.S. Tax System

Who uses tax-favored retirement savings accounts?

Q. Who uses tax-favored retirement savings accounts?

A. Almost all workers are eligible, but only half take advantage of them.

TABLE 1

Participation in Tax-Favored Retirement Plans

Percentage of eligible workers participating by type of plan, 2006

	Any plan	IRAs	401(k) type plans	Non-contributionary plans
Age				
Under 30	33	4	16	15
30-44	57	7	34	20
45-59	64	10	39	19
60 and over	45	9	23	15
All ages	52	7	29	18
Income ($2006 in thousands)				
Under 20	17	2	5	11
20-40	47	5	23	21
40-80	65	9	38	22
80-120	77	12	50	21
120-160	81	15	58	17
160 and over	81	11	56	14
All incomes	52	7	29	18
Marital status of earner				
Unmarried	41	5	22	16
Married				
Sole	52	8	30	17
Primary	74	10	48	20
Secondary	57	10	31	20
All earners	52	7	29	18

Source: Congressional Budget Office, "Use of Tax Incentives for Retirement Saving in 2006," CBO Background Paper (Washington, October 2011).

Key Elements of the U.S. Tax System

Who uses tax-favored retirement savings accounts?

Participation in tax-favored retirement savings accounts varies dramatically with age (Table 1). In recent years, about one-third of workers under age 30 participated, compared with almost two-thirds of workers ages 45 to 59. By the same token, participation varies with earnings (Table 1). About four in five high-income workers participate, but slightly fewer than one in five low-income workers participate.

401(K) CONTRIBUTIONS

In recent years, the participation rate of higher-income workers in 401(k)-type plans was more than twice that of lower-income workers. Among workers who participated, contributions were highly correlated with income. The average contribution in 2006 was $4,352. But workers earning over $160,000 contributed more than twice the mean ($11,004) and those earning $20,000 to $40,000 averaged just $1,288.

INDIVIDUAL RETIREMENT ACCOUNT CONTRIBUTIONS

Participation rates in traditional IRAs increase with income. The relationship between participation and income is less straightforward for Roth IRAs because eligibility is limited to those with adjusted gross incomes under $193,000 (for married workers in 2015).

IRA contribution limits are more restrictive than those for 401(k)s. Partly as a result of these restrictions, average contributions vary less than for 401(k)-type plans. In 2006, the average contribution to an IRA was $2,718. Those with incomes in the $20,000 to $40,000 range contributed an average of $2,587, while those earning more than $160,000 averaged $3,920. As workers approach retirement, the average contribution increases. There is little difference in contribution levels to IRAs for married and unmarried workers.

Among those with traditional IRAs, 52 percent maxed out their contributions in 2006, with a significantly higher proportion of high-income taxpayers hitting the limit. Among those with Roth IRAs, 39 percent contributed the maximum amount—again, with higher-income taxpayers doing so more frequently. This pattern illustrates one reason why proposals to increase the maximum tax-favored IRA contribution would disproportionately benefit the affluent.

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Q. What are defined-contribution retirement plans?

A. Think savings accounts with tax benefits—and a lot of rules.

Tax-deferred defined-contribution plans include 403(b) plans for nonprofit employees, 457 plans, mostly for state and local government employees, and the more familiar 401(k) plans.

TRENDS

The share of employees with defined-contribution plans has slowly increased over the last 25 years. From 1991 to 2003, participation of full-time employees at medium-size and large enterprises rose from 48 percent to 51 percent; in 2015 that figure reached 56 percent. All told, about half of all workers have defined-contribution accounts. However, within the defined-contribution plan universe, participation in savings type plans has grown at the expense of profit-sharing plans, which benefit from employer contributions.

RISKS

Defined-benefit plans offer employees a contractually assured annuity at retirement; in contrast, owners of defined-contribution plans bear the risk of underperforming assets and the possibility of outliving the income generated. This risk can be managed if employees use the assets in their plans to purchase annuities from insurance companies at retirement.

CONTRIBUTIONS AND WITHDRAWALS

Contributions to defined-contribution plans are tax-deferred, meaning that neither the employer nor the employee pays tax on the initial contributions or accumulating plan earnings. However, employees pay when they withdraw funds. The major exception is Roth-type defined-contribution plans. With these plans, taxes are due on contributions when they are made rather than when the contributions are withdrawn.

Withdrawals from defined-contribution accounts incur penalties (above regular income tax), except for specified purposes ranging from financial hardship to higher education to the first purchase of a home.

Key Elements of the U.S. Tax System

What are defined-contribution retirement plans?

Further Reading

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Q. What types of nonemployer-sponsored retirement savings accounts are available?

A. The two big types are traditional individual retirement accounts (IRAs) and Roth IRAs. The main difference: when the feds take their cut.

TRADITIONAL IRAS VERSUS ROTH IRAS

Workers and their spouses do not need their employers' help to save in tax-favored retirement accounts. Individual retirement accounts mostly come in two forms: traditional IRAs and Roth IRAs. (Other types of IRAs, such as IRA-SEPs and SIMPLE-IRAs, are only available through employers.) The primary difference is in the timing of the tax on contributions.

Qualified contributions to traditional IRAs are excluded from tax and allowed to grow tax-free, but withdrawals are taxed. Contributions to Roth IRAs, conversely, are taxed in the year they are made. But account assets are allowed to grow tax-free, and withdrawals during retirement years are not taxed. Even though the statutory contribution limits are the same for both types of accounts, the effective amount that a saver can place in tax-preferred status is higher with a Roth IRA because the contribution is made with post-tax income.

As of 2015, 40.2 million households (or 32 percent) owned at least one IRA. Some 30.4 million households (or 24.4 percent) held traditional IRAs, while 20.3 million owned a Roth IRA. Some households owned both.

THE FINE PRINT

These rules are a bit confusing. Taxpayers with income greater than a specified level, which varies with tax filing status, may not contribute to a Roth IRA and may not deduct contributions to a traditional IRA. Nor may taxpayers who participate (or whose spouses participate) in employer-provided pensions deduct traditional IRA contributions if their income exceeds a specified limit.

For single taxpayers without access to an employer-sponsored pension, and for married couples in which neither spouse participates in such a pension plan, there are no income restrictions on the deductibility of traditional IRA contributions. A married taxpayer who does not participate in an employer-sponsored plan, but whose spouse does, may contribute the maximum statutory amount to an IRA, provided the couple's joint income does not exceed $186,000.

Key Elements of the U.S. Tax System

What types of nonemployer-sponsored retirement savings accounts are available?

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Q. What are Roth individual retirement accounts?

A. Roth individual retirement accounts (IRAs) offer no up-front tax breaks. However, withdrawals of earnings as well as principal (with some restrictions) are not taxed.

OVERVIEW

A Roth IRA is a form of an individual retirement account in which contributions are made with after-tax earnings. Eligibility is limited by income. There's still a big tax break: contributions are allowed to accrue tax-free in the account, and withdrawals are not taxed under normal circumstances. In 2015, 20.3 million people, representing 16.3 percent of all US households, owned a Roth IRA.

ELIGIBILITY AND CONTRIBUTION LIMITS

Only people with incomes under specified limits are eligible to contribute to a Roth IRA. In 2017, the contribution limit for IRAs is the lesser of $5,500 ($6,500 for individuals over age 50) or the taxpayer's taxable compensation. The contribution limit falls once household income exceeds certain thresholds and eventually reaches zero (table 1).

TABLE 1
Eligibility and Contribution Limits
2017

Filing status	Modfied Adjusted Gross Income	Contribution
Single or Head of Household	Less than $118,000	$5,500 (or $6,500 if over 50)
	Between $118,000 and $133,000	A reduced amount
	$133,000 and over	Zero
Married filing jointly or qualifying widow(er)	Less than $186,000	$5,500 (or $6,500 if over 50)
	Between $186,000 and $196,000	A reduced amount
	$196,000 and over	Zero
Married filing separately	Zero	$5,500 (or $6,500 if over 50)
	Between zero and $10,000	A reduced amount
	$10,000 and over	Zero

What are Roth individual retirement accounts?

WITHDRAWALS

Investors are allowed to withdraw their contributions (but not investment returns earned on those contributions) at any time without being subject to tax. However, to receive tax benefits on investment returns, withdrawals must be qualified distributions, meaning that funds were withdrawn 5 years after the first contribution was made and after the contributor reaches age 59 years and 6 months, dies, becomes disabled, or makes a qualified first-time home purchase. Nonqualified distributions do not satisfy the above conditions and are therefore taxed and subject to a 10 percent penalty tax. There are several exceptions to the penalty for the early withdrawal of investment earnings.

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Q. How does the availability of tax-favored retirement saving affect national saving?

A. It only increases private saving if the tax breaks encourage households to set aside additional cash rather than simply transferring it from other nest eggs. It only increases national saving if the increase in private saving exceeds the revenue loss from the tax subsidy.

Tax-favored retirement savings accounts are popular: half of working adults take advantage of them. It's unclear, however, whether they make much difference to overall savings and retirement preparedness. Although traditional pensions and other tax-deferred vehicles such as 401(k) plans and individual retirement accounts (IRAs) do make up a sizable share of households' wealth, the accounts only increase private saving if they encourage households to finance their own contributions through reductions in consumption or increases in earnings.

Put another way, incentives do not increase private saving if households finance their contributions by borrowing, by shifting their existing assets into tax-favored accounts, or by shifting current saving that would have occurred even in the absence of the incentive. Likewise, there is no increase in private saving if households respond to employer-provided pensions or contributions with equivalent reductions in other saving or with increased borrowing.

The earliest research on both traditional defined-benefit pensions and defined-contribution plans suggested that they had a very strong impact on private wealth and saving. These studies, however, were marred by technical missteps, and later research has found a significantly smaller impact—and, in some cases, none at all.

To the extent that the tax incentives do raise saving, the impact can be expected to be greater for lower- and middle-income households than for high-income households, who tend to use the accounts as a means to reduce present or future tax liability.

Key Elements of the U.S. Tax System

How does tax-favored retirement saving affect national saving?

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Q. What's the difference between front-loaded and back-loaded retirement accounts?

A. Your choice: pay the IRS now or pay them later.

Broadly speaking, there are two types of tax-favored retirement accounts: "front-loaded" accounts, such as traditional IRAs and 401(k)s, and "back-loaded" accounts, such as Roth IRAs. With front-loaded accounts, contributions are tax-deductible but withdrawals are taxed. These accounts are also called EET accounts (the contribution is *exempt* from taxation, the accrual of returns is *exempt* from taxation, the withdrawal is *taxed*). In back-loaded accounts, contributions are not tax-deductible but accruals and withdrawals are tax-free. These accounts are also called TEE accounts (contributions *taxed*, accruals *exempt*, withdrawals *exempt*). In both types of accounts, investment returns on assets kept within the account (accruals) are untaxed.

Which is a better deal? That depends on the difference between individuals' tax rates during their working years and during retirement. Individuals with high tax rates during their working years and lower rates during retirement benefit more from front-loaded accounts, since the original contributions are deducted against high tax rates and withdrawals are taxed at lower rates. Someone who expects to be in a higher bracket in retirement would benefit more from a back-loaded account.

The example in Table 1 shows that if tax rates during working years and retirement are the same, front- and back-loaded accounts yield the same result.

Consider a front-loaded account first. Say an individual faces a 25 percent tax rate when making both contributions and withdrawals, makes a before-tax contribution of $2,000, earns 5 percent per year, and withdraws all funds after 10 years. In a front-loaded account, the individual will be able to contribute the full $2,000. The account will accumulate interest, and after 10 years the balance will be $3258. Upon withdrawal, the individual will pay $814 in taxes, leaving net retirement assets of $2,443. With a back-loaded account, an individual pays a 25 percent tax on $2,000 in income, leaving $1,500 to contribute to the account. With the same 5 percent return, the balance will grow to $2,443. Since no taxes will be paid on withdrawal, after-tax proceeds are $2,443, which is the same as in the front-loaded example.

Key Elements of the U.S. Tax System

What's the difference between front-loaded and back-loaded retirement accounts?

TABLE 1
Front and Back Loaded Savings Accounts with Constant Tax Rate
$2015

Plan overview		
Tax rate: 0.25		
Interest: 0.05		
Time (years): 10		
	Front loaded	Back loaded
Before tax income	2,000	2,000
Less: taxes paid (25%)	0	500
Contribution	2,000	1,500
Accumulated balance in account	3,258	2,443
Less: taxes paid on withdrawal (20%)	814	0
After-tax proceeds	2,443	2,443

Now check out the example in Table 2, the tax rate decreases from 25 percent during working years to 20 percent during retirement. Here, the front-loaded account will accrue $163 more than the back-loaded account, since taxes are imposed upon withdrawal, when rates are lower. Of course, the conclusion is reversed if the tax rate is higher during retirement than during working years.

TABLE 2
Front and Back Loaded Accounts with Lower Tax Rate at Retirement
$2015

Plan overview		
Tax rate T0: 0.25		
Tax rate T10: 0.20		
Interest: 0.05		
Time (years): 10		
	Front loaded	Back loaded
Before tax income	2,000	2,000
Less: taxes paid (25%)	0	500
Contribution	2,000	1,500
Accumulated balance in account	3,258	2,443
Less: taxes paid on withdrawal (20%)	652	0
After-tax proceeds	2,606	2,443
Tax savings from front loaded account: 163		

Key Elements of the U.S. Tax System

What's the difference between front-loaded and back-loaded retirement accounts?

That's not quite the end of the story, though. If the two accounts have the same contribution limit, an individual can shelter more savings in a back-loaded account than in a front-loaded account. For example, if an individual facing a 25 percent marginal income tax rate contributes $2,000 to a front-loaded account, he or she is really contributing $1,500 and $500 of government funds because of the tax deduction. When the funds are withdrawn, the government reclaims its share of the principal contribution, plus taxes on interest earned (table 3). In a back-loaded account, however, taxes are paid on the initial contribution and interest can be withdrawn tax-free. Note the distinction here. The value of the tax shelter per dollar saved is the same with either account. However, if the nominal contribution limits are identical, a determined saver can sock away more with a back-loaded account.

TABLE 3

Tax Savings in Front and Back Loaded Savings Accounts with Constant Tax Rate

$2015

Plan overview		
Tax rate: 0.25		
Interest: 0.05		
Time (years): 10		
	Front loaded	Back loaded
Contribution	2,000	2,000
Own income	-1,500	-2,000
Government tax expenditure	-500	0
Accumulated balance in account	3,258	3,258
Taxes paid on withdrawal	814	0
After-tax proceeds	2,443	3,258
Additional savings with back loaded account: 814		

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Key Elements of the U.S. Tax System

Q. What is an automatic 401(k)?

A. An Automatic 401(k) enrolls workers automatically, assigning them a default contribution rate and allocation of funds that they are free to change later.

An automatic 401(k) is one that automatically enrolls workers in the plan, rather than requiring them to sign up. Eligible workers are assigned a default contribution rate—often 3 percent of wages—and a default allocation of funds contributed to the retirement account. As with traditional 401(k)s, workers are still in control; they can change the default contribution rate and allocation or opt out entirely. The main difference: with an automatic 401(k), inaction on the worker's part will automatically result in the worker saving for retirement.

This difference is, as a practical matter, significant. With traditional 401(k) plans, workers must decide whether to sign up, how much to contribute, how to allocate their investment funds, how often to rebalance their portfolios, what to do with the accumulated funds when they change jobs, and when and in what form to withdraw the funds during retirement. These decisions are difficult, and many workers, daunted by the complexity, either make inappropriate choices or never sign up at all.

With an automatic 401(k), sometimes called an "opt-out plan," unless workers make the active decision not to participate, each stage of the savings and investment allocation process is automatically set at a pro-saving default. Workers can choose to override any of these choices, but the inertia that discourages so many from opting in to a traditional 401(k) is now likely to keep them on the default path.

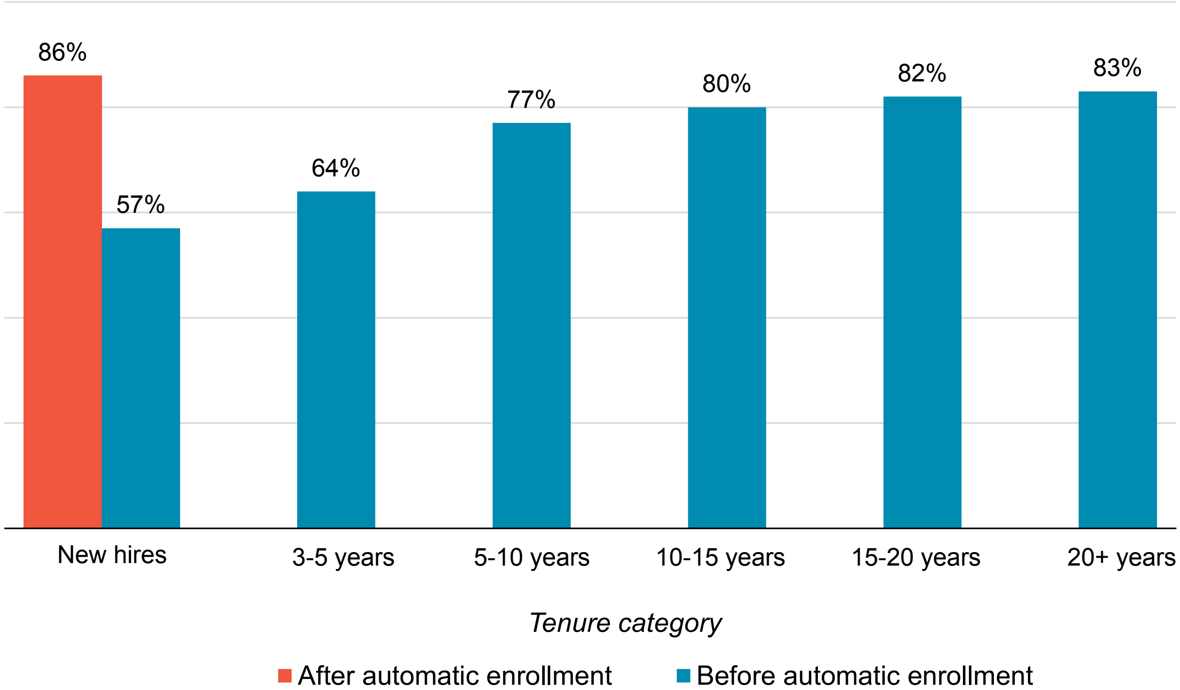
Figure 1 shows that automatic enrollment raises 401(k) participation rates among new hires. This is especially true for women, minority groups, and low earners.

The automatic escalation of default contributions over time raises overall contributions to 401(k)s relatively painlessly as employees become accustomed to deferring the receipt of a portion of their pay. The gradual escalation also helps ensure that inertia does not keep employees at a default contribution rate lower than the rate they might have chosen without the default.

What is an automatic 401(k)?

FIGURE 1

Participation Rates in 401(k) by Tenure: Pre- and Post-auto 401(k)



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Key Elements of the U.S. Tax System

Q. How might low- and middle-income households be encouraged to save?

A. Expanding access to savings vehicles and scaling back deductions to provide greater incentives to low- and middle-income households could make a difference.

Low- and middle-income families receive significant income support through tax breaks, notably through refundable credits such as the earned income tax credit and the child tax credit. When it comes to building wealth, however, the tax code's more than $400 billion in subsidies—incentives for everything from homeownership to health insurance to higher education—go mainly to high-income households.

Roughly 70 percent of the mortgage interest deduction and deductions for state and local property taxes, along with about two-thirds of subsidies for employer-based and individual retirement accounts, go to the top 20 percent of earners. That's because these tax subsidies are structured as deductions and exclusions, which provide bigger subsidies to households in higher tax brackets. Further, lower-income households are less likely to have enough deductions to make it worthwhile to itemize on their tax returns, and itemization is required for claiming major homeownership tax breaks. Lower-income workers, particularly those in part-time or temporary employment, have less access and are less likely to participate in employer-based retirement plans.

At the same time, many low- and middle-income taxpayers simply do not participate in the regular and automatic saving vehicles through which much wealth accumulation occurs, such as paying off a mortgage and making regular deposits to retirement accounts.

A variety of changes would reduce the bias toward higher-income households by replacing existing subsidies with better-targeted incentives. Almost all these proposals favor some movement toward tax credits and scaling back deductions, and many use insights from behavioral economics to get more bang for a tax buck forgone.

How might low- and middle-income households be encouraged to save?

HOMEOWNERSHIP

Credits to encourage homeownership can take different forms. They can provide an up-front credit for first-time homebuyers of primary residences, similar to a temporary credit employed as a stimulus measure from 2008 to 2009. (An early version of this credit served as an interest-free loan to be paid back to the IRS.) Alternatively, homeowners could receive smaller annual credits proportional to their home equity, up to a designated maximum. Another approach is to provide a credit against property taxes paid on a home to defray a significant cost of homeownership. Reforms that reward building equity instead of subsidizing mortgage interest (which a badly designed credit could also do) would encourage actual saving instead of the acquisition of debt.

RETIREMENT

A saver's credit is available to moderate-income taxpayers who contribute to qualified retirement plans. However, the credit is nonrefundable and phases out quickly at higher levels of income, making few people eligible for the maximum amount. Some economists have proposed expanding the credit and making it refundable, so that workers with no net income tax liability could claim it. More expansive proposals include reshaping the complicated pension landscape to simplify plans and increase access to employer-based retirement accounts with automatic enrollment. Contribution limits to tax-favored accounts would be lowered, and low- and moderate-income workers would instead receive government matches on their contributions. Any credits or matching employer contributions could not be accessed until retirement. Pension antidiscrimination rules could be revised to favor plans that support a larger percentage of full- and part-time employees.

ENCOURAGE SAVINGS AND ACCOUNT OWNERSHIP AT TAX TIME

Many low- and middle-income workers receive large refunds at tax time from refundable tax credits. A "saver's bonus" could be offered to encourage taxpayers to save a portion of their refunds in qualified savings accounts. Taxpayers are already able to contribute to individual retirement accounts until the tax filing deadline and apply any deductions or saver's credits against their tax year's liability. Some tax preparers and tax preparation software remind taxpayers that they are able to do this and make clear how much tax they can save if they do. Tax time could also be used to link taxpayers to savings vehicles, such as children's savings accounts or prepaid cards with savings features for taxpayers without bank accounts.

Key Elements of the U.S. Tax System

How might low- and middle-income households be encouraged to save?

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What is the myRA?

Q. What is the myRA?

A. The myRA is a Roth-structure retirement savings account targeted at low-income households and those without access to an employer-sponsored plan.

Launched in December 2014 by executive order, the myRA program is a savings plan offered by the US Treasury that's intended to encourage retirement saving among low-income individuals lacking employer-sponsored accounts or other convenient saving options. As of March 2016, 10,000 people opened a myRA account, with a median monthly contribution of $50. MyRAs have a Roth IRA structure and follow more or less the same rules as private-sector Roth IRAs. The sole investment available is a new Treasury security that earns the same interest rate as the government bond fund available to federal employees.

After accounts reach a maximum balance of $15,000 or have been in existence for 30 years, savings must be rolled over to a Roth IRA in the private sector. Currently, the only way for an individual to contribute funds to a myRA account is to establish a direct-deposit system with an employer. MyRAs do not have start-up fees or account maintenance fees.

Further Reading

US Treasury Department. MyRA website.

Key Elements of the U.S. Tax System

Q. How are charitable contributions treated?

A. Corporations and individual taxpayers who itemize can deduct charitable contributions to 501(c)(3) organizations.

Many nonprofit institutions are exempt from paying federal income tax, but only organizations set up under Internal Revenue Code section 501(c)(3) qualify their donors to deduct contributions on their income tax returns. Donations to other nonprofits are made after taxes.

Since 1917, individual taxpayers have been able to deduct charitable contributions from income that might otherwise be taxed. Today, individuals may deduct cash and certain other contributions up to 50 percent of adjusted gross income (AGI) in a given year and may carry forward any excess for deduction on future tax returns for up to five years. An important caveat: Only taxpayers who choose to itemize may take the charitable deduction; taxpayers who instead claim a standard deduction generally get more deductions that if they itemize but, as a result, get no additional incentive for contributions to charity.
In 1935, Congress extended the right to deduct charitable contributions to corporations. Corporations may not deduct more than 10 percent of their pretax income in a given year, but, like individuals, may carry forward excess donations for five years. Some corporate contributions, however, might also qualify as business expenses.

Contributions by individuals or corporations can take the form of cash, financial assets, or other noncash property such as real estate, clothing, or artwork. Certain contributions face greater restrictions than cash contributions, whereas others receive more generous treatment than cash. The limit for donations of appreciated real property is generally 30 percent of AGI, and the limit for contributions to private nonoperating foundations is the same. But donors may deduct the full current market value of appreciated property. This effectively allows the capital gains portion to be deducted twice: donors pay no tax on the capital gain, and then they reduce their other income subject to tax by the amount of the contributed but unrealized income.

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Q. What entities are tax-exempt as charitable activities?

A. Nonprofit organizations that do not distribute profits can be exempt from federal income tax if organized expressly for public purposes.

Although many nonprofits qualify for tax exemption, only about two-thirds also qualify to receive contributions that donors can deduct on their tax returns. These are organi-zations for "charitable purpose," defined under section 501(c)(3) of the tax code as "re-ligious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition [or] the prevention of cruelty to children or animals." This definition covers both public charities and private foundations; the latter organizations are created to distribute funds to charities or indi-viduals.
Tax-exempt organizations (including charities) include many diverse entities. The Na-tional Taxonomy of Exempt Entities—developed by the National Center of Charitable Statistics at the Urban Institute and used by the Internal Revenue Service (IRS)—classifies into 9 major groups, 26 categories, and over 600 subcategories.

The major groups are as follows:

1. Arts, culture, and humanities (e.g., art museums, historical societies)
2. Education (e.g., private schools, universities, parent-teacher associations)
3. Environment and animals (e.g., humane societies, the Chesapeake Bay Founda-tion)
4. Health (e.g., nonprofit hospitals, the American Lung Association)
5. Human services (e.g., the Girl Scouts, the YMCA, food banks, homeless shelters)
6. International and foreign affairs (e.g., CARE, the Asia Society, the International Committee of the Red Cross)
7. Public society benefit (e.g., the Rockefeller Foundation, the Urban Institute, civil rights groups, the United Way)
8. Religion-related (e.g., interfaith coalitions, religious societies)
9. Mutual membership or benefit (e.g., nonprofit credit unions, labor unions, fra-ternal organizations)

In 2013, approximately 1.41 million tax-exempt organizations were registered with the IRS. These nonprofits accounted for approximately 5.4 percent of U.S. gross domestic product and paid 9 percent of U.S. wages and salaries (as of 2014). About 35 percent of registered nonprofits are required to file annual returns (Form 990, 990-EZ, or 990-PF); organizations with gross receipts between $25,000 and $50,000 must file a simpler in-formation return known as the 990-N (e-postcard). Religious congregations, as well as organizations with less than $25,000 in gross receipts are exempted from the annual filing requirement. All private foundations are required to file the 990-PF.

Key Elements of the U.S. Tax System

What entities are tax-exempt as charitable activities?

Tax-exempt status confers multiple benefits. Not only are nonprofits exempt from federal tax on earnings from their income-producing assets and activities (other than those that generate unrelated business income), but charities also sometimes qualify to issue tax-exempt bonds and are often exempt from state and local property taxes and sales taxes.

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Q. Who benefits from charitable deductions?

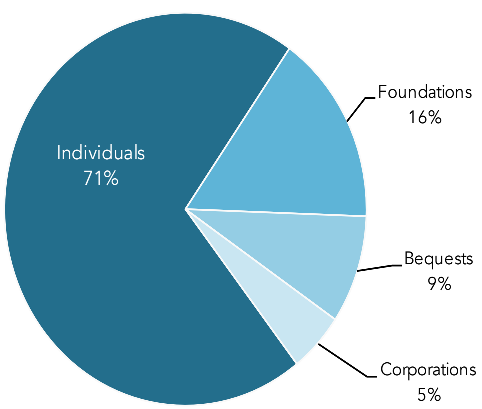
A. The charitable deduction subsidizes charitable giving by lowering the net cost to the donor.

A charitable contribution is intended for the benefit of those supported by the charitable activity, whether through education, health care, or the like. If the tax deduction spurs additional giving, charitable organizations may be able to provide more services. Do-nors are assisted in their efforts by the charitable deduction, which reduces their own tax liability.

FIGURE 1

Sources of Charitable Giving

2015



Source: Giving USA Foundation. 2016. Giving USA 2016: *The Annual Report on Philanthropy for the year 2016*. Indianapolis, IN: Giving USA Foundation.

Key Elements of the U.S. Tax System

Who benefits from the charitable deductions?

The charitable deduction subsidizes donors by lowering the net cost of the gift. Just how much the tax deductibility lowers the cost of giving depends on the donor's mar-ginal tax rate. For instance, a donor in the 30 percent tax bracket pays 30 cents less tax for every dollar donated. At the same time, the deduction subsidizes the ultimate bene-ficiaries of the charitable activities. The tax system is inconsistent about whether income should be treated as that of transferors or transferees. For instance, child support is treated as income of the transferor; alimony as income of the transferee.

Higher-income individuals generally save more taxes by giving to charity than those with lower incomes for two reasons: they have higher marginal tax rates, and they are more likely to itemize deductions and take advantage of the tax savings. About three-quarters of charitable giving comes directly from individuals, with the balance coming from their foundations, estates, and corporations (figure 1). Total contributions totaled $373.25 billion in 2015.

The deductibility of contributions subsidizes charitable activity but is also sometimes independently justified as an appropriate adjustment to the tax base. Many economists and lawyers argue that a taxpayer's taxable income should be determined by income net of contributions, since a taxpayer with, say, $50,000 of income and $10,000 of con-tributions has no more ability to consume than someone with $40,000 of income and no contributions.

Donors may choose which charitable activities to support. Thus, because part of the cost of their donations is borne by the government through reduced revenue, donors have a say in which activities the government supports.

Some donations fund activities that substitute for those the government might other-wise undertake. Other donations complement government activities, and still others support an adversarial relationship with government. Nonprofits, for instance, may seek further government funding for a given activity, or its members may engage in debates with government officials. Many believe these types of charitable activity make democracies healthier, even when particular chartable efforts have little impact.

Although the tax deduction likely induces additional giving, estimates of the size of this effect vary. Indeed, there is considerable debate over whether the increase in giving exceeds the loss of government revenue.

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Q. How could we improve incentives for charitable giving?

A. Proposals include establishing a floor on deductions in exchange for more effective incentives such as offering a nonitemizer charitable deduction, strengthening the IRA charitable rollover, revising the excise tax on foundations, raising the limit on deductions, and allowing people to claim charitable deductions for the previous year up to the time of filing tax returns, as in the case of deposits to individual retirement accounts.

Under current law, taxpayers who itemize are allowed to deduct most of their charitable contributions, thereby reducing their tax liability. Taxpayers who do not itemize have no comparable tax incentive to donate to charities. In addition, current limitations on deductions reduce existing incentives to donate. Various proposals would restructure tax incentives to encourage more giving. Some of these proposals would replace less effective incentives with more effective ones.

FLOOR ON DEDUCTIONS

One proposal would expand the existing incentive in exchange for a floor on deduc-tions. This makes sense because incentives are more powerful for the incremental dol-lar of giving than for the first dollar.

Consider a person who would give away $1,000 with no tax incentive but who would give $1,100 if offered a tax incentive to do so. Clearly, an incentive applied to the last $100 of that person's giving would have a greater effect than one for the first $100 or even the first $1,000, which would be given anyway. It therefore may make sense to allow deductions only above a floor. The revenue gains from disallowing deductions below the floor could then be used to expand other incentives. For instance, nonitem-izers who give significant amounts to charity might be allowed to deduct some of their charitable contributions.

The revenue gains from a floor could be significant. The Congressional Budget Office estimated that only allowing deductions that exceed 2 percent of adjusted gross in-come (AGI) would increase federal revenue by more than $15 billion a year. A more modest floor would still provide substantial revenues that could be used to increase other, more powerful, incentives to give.

Key Elements of the U.S. Tax System

How could we improve incentives for charitable giving?

NONITEMIZER DEDUCTION

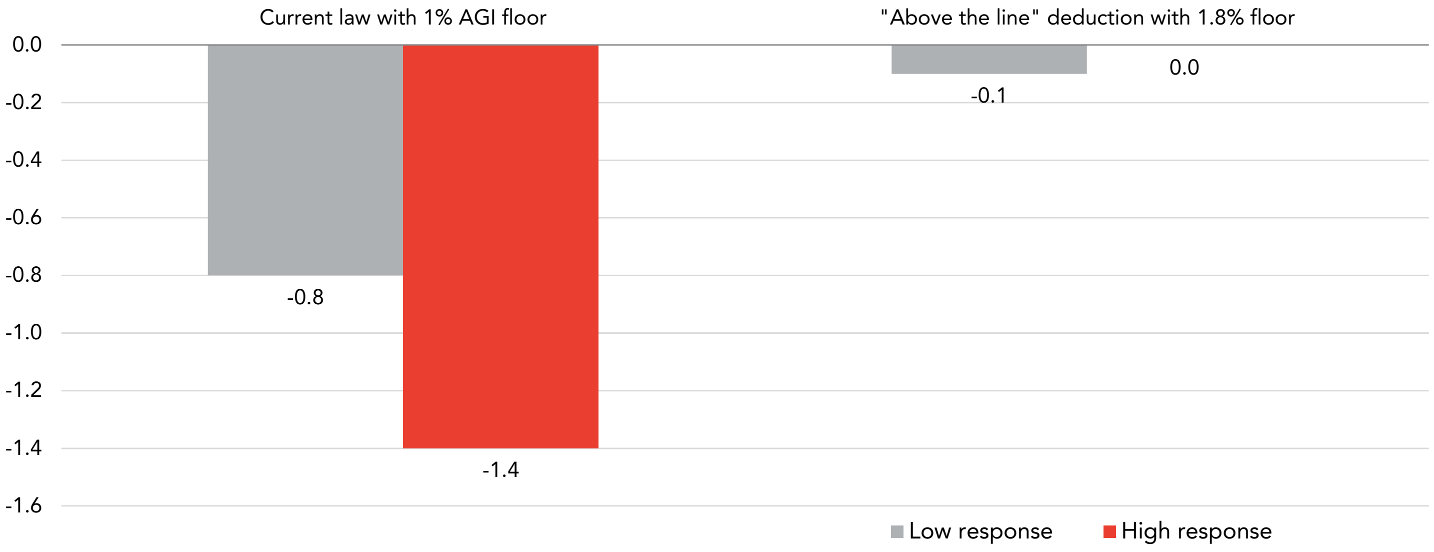
At present, taxpayers who take the standard deduction cannot claim a deduction for charitable giving. Extending the deduction to these nonitemizers would likely increase charitable contributions, but by itself might create compliance problems: the Internal Revenue Service cannot reasonably be expected to audit small donations. Also, offer-ing a deduction to nonitemizers separate from the deduction for itemizers would in-crease the complexity of filing in an already complicated income tax system. Many tax-payers would have to calculate taxes two different ways to decide whether they should take their charitable deductions as an itemizer or as a nonitemizer.

However, if a deduction for nonitemizers were combined with a reasonable floor ap-plied to all taxpayers, much or all of the revenue loss due to noncompliance would be eliminated, as would the added complexity. (Small, merely symbolic floors would not achieve this objective.) For instance, taxpayers might be allowed to claim charitable deductions greater than 1.8 percent of AGI, regardless of whether they itemize. This combination would likely have little impact on charitable giving but would raise as much as $10 billion in tax revenue, and would address concerns about administration and compliance. How much net giving would change depends upon the sensitivity of giving to incentives (figure 1).

FIGURE 1

Impact on Charitable Giving of Options to Change the Charitable Deduction

2011



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0411-2).

RAISING THE LIMIT ON THE DEDUCTION

Another option would be to raise the limit on deductions above the current 50 percent of AGI. This would significantly increase incentives at the margin for large givers. One could also make the carryover provisions more generous with respect to the 50 percent limit. Taxpayers may currently carry over excess contributions to future returns, but only for five years, and any new contributions must be deducted before any carryover.

How could we improve incentives for charitable giving?

IRA ROLLOVERS

Yet another proposal would expand the charitable individual retirement account (IRA) rollover provision. This provision allows some taxpayers over age 70 years and 6 months to donate up to $100,000 from traditional IRAs to charity without having to count the distributions as taxable income or separately take an itemizer deduction for already excluded income. Raising or eliminating the $100,000 annual limit on dona-tions, lowering the age limit to 59 years and 6 months (the age at which IRA owners may withdraw funds without penalty), or allowing such giving to be deposited in donor advised funds (currently ineligible for such tax treatment) could increase charitable giving.

FOUNDATION EXCISE TAX

Another option would eliminate or reform the excise tax on foundation income. The current excise tax on income from foundation assets was initially intended to cover the IRS's costs of overseeing the tax compliance of charitable organizations, but the monies were not appropriated. The tax rate is either 1 or 2 percent, depending on whether the year's giving equals or exceeds the average of the last few years. Under these current rules, foundations that give at above-average rates today face a penalty of being more likely to face the 2 percent rate in future years. Lowering or eliminating the tax would increase the net assets available to give to charitable beneficiaries.

Congress could also increase the minimum payouts that a foundation must make by the amount of the tax reduction. At very least, Congress could impose a single tax rate on all such income; this would eliminate the current perverse incentive for foundations to limit current grants today in order to avoid a higher tax in the future.

ALLOWING CHARITABLE DEDUCTIONS UP TO APRIL 15 OR TIME OF FILING TAX RETURNS

Another proposal that passed the House of Representatives, sometimes called the April 15 option, would allow individuals to take charitable deductions up to April 15 or the time of filing tax returns. The proposal costs the government almost nothing if there are no increases in giving because it doesn't really change the subsidy value of gifts already made. In terms of bang per buck, or increased giving per dollar of revenue cost, it ranks very high, since the incentive for the most part only loses revenues when there are additional gifts. Economic and marketing evidence supports the notion that people would give more because they would be more aware of the size of the incentive; meanwhile, tax return preparers and tax software developers would help advertise the opportunity at hand, and people would receive immediate rather than delayed support for their contributions.

Key Elements of the U.S. Tax System

How could we improve incentives for charitable giving?

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Q. How large are individual income tax incentives for charitable giving?

A. The individual income tax deduction for charitable giving provides a substantial incentive to give by reducing the economic cost of making a donation. In 2017, charitable giving by individuals is estimated to reach $292 billion at an annual revenue loss of approximately $57 billion.

An income tax deduction for charitable giving is available only to taxpayers who itemize their deductions. Estimates from the Tax Policy Center suggest that for 2017, charitable giving by individuals could reach a total of $292 billion. Itemizers are estimated to provide about 82 percent of total charitable giving; nonitemizers provide about 18 percent of total charitable giving (table 1).

Charitable Giving by Itemizers and Nonitemizers

TABLE 1

Estimated Charitable Giving by Itemizers and Nonitemizers, 2017

Under current law

Current law baseline	Itemizers	Nonitemizers
Number of tax units	45,460	129,220
Percentage of total tax units	26	74
Total giving ($ billions)	239	53
Percentage of total giving	82	18

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).

Giving by Income Group

Charitable giving patterns differ by income. Some research indicates that the value of the charitable deduction provides greater incentive for higher-income individuals because they face higher marginal rates, are more likely to itemize, and can give more to charity. Tax proposals that reduce incentives for higher-income individuals will have a disproportionate effect on the charities to which these individuals are more likely to give, such as higher education and museums. Table 2 shows the amount of charitable giving by adjusted gross income.

Key Elements of the U.S. Tax System

How large are individual income tax incentives for charitable giving?

TABLE 2

Returns with Itemized Deductions: Estimated Amount of Charitable Contributions by Adjusted Gross Income

Tax year 2014, (Filling year 2015)

AGI category	Total AGI ($ thousands)	Total itemized contributions ($ thousands)
Under $5,000	955,740	134,337
$5,000 to under $10,000	3,359,968	341,169
$10,000 to under $15,000	8,169,789	637,755
$15,000 to under $20,000	15,328,409	1,149,321
$20,000 to under $25,000	21,672,869	1,509,083
$25,000 to under $30,000	32,646,115	2,151,621
$30,000 to under $35,000	41,969,826	2,324,693
$35,000 to under $40,000	52,640,593	2,401,840
$40,000 to under $45,000	66,729,093	2,982,981
$45,000 to under $50,000	74,052,828	3,235,184
$50,000 to under $55,000	82,706,027	3,388,894
$55,000 to under $60,000	93,794,233	3,694,880
$60,000 to under $75,000	302,979,889	10,814,141
$75,000 to under $100,000	634,243,182	19,945,031
$100,000 to under $200,000	1,876,134,643	48,902,399
$200,000 to under $500,000	1,352,486,670	31,660,400
$500,000 to under $1,000,000	529,449,597	13,530,016
$1,000,000 to under $1,500,000	200,173,458	6,016,733
$1,500,000 to under $2,000,000	121,057,243	3,752,949
$2,000,000 to under $5,000,000	301,110,263	10,318,593
$5,000,000 to under $10,000,000	173,629,968	6,974,756
$10,000,000 or more	497,720,321	34,732,005
All returns	**6,483,010,725**	**210,598,779**

Source: Internal Revenue Service, Statistics of Income Division, 2014.

Note: AGI = adjusted gross income. Table only captures charitable donations reported to the Internal Revenue Service.

Average Incentive

The after-tax cost of giving is the value of the gift minus any tax benefits received. If an itemizing taxpayer with a marginal tax rate of 28 percent (that is, the tax rate on the last dollars of income) gives $100 to a local college, for instance, the gift reduces the income tax bill for that person by $28, so the deductible charitable gift has a net cost of only $72. The $28 is the amount of the federal subsidy for giving. If the taxpayer had a 40 percent tax rate, the donation becomes even less costly, at only $60. In other words, as tax rates increase, the after-tax "price" of charitable giving decreases.

Figure 1 shows a summary of the average after-tax price of charitable giving under current law. The average after-tax federal subsidy is 20.8 percent. Note that taxpayers in the top 1 percent have the lowest after-tax price of charitable giving.

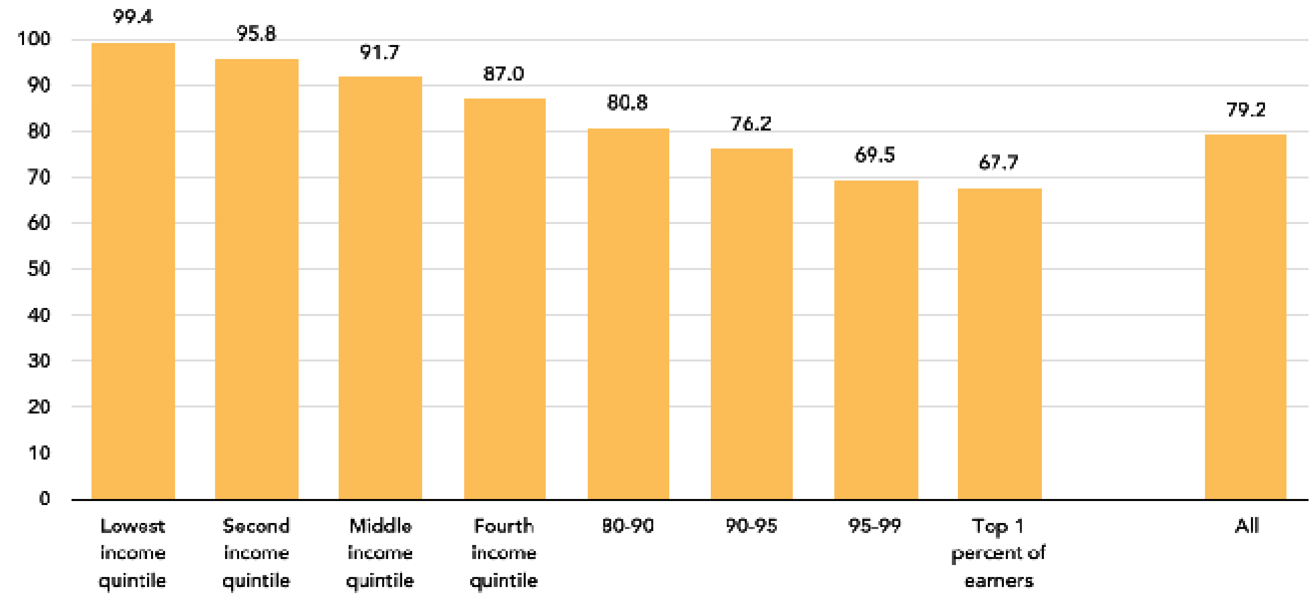
Key Elements of the U.S. Tax System

How large are individual income tax incentives for charitable giving?

FIGURE 1

Estimated Average After-Tax Price of Charitable Giving, 2017

By expanded cash income percentile, under current law



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).
Notes: Graph depicts the average marginal after-tax price of a $100 donation.

Estimated Revenue Loss from Charitable Gifts, 2016- 20

The size of the after- tax price of charitable giving can have significant policy implications. For example, if losses in federal revenue from allowing the charitable deduction are greater than the increase in charitable giving caused by the deduction, then the entire amount of the federal subsidy for giving does not flow through to the charitable organizations receiving the gifts. The charitable deduction is estimated to cost approximately $57 billion in 2017 and $293 billion over five years (2016–20).

TABLE 3

Estimated Tax Expenditures by Charitable Deductions

Fiscal years 2016–20 ($ billions)

Charitable deductions	2016	2017	2018	2019	2020
Educational institutions	$9.3	$9.6	$9.9	$10.2	$10.5
Health organizations	$4.4	$4.5	$4.6	$4.7	$4.9
Other	$41.5	$42.8	$44.1	$45.2	$46.6
Total	$55.2	$56.9	$58.5	$60.1	$62.0

Source: Joint Committee on Taxation (2017, 37–39).

How large are individual income tax incentives for charitable giving?

Limits on the Charitable Deduction

The charitable deduction has many limits. Among them are the following:

- The charitable deduction is only available for a subset of qualifying, tax-exempt organizations that are charitable in nature, as defined in section 501(c)(3) of the tax code.
- Contributions for individuals are generally allowed up to 50 percent of adjusted gross income, but there is a 30 percent limit for contributions to a foundation and certain other organizations and a 30 percent limit for contributions of capital gain property. Deductible contributions for corporations are limited to 10 percent of corporate income.
- Contributions to many tax-exempt organizations, such as unions and chambers of commerce, are not deductible, though income earned on assets within those organizations generally are excluded from taxation.

Data Sources

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Q. How might tax reforms reduce incentives for charitable giving?

A. Tax reforms can reduce charitable giving through direct and indirect changes to the tax code. The indirect effects are often greater than the direct effects from changes in rules related to charitable giving.

Several recently proposed tax reforms would, indirectly, reduce incentives for charitable giving. These reforms include reductions in marginal tax rates, caps on total itemized deductions, caps on the maximum tax rate at which all itemized deductions can be allowed, increases to the standard deduction or reductions in other itemized deductions, and elimination or reduction of the estate tax.

Reductions in marginal tax rates increase after-tax costs for charitable donations, thereby reducing the incentive to give. If an itemizing taxpayer with a tax rate of 39.6 percent gives $100 to a local college, for example, that charitable deductible gift has an after-tax cost to the taxpayer of $60.40 because of the $39.60 reduction in his or her income tax bill. If that tax rate is reduced to 33 percent, the after-tax of the donation would increase to $67 because the federal subsidy for giving falls from $39.60 to $33.

Caps on total itemized deductions could also reduce charitable giving because the caps reduce, and in many cases remove, incentives for high-income taxpayers to give. During the 2016 presidential campaign, for instance, President Trump proposed an overall cap on itemized deductions of $100,000 per single return and $200,000 per joint return. Higher-income taxpayers with mortgage interest, property tax, and other deductions in excess of such amounts would have no tax incentives to give to charity because charitable gifts would not add to their deductions. Though only a small percentage of taxpayers have such high incomes, research suggests that high-income tax payers are more responsive to tax reforms that affect charitable giving because they have more income, more tax advisers, and more incentive to devote time to figuring out the after-tax price of giving.

A maximum cap on the subsidy rate for itemized deductions also reduces the incentive to give because it increases the after-tax cost of giving. For instance, if the top statutory tax rate is 39.6 percent, but the maximum subsidy rate is set at 28 percent, then the subsidy for those in that 39.6 percent bracket would be reduced by more than one-quarter. President Obama proposed this type of cap.

Key Elements of the U.S. Tax System

How might tax reforms reduce incentives for charitable giving?

Increases to the standard deduction or reductions in other itemized deductions also reduce incentives to give by reducing the number of taxpayers who itemize their deductions. These types of changes have been common to many tax reforms. Currently, itemizers are estimated to provide about 82 percent of total giving, about $239 billion; nonitemizers, who on average have lower incomes, provide about 18 percent of total charitable giving, about $53 billion. If fewer people itemize, fewer people have a tax incentive to give.

Eliminating or reducing the estate tax could also negatively affect charitable giving because such tax reform reduces higher-income individuals' incentive to give. The estate tax encourages charitable giving by allowing a deduction for charitable bequests. One study published in 2003, when the top estate tax rates were higher than today, estimated that estate tax repeal could reduce charitable bequests between 22 and 37 percent.

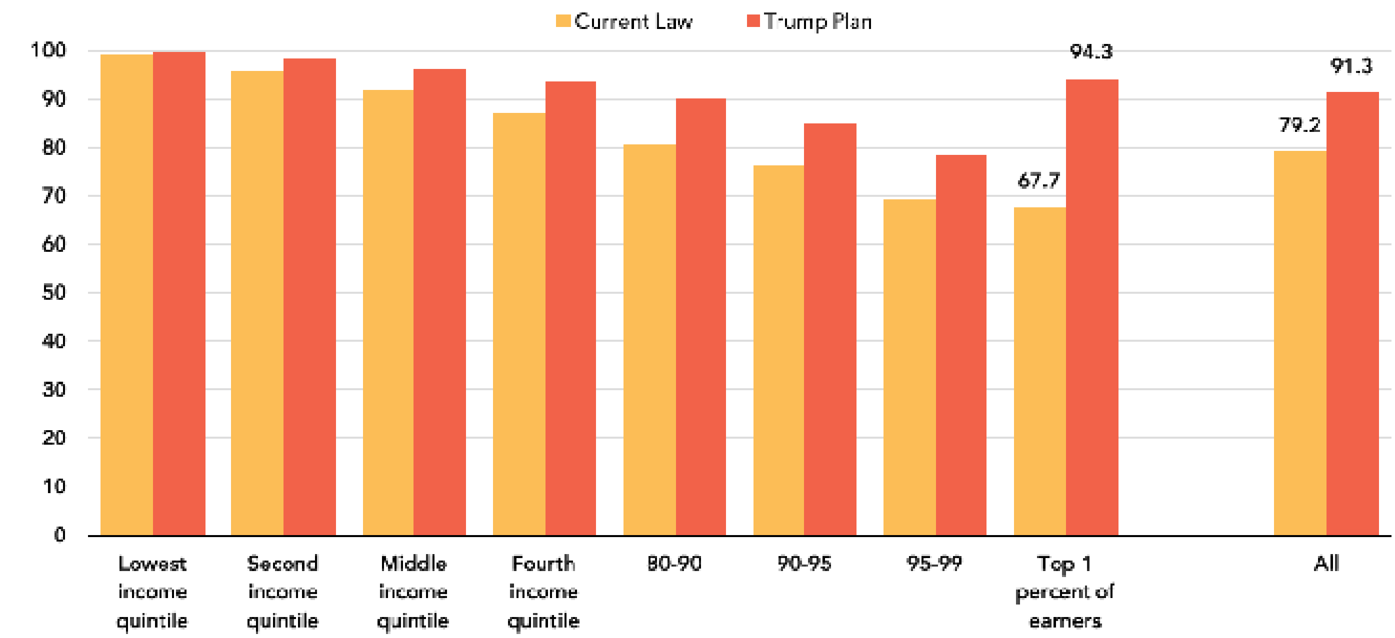
Examples from Some Recent Tax Reform Proposals

Donald Trump's campaign tax plan proposed reductions in marginal tax rates and overall caps on itemized deductions. Figure 1 shows how these tax reform proposals would indirectly affect charitable giving by increasing the average after-tax price of giving from $79.20 to $91.30, thereby reducing the incentive to give. Households in the top 1 percent are the most affected by Trump's proposed rate cuts and overall caps on itemized deductions; their average after tax-price of giving would rise from $67.70 to $94.30.

FIGURE 1

Estimated Average After-Tax Price of Charitable Giving, 2017

By expanded cash income percentile, under current law



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).
Notes: Graph depicts the average marginal after-tax price of a $100 donation.

Key Elements of the U.S. Tax System

How might tax reforms reduce incentives for charitable giving?

House Committee on Ways and Means Chairman Dave Camp's tax plan proposed different tax reforms that could have affected charitable giving in different ways. For example, the plan proposed lowering tax rates, increasing the standard deduction, limiting itemized deductions other than charity, limiting maximum charitable deductions annually to 40 percent of adjusted gross income, and allowing charitable deductions only above a floor of 2 percent of adjusted gross income. Overall, estimates from the Tax Policy Center show that Chairman Camp's tax plan would have reduced individual giving in the range of 7 to 14 percent, which corresponds to a reduction of between 17 and 34 billion dollars based on 2013 giving levels (table 1). Note that multiple interactions in this case make the combined effect of many provisions greater than the sum of their parts.

TABLE 1

Effect of Chairman Dave Camp's Proposals on Charitable Giving

Estimated percentage-point reductions in charitable giving

Camp tax reform tax plan (total)	Rate structure	Standard deduction and other nonitemized deduction provisions	Itemized deductions other than charity	Charitable deduction	Residual because of interactions
7.0–14.0	0.9–1.9	0.9–1.8	1.2–2.6	2.2–4.4	1.6–3.1

Source: Rosenberg et al. (2014).

Note: Numbers do not total 7.0–14.0 because of rounding.

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Q. How much does the federal government spend on health care?

The federal government will spend more than $1,124 billion in fiscal year 2017. In addition, tax expenditures for health care will total nearly $260 billion.

FEDERAL SPENDING ON HEALTH CARE IN 2017

The Congressional Budget Office and the Office of Management and Budget estimate that the federal government will spend more than $1,124 billion on health care in fiscal year 2017 (see table 1). Of that, Medicare will claim roughly $593 billion, Medicaid and the State Children's Health Insurance Program (SCHIP) about $407 billion, veterans' medical care about $71 billion, and subsidies for the Affordable Care Act's health insurance exchanges about $54 billion. In addition to these direct outlays, various tax provisions for health care create tax expenditures that total nearly $260 billion. About 60 percent of that figure comes from the exclusion from taxable income of employers' contributions for medical insurance premiums and medical care.

Key Elements of the U.S. Tax System

How much does the federal government spend on health care?

TABLE 1
Estimated Federal Spending and Tax Expenditures for Health Care
FY 2017

Program	Millions of dollars
Spending	
Spending for Medicare net of offsetting receipts	593,041
Medicaid and SCHIP	407,019
Veterans' medical care	70,600
Exchange subsidies and related spending	54,181
Tax expenditures[c]	
Exclusion of employer contributions for health care, health insurance premiums, and long-term care insurance premiums	151,400
Subsidies for insurance purchased through health benefit exchanges[b]	72,500
Deduction for medical expenses and long-term care expenses	11,400
Deduction for health insurance premiums and long-term care insurance premiums by the self-employed	5,400
Exclusion of workers' compensation benefits (medical benefits)	5,100
Deduction for charitable contributions to health organizations	3,400
Exclusion of medical care and TRICARE medical insurance for military dependents, retirees, and retiree dependents not enrolled in Medicare	2,800
Health savings accounts	2,400
Exclusion of interest on State and local government qualified private activity bonds for private nonprofit hospital facilities	2,000
Exclusion of health insurance benefits for military retirees and retiree dependents enrolled in Medicare	1,000
Tax credit for small businesses purchasing employer insurance	600
Credit for orphan drug research	<50

Sources: Congressional Budget Office, Updated Budget Projections: 2016 to 2026; Office of Management and Budget, Budget of the United States Government FY2017, Historical Tables; Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 2014-18.
(a) Figure only includes lost income tax revenues. Including income and payroll taxes the exclusion reduces federal revenue by $260 billion.
(b) JCT estimates thatexchange subsidies will reduce tax revenues by $72.5 billion and result in outlays of $177.1 billion in 2017.
(c) JCT no longer classifies the exlusion of Medicare benefits as a tax expenditure.

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Q. Who has health insurance coverage?

A: Eighty-three percent of nonelderly individuals were covered in 2013, with rates rising sharply with income. Since then, the ACA has increased total coverage among non-elderly adults by more than 7 percentage points.

In 2013, before the major coverage expansions under the Affordable Care Act (ACA), nearly 57 percent of the nonelderly population obtained health insurance coverage through employment (see figure 1). Another 4 percent purchased coverage on their own in the private market, while about 19 percent were covered by Medicaid and 3 percent had coverage from other public sources. That left nearly 17 percent unin-sured. Virtually all elderly individuals participate in Medicare, and those with low in-comes also receive assistance through Medicaid.

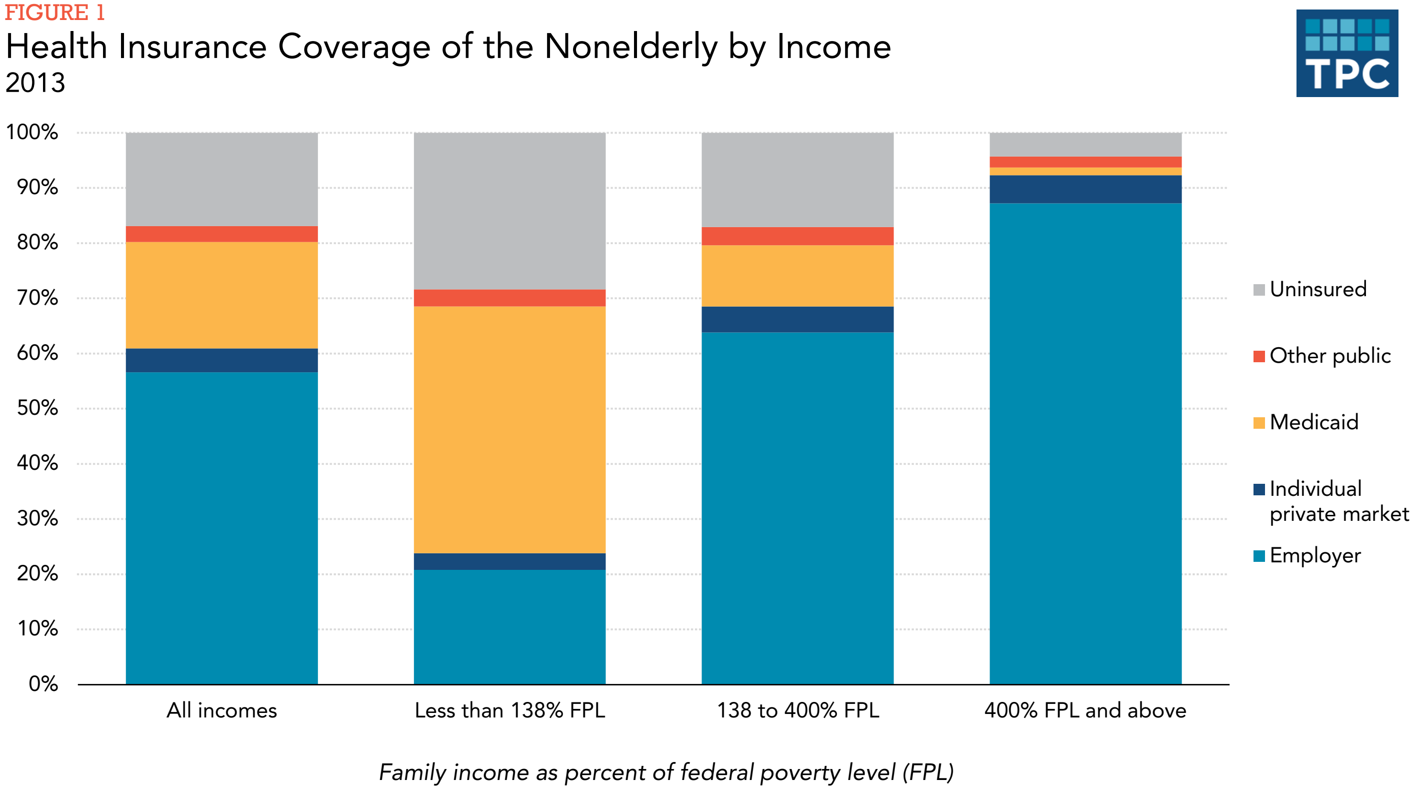
Key Elements of the U.S. Tax System

Who has health insurance coverage?

FIGURE 1

Health Insurance Coverage of the Nonelderly by Income

2013



Source: Kaiser Commission on Medicaid and the Uninsured, "Health Insurance Coverage in 2013: Gains in Public Coverage Continue to Offeset Loss of Private Insurace," Table 1, Appendix A.
Notes: Other public insurance includes Medicare and military-related coverage. State Children's Health Insurance Programs (SCHIP) is included in Medicaid.

Health insurance coverage rises sharply with income. Less than one-quarter of the nonelderly with family incomes below 138 percent of the federal poverty level (FPL) had private coverage in 2013; 28 percent re-ported having no health insurance, public or private. In contrast, more than two-thirds of those with incomes between 138 and 400 percent of FPL had private coverage, while 17 percent had no insurance. Over 90 percent of the nonelderly with incomes above 400 percent of FPL had private cover-age, and just 4 percent lacked any health insurance.

Key Elements of the U.S. Tax System

Who has health insurance coverage?

GAINS IN HEALTH INSURANCE COVERAGE SINCE 2013

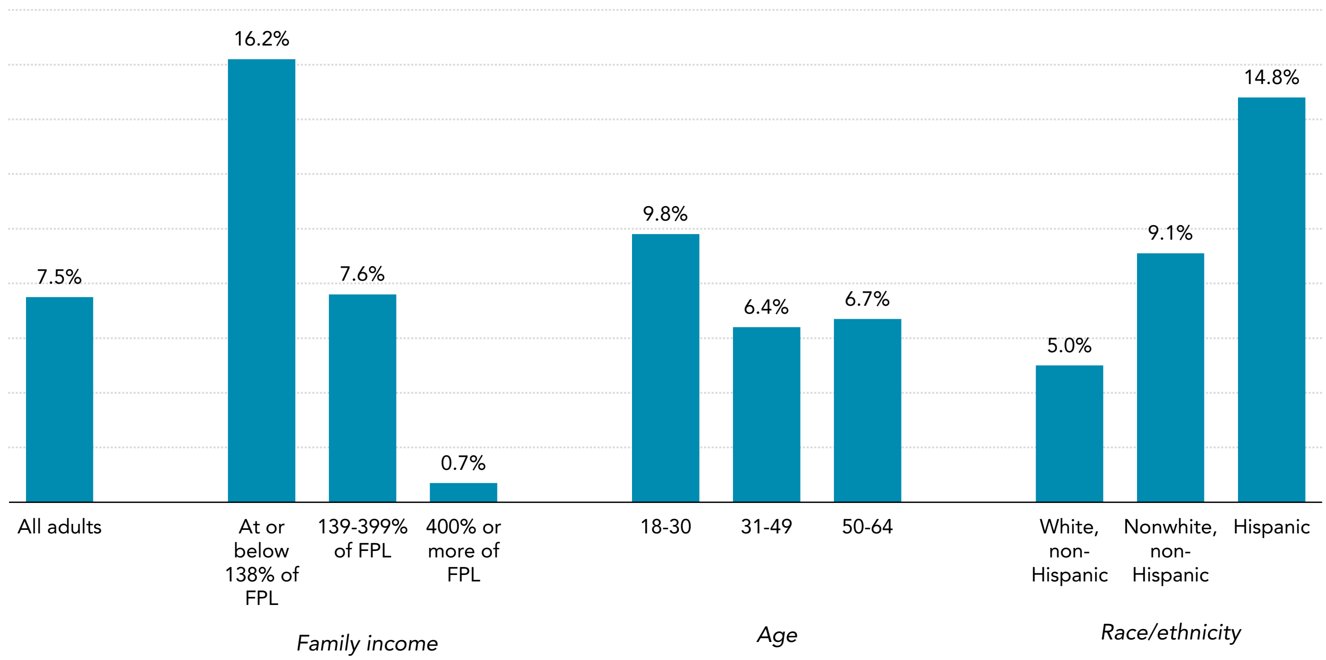
Coverage has increased markedly since implementation of the Affordable Care Act in 2014. Under the ACA, families with incomes between 100 and 400 percent of FPL, lacking other affordable health insurance options, can use tax credits to purchase in-surance on national or state exchanges. Additionally, states may expand Medicaid eli-gibility to all nonelderly with incomes below 138 percent of FPL, with the federal gov-ernment initially paying the entire cost.

Estimates from the Urban Institute's Health Reform Monitoring Survey (2015) show that between fall 2013 and spring 2015 the percentage of adults under age 65 with health insurance increased by 7.5 percentage points (see figure 2). Gains have been largest among low- and moderate-income families, the young, and racial and ethnic minorities.

FIGURE 2

Percentage-Point Increase in Insurance Coverage for Adults Ages 18–64

Between quarter 3, 2013 and quarter 1, 2015



Source: Urban Institute, 2015.
Note: FPL = federal poverty level.

Data Sources

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Key Elements of the U.S. Tax System

Q. What tax provisions subsidize the cost of health care?

A. A host of tax preferences for health care will cost the federal government roughly $250 billion in revenue in 2015. The largest is the exclusion from taxable income of employer contributions for health insurance premiums.

EXCLUSION FOR EMPLOYER CONTRIBUTIONS TO HEALTH INSURANCE

In 2015, the federal government will lose roughly $250 billion in income tax revenue from at least 10 tax preferences for health care. By far the most costly is the exclusion of employer contributions for health insurance premiums from taxable income. In most cases, employee contributions to health insurance premiums are excluded from income taxes. The Joint Committee on Taxation estimates tax expenditures on the exclusion for employer-sponsored health insurance will be $150.6 billion in fiscal year 2015.

TABLE 1

Tax Expenditures for Health Care

Millions of dollars, 2017

Tax expenditures[c]	Millions of dollars
Exclusion of employer contributions for health care, health insurance premiums, and long-term care insurance premiums	151,400
Subsidies for insurance purchased through health benefit exchanges[a]	72,500
Deduction for medical expenses and long-term care expenses	11,400
Deduction for health insurance premiums and long-term care insurance premiums by the self-employed	5,400
Exclusion of workers' compensation benefits (medical benefits)	5,100
Deduction for charitable contributions to health organizations	3,400
Exclusion of medical care and TRICARE medical insurance for military dependents, retirees, and retiree dependents not enrolled in Medicare	2,800
Health savings accounts	2,400
Exclusion of interest on State and local government qualified private activity bonds for private nonprofit hospital facilities	2,000
Exclusion of health insurance benefits for military retirees and retiree dependents enrolled in Medicare	1,000
Tax credit for small businesses purchasing employer insurance	600
Credit for orphan drug research	<50

Sources: Joint Committee on Taxation.

(a) JCT estimates that exchange subsidies will reduce tax revenues by $72.5 billion and result in outlays of $177.1 billion in 2017.

(b) Figure only includes lost income tax revenues. Including income and payroll taxes the exclusion reduces federal revenue by $260 billion.

(c) JCT no longer classifies the exlusion of Medicare benefits as a tax expenditure.

Key Elements of the U.S. Tax System

What tax provisions subsidize the cost of health care?

OTHER MAJOR TAX EXPENDITURES FOR HEALTH CARE

Table 1 outlines the major federal tax expenditures for health care:

- Medicare benefits are excluded from taxable income ($64.3 billion).
- Individuals may claim as an itemized deduction out-of-pocket medical expenses and health insurance premiums paid with after-tax dollars and exceeding 10 percent of their adjusted gross income ($11.0 billion).
- By the same token, self-employed individuals may deduct health insurance premiums from their income ($5.6 billion).
- Individuals ineligible for employer-sponsored or public health insurance may use tax credits to purchase insurance on ACA exchanges ($5.4 billion).
- Corporations and individuals may claim contributions to qualified health organizations as itemized deductions if the contributions are less than half of their adjusted gross income ($5.1 billion).
- Medical benefits provided by workers' compensation insurance are excluded from taxable income ($4.9 billion).
- Coverage for military retirees and dependents is excluded from taxable income ($3.2 billion).
- Interest on certain bonds issued for hospital construction is excluded from taxable income ($2.5 billion).
- Individuals under 65 covered by high-deductible health insurance plans may take an income tax deduction for contributions to health savings accounts (HSAs). Employers may make HSA contributions that are excluded from income taxes. Additionally, HSA balances grow tax free, and withdrawals for medical expenses are not subject to income tax ($1.9 billion).
- Small employers who pay low average wages may take a credit when providing employees with health insurance. The credit phases out as firm size and average wages increase; it can only be taken for two years ($1.5 billion).
- Pharmaceutical companies testing drugs for rare diseases may claim the orphan drug credit ($0.8 billion).

Data Sources

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Q. How does the tax exclusion for employer-sponsored health insurance work?

A. The exclusion lowers the after-tax cost of health insurance for most Americans.

Employer-paid premiums for health insurance are exempt from federal income and payroll taxes. Additionally, the portion of premiums paid by employees is typically ex-cluded from taxable income as well. The exclusion of premiums lowers most workers' tax bills and thus reduces their after-tax cost of coverage. This tax subsidy partly ex-plains why most American families have health insurance coverage through employers. Other factors play a role though, notably the economies of group coverage.

ESI EXCLUSION IS WORTH MORE TO TAXPAYERS IN HIGHER TAX BRACKETS

Because the exclusion of premiums for employer-sponsored insurance (ESI) reduces taxable income, it is worth more to taxpayers in higher tax brackets than to those in lower brackets. Consider a worker in the 15 percent income-tax bracket who also faces a payroll tax of 15.3 percent (7.65 percent paid by the employer and 7.65 percent paid by the employee). If his employer-paid insurance premium is $1,000, his taxes are $281 less than they would be if the $1,000 was paid as taxable compensation. His after-tax cost of health insurance is thus $1,000 minus $281, or $719. In contrast, the after-tax cost of a $1,000 premium for a worker in the 25 percent income tax bracket is just $626 ($1,000 minus $374). Savings on state and local taxes typically lower the after-tax cost of health insurance even more.

ESI EXCLUSION IS COSTLY

The ESI exclusion cost the federal government an estimated $260 billion in income and payroll taxes in 17 making it the single largest tax expenditure. Note, too, that the open-ended nature of the tax subsidy has likely increased health care costs by encouraging the purchase of more comprehensive health insurance policies with lower cost sharing or with less tightly managed care.

Replacing the ESI exclusion with a tax credit would equalize tax benefits across tax-payers in different tax brackets, as well as between those who get their insurance through their employers and those who obtain coverage from other sources. Making the credit refundable would extend that benefit to those whose tax liability falls below the value of the credit. And designing the credit so that it does not subsidize insurance on the margin (i.e., to be a fixed dollar amount as opposed to a percentage of the premium) could lower health care costs.

Key Elements of the U.S. Tax System

How does the tax exclusion for employer-sponsored health insurance work?

[1] These examples assume that workers bear the full burden of employer payroll taxes. Note that the effective mar-ginal tax rates (28.1 percent for the worker in the 15 percent income-tax bracket and 37.4 percent for the worker in 25 per-cent income-tax bracket) are less than the sum of the income tax and payroll tax rates (30.3 percent and 40.3 percent, respectively) because those rates are applied to compensation after the employer's share of payroll taxes has been deducted. Thus, for example, if the employer increases compensation by $1,000, cash wages only increase by $929 [cal-culated as $1,000 / (1+employer payroll tax rate)], because the employer would have to pay additional employer payroll taxes of $71. The lower-wage worker's resulting combined income and payroll tax would be 30.3 percent of $929 or $281. The higher-wage worker's resulting combined income and payroll tax would be 40.3 percent of $929 or $374.

Data Sources

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Gruber, Jonathan. 2011. "The Tax Exclusion for Employer-Sponsored Health Insurance." National Tax Journal 64(2, part 2): 511–30.

Q. How does the employer-sponsored insurance exclusion affect health insurance coverage?

A. It modestly increases health insurance coverage, but the benefit is poorly targeted.

HEALTH INSURANCE EXCLUSION MODESTLY INCREASES HEALTH INSURANCE COVERAGE

In 2015, 84 percent of private-sector employees worked for companies offering em-ployer-sponsored health insurance (ESI), and 57 percent of the nonelderly population were covered by ESI as policyholders or dependents.

One reason so many people are covered through their employers is that ESI benefits are excluded from taxable income. The exclusion reduces workers' tax bills, which lowers their after-tax cost of insurance. However, there are other important reasons for the prevalence of ESI, including low administrative costs and the benefits of risk pooling across groups of workers.

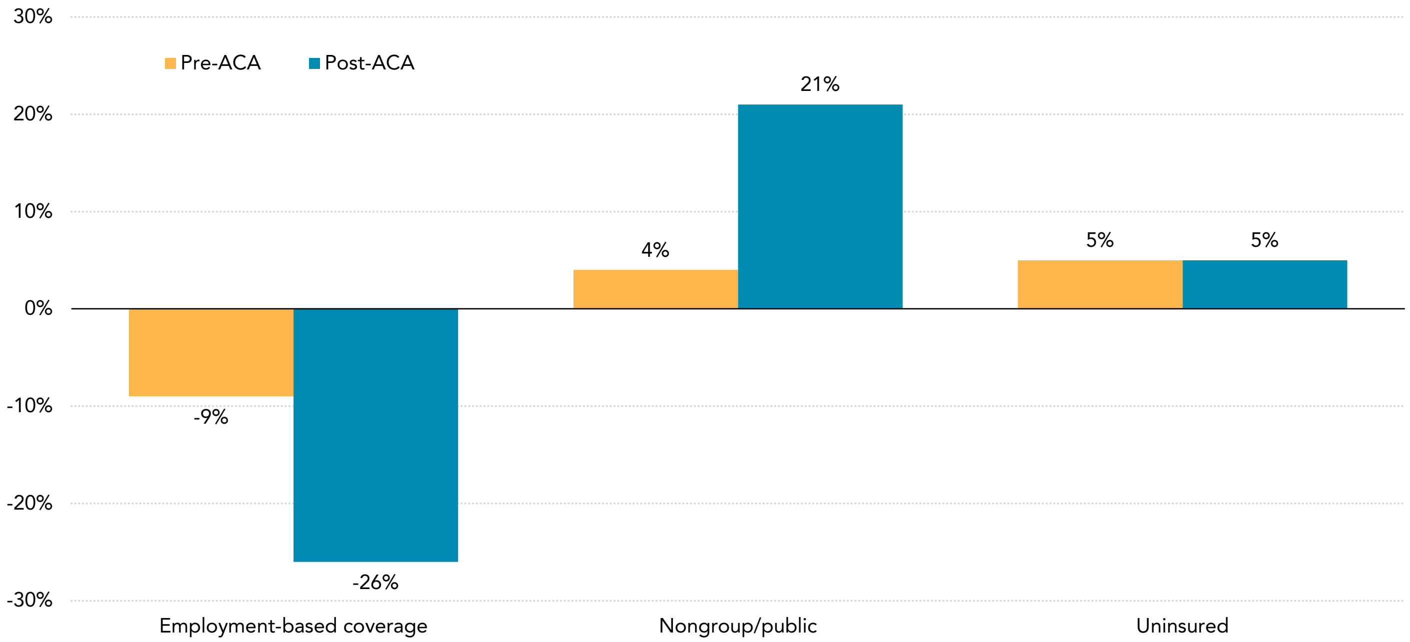
Research examining how marginal tax rates correlate with the portion of employers offering ESI suggests that large and medium-size employers are not very sensitive to changes in after-tax insurance costs. That's why simulation models find that eliminating the ESI exclusion would only modestly affect coverage. According to the Congressional Budget Office (CBO), estimates that do not include the effects of the Affordable Care Act (ACA) show that eliminating the ESI exclusion would reduce the number of insured by 6 percent. CBO estimates that though ESI coverage would decline by 15 percent, the number of people covered by private nongroup or public coverage would increase by 16 percent, offsetting a portion of that decline (figure 1).

The ACA's health insurance exchanges, related subsidies, and Medicaid expansion have increased the attractiveness of private nongroup and public coverage. Low- and moderate-income families may qualify for premium credits or expanded Medicaid, and the exchanges give families access to savings associated with stable risk pools and lower administrative costs. When taking into account the new exchanges, subsidies, and expanded Medicaid under the ACA, the CBO finds that eliminating the ESI exclusion would result in significantly more shifting from ESI to non-group/public coverage. However, the number of insured would still decrease by only 6 percent.

Key Elements of the U.S. Tax System

How does the employer-sponsored insurance exclusion affect health insurance coverage?

FIGURE 1
Impact on Coverage of Repealing Health Insurance Exclusion



Source: Congressional Budget Office, "Coverage Effects of Limiting the Tax Exclusion for Employment-Based Health Insurance." Presentation at the Fifth Biennial Conference of the American Society of Health Economists, 2014. https://www.cbo.gov/publication/45456.

HEALTH INSURANCE EXCLUSION IS POORLY TARGETED

Because low-wage workers are less likely to have the option of ESI, and because the benefit of the exclusion increases with workers' marginal tax rates, ESI is worth more to the higher-income families who would be more likely to purchase insurance in the first place. In 2015, less than 30 percent of families in the bottom income quintile were offered ESI; for them, the average benefit of the ESI exclusion was less than $10 (figures 2 and 3). In contrast, nearly 90 percent of families in the top quintile have ESI offers and the average benefit is almost $3,200.

Replacing the exclusion with a refundable tax credit that could be used for either ESI or nongroup insurance would provide low- and moderate-income families with more benefits. Families without ESI would benefit, and converting the tax deduction to a tax credit would mean that everyone with a given level of insurance could claim the same subsidy. Simulations show that better targeted health insurance subsidies could increase coverage for the same total cost.

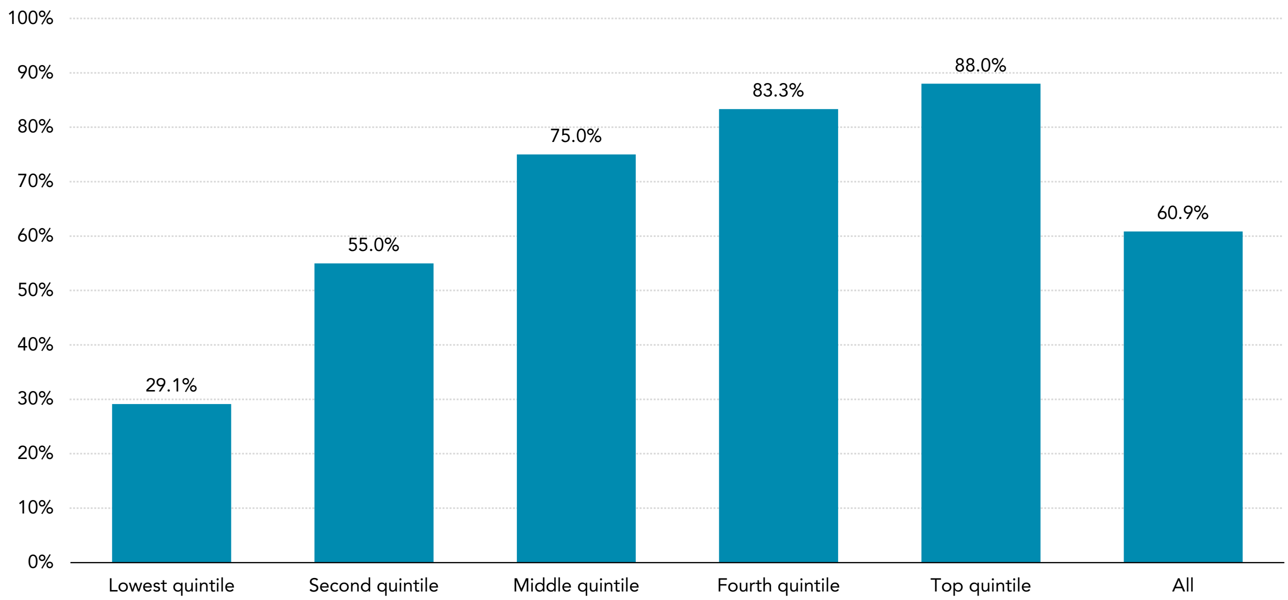
Key Elements of the U.S. Tax System

How does the employer-sponsored insurance exclusion affect health insurance coverage?

FIGURE 2

Percentage of Tax Units with ESI Offers by Income Quintile

2015

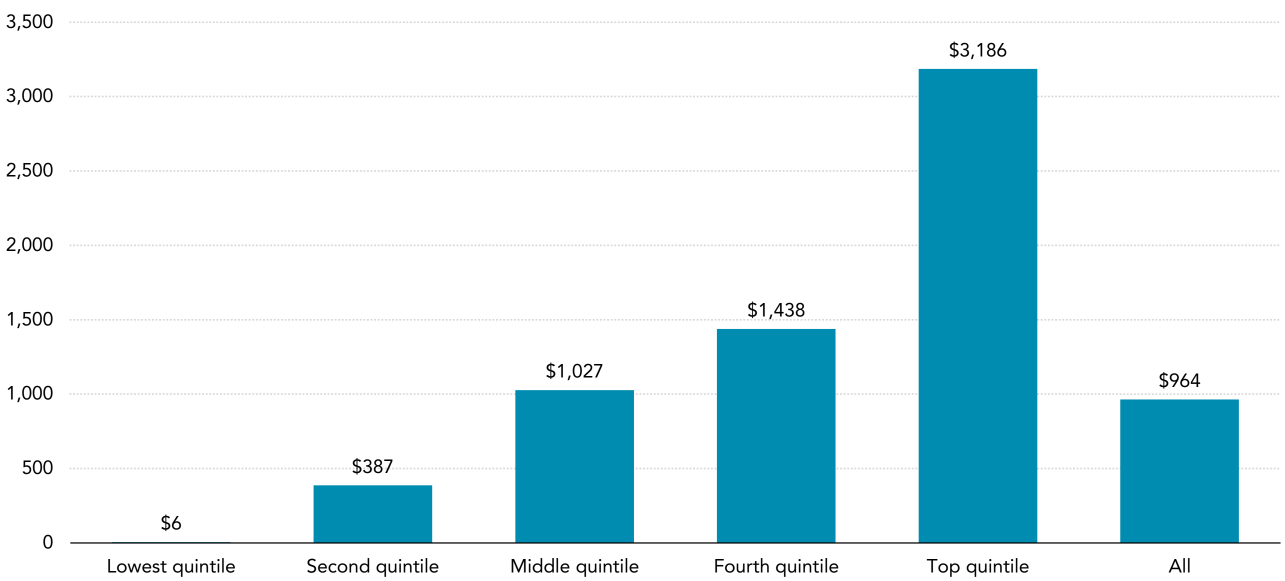


Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0515-1).

FIGURE 3

Average Tax Benefit of the Exclusion of Employer-Sponsored Health Benefits

$2015



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0515-1).
Notes: Tax benefits include exclusion from income of employer-sponsored health, dental, and vision insurance premiums; and contributions to Health Savings Accounts, Health Reimbursement Arrangements, and Medical Flexible Spending Accounts. Tax benefits also include the deduction for self-employed health

Key Elements of the U.S. Tax System

How does the employer-sponsored insurance exclusion affect health insurance coverage?

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Key Elements of the U.S. Tax System

Q. What are premium tax credits?

A. The Affordable Care Act provides families with refundable, ad-vanceable tax credits to purchase health insurance through exchanges. Premium credits cap contributions as a share of income for families with incomes between 100 and 400 percent of the federal poverty level.

ACA TAX CREDITS FOR HEALTH INSURANCE

The Affordable Care Act (ACA) provides families with refundable tax credits to pur-chase health insurance through both state and federal exchanges—an arrangement confirmed by the Supreme Court. Tax filers can claim premium credits if they (1) have incomes between 100 and 400 percent of the federal poverty level (FPL), (2) are ineli-gible for adequate and affordable health insurance from other sources, and (3) are le-gal residents of the United States. Tax filers with incomes between 100 and 138 per-cent of the FPL are generally ineligible for premium credits if they reside in states that take advantage of the ACA's expansion of Medicaid eligibility.

CALCULATION OF PREMIUM CREDITS

Premium credits effectively cap family contributions as a share of income for those purchasing mid-range "benchmark" plans. In 2017, maximum family contributions ranged from a low of 2.04 percent of income for families at the poverty threshold to 9.69 percent for families between 300 and 400 percent of FPL (table 1). Premium cred-its equal the difference between gross premiums and maximum family contributions.

For example, consider a family of four with income equal to 200 percent of FPL in 2017 that is purchasing an insurance plan costing $15,000. Multiplying family income (here, $48,600) by the applicable 6.43 percent maximum premium results in a family contribution of $3,125 and thus a premium credit of $11,875 ($15,000–$3,125).

The example above assumes the family purchases the second least expensive (Silver) plan from the menu of Bronze, Silver, Gold, and Platinum health insurance plans of-fered through exchanges. If the family purchased a more expensive plan, the credit would remain unchanged and the family would pay the full difference in premiums.

Key Elements of the U.S. Tax System

What are premium tax credits?

TABLE 1
Tax Expenditures for Health Care
Millions of dollars, 2017

Tax expenditures[c]	Millions of dollars
Exclusion of employer contributions for health care, health insurance premiums, and long-term care insurance premiums	151,400
Subsidies for insurance purchased through health benefit exchanges[a]	72,500
Deduction for medical expenses and long-term care expenses	11,400
Deduction for health insurance premiums and long-term care insurance premiums by the self-employed	5,400
Exclusion of workers' compensation benefits (medical benefits)	5,100
Deduction for charitable contributions to health organizations	3,400
Exclusion of medical care and TRICARE medical insurance for military dependents, retirees, and retiree dependents not enrolled in Medicare	2,800
Health savings accounts	2,400
Exclusion of interest on State and local government qualified private activity bonds for private nonprofit hospital facilities	2,000
Exclusion of health insurance benefits for military retirees and retiree dependents enrolled in Medicare	1,000
Tax credit for small businesses purchasing employer insurance	600
Credit for orphan drug research	<50

Sources: Joint Committee on Taxation.
(a) JCT estimates that exchange subsidies will reduce tax revenues by $72.5 billion and result in outlays of $177.1 billion in 2017.
(b) Figure only includes lost income tax revenues. Including income and payroll taxes the exclusion reduces federal revenue by $260 billion.
(c) JCT no longer classifies the exlusion of Medicare benefits as a tax expenditure.

ADVANCE PREMIUM CREDITS AND RECONCILIATION

Premium credits are based on a household's income in the tax year premiums are paid. Yet the credits are calculated the following year, when households file their in-come tax returns. However, most participating households receive their tax credits in advance as a reduction in the insurance premium they would otherwise pay. This re-duced premium is based on estimated income, generally from the last tax return filed before en-rollment in health insurance. If actual income in the year of enrollment is less than estimated income, families will qualify for larger credits. If actual income is great-er than estimated income, families will be required to repay part or all of the advance credit.

Fortunately for most households with large income increases, the maximum reconciliation payment is limit-ed. In tax year 2016, the maximum payment ranged from $600 for married couples with incomes below 200 percent of FPL to $2,550 for couples with incomes of at least 300 but less than 400 percent of FPL (see table 2). Families whose income equals 400 percent or more of FPL have no limit on reconciliation payments.

For tax year 2014, 54 percent of families receiving advanced credits had to make rec-onciliation payments. However, analysis of tax refund data suggests that for most low-er-income filers, reconciliation payments will reduce tax refunds rather than require additional payments. Still, reconciliation will likely present hardships for some families receiving advanced premium credits, even if they do not have tax payments due, be-cause many low-income households have grown to rely on tax refunds for pressing needs.

What are premium tax credits?

FIGURE 1

Maximum Reconciliation Payment by Income

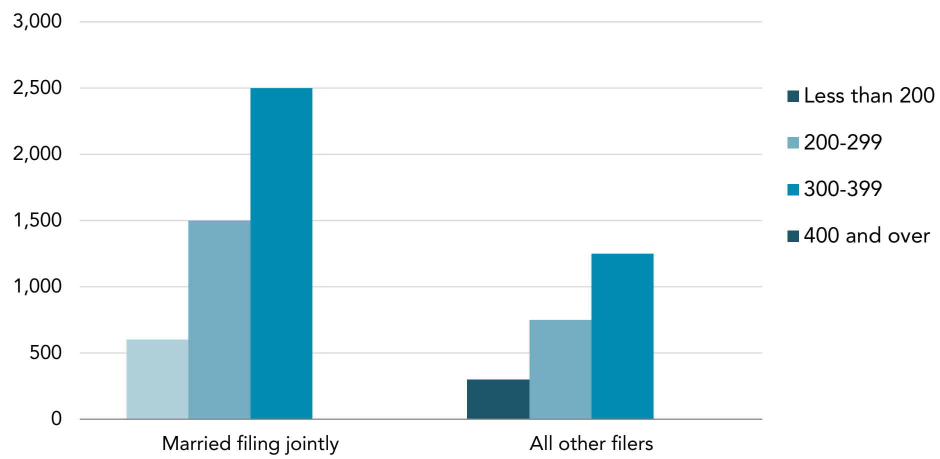

TABLE 2

Maximum Reconciliation Payment

By income level, 2016

Household income as a share of federal poverty level (FPL)	Married filing jointly	All other filers
Less than 200%	$600	$300
200–299%	$1,500	$750
300–399%	$2,550	$1,275
400% and over	unlimited	unlimited

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Q. What is the Cadillac tax?

A. Employer-sponsored health benefits whose value exceeds legally specified thresholds will be subject to a 40 percent excise tax, starting in 2020. The so-called "Cadillac tax" will be levied on insurance companies, but the burden will likely fall on workers. The tax will effectively limit the tax preference for employer-sponsored health insurance.

TAX ON HIGH-COST HEALTH PLANS STARTING IN 2020

Under the Affordable Care Act, employer-sponsored health benefits whose value ex-ceeds specified thresholds will be subject to an excise tax starting in 2020. This "Cadillac tax" will equal 40 percent of the value of health benefits exceeding thresholds projected to be $10,800 for single coverage and $29,050 for family coverage in 2020. The thresholds will be indexed to growth in the consumer price index in subsequent years. Thresholds will be higher for plans with more-expensive than-average demographics, retirees ages 55 to 64, and workers in high-risk professions. The Cadillac tax will apply not only to employers' and employees' contributions to health insurance premiums, but also to health saving account, health reimbursement arrangement, and medical flexible spending account contributions.

WORKERS BEAR THE BURDEN

The tax will be levied on insurance companies, but the burden will likely be passed on to workers in the form of lower wages. Some employers will avoid the tax by switching to less expensive health plans; this will translate into higher wages but also higher income and payroll taxes. In fact, the Joint Committee on Taxation and the Congressional Budget Office predict that 80 percent of the revenue raised by the Cadillac tax will be through the indirect channel of higher income and payroll taxes, rather than through excise taxes collected from insurers. Simulations suggest the excise tax will have the largest relative impact on after-tax income of families in the middle income quintile.

EFFECTIVELY LIMITS THE ESI EXCLUSION

Employer-provided health benefits are excluded from taxable income, reducing in-come and payroll tax revenue by an estimated $260 billion in 2017. Even if one ig-nores the revenue losses, there are other undesirable aspects of the exclusion. The exclusion for employer-sponsored health insurance (ESI) is poorly targeted, as it is worth more to taxpayers in higher brackets who would be more likely to purchase insurance in the first place. Additionally, the ESI exclusions' open-ended nature may contribute to faster health care cost growth. For these reasons, analysts have often suggested limiting the ESI exclusion by including the value of health benefits beyond a certain threshold in taxable income (Congressional Budget Office 2013).

Key Elements of the U.S. Tax System

What is the Cadillac tax?

While the Cadillac tax plan is not a direct limit, it effectively curtails the ESI exclusion. If employers avoid the excise tax by shifting compensation from health benefits to taxable wages, the ultimate impact will be identical to an exclusion limit. In both cases, health benefits that exceeded the thresholds before introduction of the Cadillac tax would become subject to income and payroll taxes. If employers continue to offer high cost health plans, the impact will be similar to an exclusion limit—though less progressive. Excess benefits would be taxed at a 40 percent rate rather than an individual worker's marginal tax rate.[1]

[1] After accounting for income and payroll tax offsets, the effective excise tax rate is ultimately lower than 0.4 and in fact declines with income.

Data Sources

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Mermin, Gordon, and Eric Toder. 2015. "Distributional Impact of Repealing the Excise Tax on High-Cost Health Plans." Washington, DC: Urban-Brookings Tax Policy Center.

Q. What changes did the Affordable Care Act make?

A. The Affordable Care Act made several changes to the tax code intended to increase health insurance coverage, reduce health care costs, and finance health care reform.

The Affordable Care Act (ACA) made several changes to the tax code intended to increase health insurance coverage, reduce health care costs, and finance health care reform. To increase health insurance coverage, the ACA provided a tax credit for individuals and small employers to purchase insurance and imposed excise taxes on individuals without adequate coverage and on employers who do not offer adequate coverage. To reduce health care costs and raise revenue for insurance expansion, the ACA imposed an excise tax on high-cost health plans. To raise additional revenue for reform, the ACA imposed surtaxes on high-income families and excise taxes on health insurers, pharmaceutical companies, and manufacturers of medical devices.

TABLE 1
Estimated Effect of ACA Tax Provisions on Federal Deficit
FY 2020

Source	$ billions
Premium Tax Credit[a b]	36
Small business health insurance credit	1
Excise taxes	-45
Inadequate health insurance coverage by individua	-3
Inadequate health insurance coverage by employe	-20
High cost health plans[c]	-3
Health insurance providers, pharmaceuticals, and medical devices	-19
High income surtaxes	-35
Additional limitation on medical expense deduction	-3
Total	-46

Source: Congressional Budget Office (2015, 2016, and 2017), Urban Institute's Health Insurance Policy Simulation Model (HIPSM), and Urban-Brooking Tax Policy Center Microsimulation Model (version 0516-2).

(a) PTC estimate from HIPSM. CBO projects the PTC will grow faster over time than HIPSM. CBO projects the impact of the PTC on the deficit will be $65 billion in FY2020.

(b) PTC estimate includes impact on revenues and outlays.

(c) Annual revenue from the excise tax on high-cost health plans is projected to grow rapidly, reaching $20 billion by 2026.

Key Elements of the U.S. Tax System

What changes did the Affordable Care Act make?

As shown in table 1, ACA tax provisions include the following:

- A refundable tax credit for families to purchase health insurance through state and federal exchanges. Tax filers must have incomes between 100 and 400 percent of the federal poverty level, be ineligible for health coverage from other sources, and be legal residents of the United States. The premium credit is projected to cost $70 billion in 2020.
- A tax credit for small employers to purchase health insurance for their workers. Employers must have fewer than 25 workers whose average wages are less than $50,000. Employers can only receive the credit for up to two years. The small-employer health insurance credit is projected to cost $1 billion in 2020.
- An excise tax on individuals without adequate health insurance coverage. Many individuals are exempt from the excise tax, including those with incomes low enough that they are not required to file a tax return, those whose premiums would exceed a specified percentage of income, and unauthorized immigrants. The excise tax is projected to raise $4 billion in 2020.
    - Try our ACA tax calculator to see how big the penalty would be.
- An excise tax on employers offering inadequate health insurance coverage. The tax applies to employers with 50 or more full-time equivalent employees. The excise tax is projected to raise $16 billion in 2020.
- An excise tax on employer-sponsored health benefits whose value exceeds specified thresholds. The thresholds are only indexed to price inflation, so more plans will be affected over time as health care costs grow faster than general inflation. The excise tax on high-cost health plans is projected to raise $7 billion in 2020 with the revenue gain growing rapidly over time, reaching $21 billion by 2025.
- An additional 0.9 percent payroll tax on earnings and a 3.8 percent tax on net investment income for individuals with incomes exceeding $200,000 and couples with incomes exceeding $250,000. The high-income surtaxes are projected to raise $35 billion in 2020.
- Excise taxes on health insurance providers, pharmaceutical manufacturers and importers, and medical device manufacturers and importers. These excise taxes are projected to raise $19 billion in 2020.

Data Sources

Congressional Budget Office. *Insurance Coverage Provisions of the Affordable Care Act—CBO's March 2015 Baseline.*

Congressional Budget Office. 2015. "Budgetary and Economic Effects of Repealing the Affordable Care Act." Report, June 19. Washington, DC: Congressional Budget Office.

Key Elements of the U.S. Tax System

Q. How do health savings accounts (HSAs) work?

A. HSAs are tax-exempt savings accounts used in conjunction with a high-deductible health insurance plan (HDHP) to pay for qualifying medical expenses.

Individuals who participate in a qualifying HDHP can establish an HSA to pay for qualifying medical expenses. Both employees and employers can make contributions to an HSA.

HSAs have many tax advantages. Contributions made by employers are exempt from federal income and payroll taxes, and account owners can deduct any contributions they make from income subject to federal income taxes. Further, any income earned on the funds in an HSA accrues tax-free, and withdrawals for qualifying medical expenses are not taxed. Withdrawals used for nonqualifying expenses are subject to income tax and an additional 20 percent penalty, but the penalty is waived for account holders who are disabled, who are age 65 or over, or who have died. Unused balances can be carried over from year to year without limit.

Annual HSA contributions are limited to $3,400 for an individual and $6,750 for a family in 2017. Account holders age 55 or older can contribute an additional $1,000 to either type of account. The contribution limits are indexed annually for inflation.

In 2014, employers contributed $15.6 billion to HSAs, and individual tax filers contributed another $4.4 billion. The US Department of the Treasury estimates the tax preference for HSAs reduced income and payroll taxes by $7 billion in 2014.

Employers must offer an HSA-qualified insurance plan—usually an HDHP—for an employee to be eligible for an HSA. Individuals may also purchase an HSA-qualified insurance plan through the individual insurance market to become eligible. A plan is HSA-qualified if it meets certain requirements; in 2017, those requirements include a minimum deductible of $1,300 for individual coverage and $2,600 for family coverage.

How do health savings accounts (HSAs) work?

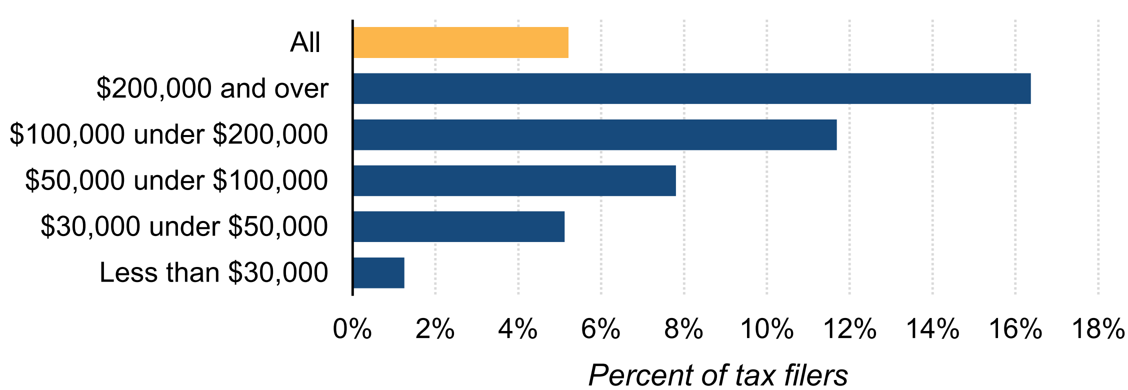
The Medicare Prescription Drug, Improvement, and Modernization Act authorized HSAs in 2003 to address the rising cost of medical care and the increasing number of uninsured individuals. HSAs are an expanded version of medical savings accounts (MSAs). MSAs also require account holders to have an HDHP and have many of the same tax advantages as HSAs. They are limited, however, to the self-employed or workers in small firms (50 or fewer employees). MSAs were established in 1996, but no new contributions to MSAs could be made after 2007, except for individuals who previously made contributions to an MSA or who work for employers that had already established MSAs.

HSAs and their associated HDHP plans place more of the health care financing burden on out-of-pocket costs and are intended to encourage more cost-conscious spending by health-care consumers. In practice, HSAs accounts are most attractive to higher-income individuals because the value of the tax exemptions associated with HSA contributions, account earnings, and withdrawals are greater for individuals in higher income-tax brackets. Additionally, high-wage workers are more likely to be constrained by contribution limits for retirement account and use HSAs as an additional means of tax-preferred saving.

In 2014, 11.7 percent of taxpayers with income between $100,000 and $200,000 contributed to an HSA, as did 16.4 percent of taxpayers with income over $200,000 (figure 1). In comparison, only 5.1 percent of taxpayers with income between $30,000 and $50,000 made such contributions. The average contribution for taxpayers with income over $200,000 was $4,716, compared with an average contribution of $1,500 for taxpayers with income between $30,000 and $50,000 (figure 2).

FIGURE 1

Percent of Tax Return Filers with HSA contributions by Adjusted Gross Income, 2014



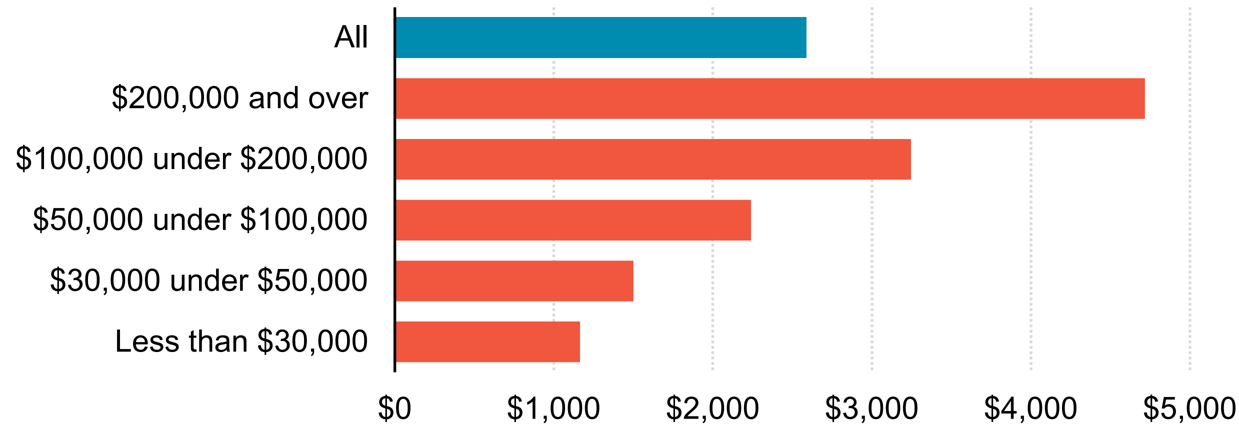
Source: United States Department of the Treasury, Office of Tax Analysis, "Health Savings Accounts, 2014," at Office of Tax Analysis Resource Center, https://www.treasury.gov/resource-center/tax-policy/Pages/Tax-Analysis-and-Research.aspx; IRS Table 1.4. "All Returns: Sources of Income, Adjustments, and Tax Items," at SOI Tax Stats, https://www.irs.gov/uac/soi-tax-stats-individual-income-tax-returns-publication-1304-complete-report; author calculations.
Note: Includes both individual and employer contributions.

Key Elements of the U.S. Tax System

How do health savings accounts (HSAs) work?

FIGURE 2

Average HSA Contribution by Adjusted Gross Income, 2014



Source: United States Department of the Treasury, Office of Tax Analysis, "Health Savings Accounts, 2014," at Office of Tax Analysis Resource Center, https://www.treasury.gov/resource-center/tax-policy/Pages/Tax-Analysis-and-Research.aspx; IRS Table 1.4. "All Returns: Sources of Income, Adjustments, and Tax Items," at SOI Tax Stats, https://www.irs.gov/uac/soi-tax-stats-individual-income-tax-returns-publication-1304-complete-report; author calculations.
Note: Includes both individual and employer contributions.

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Key Elements of the U.S. Tax System

Q. How do flexible spending accounts (FSAs) for health care expenses work?

A. A health care FSA is an employer-sponsored account used to reimburse employees for qualifying health care expenses.

Health care FSAs are benefit plans established by an employer to reimburse employees for qualified health care expenses, such as copayments and certain prescription drug costs. FSAs are usually funded through salary reduction agreements in which the employee agrees to receive lower monetary compensation in exchange for equivalent contributions to an FSA. For example, an employee who elects to reduce his or her monthly paycheck by $200 would receive, in return, a $2,400 annual contribution to his or her FSA.

The key benefit of FSAs is that these contributions are not subject to income or employment taxes, which could mean significant tax savings for the account holder. An employee contributing $200 a month to an FSA would save $360 in federal income taxes if he or she were in the 15 percent tax bracket ($2,400 × 0.15 = $360) and an additional $184 dollars from reduced Social Security and Medicare payroll taxes ($2,400 × 0.765 = $183.60). Because the federal income tax savings depend upon the employee's income tax rate (which rises with income), the benefit of using an FSA is greater for higher-income workers. For example, the income tax savings for an employee in the 35 percent tax bracket with the same $2,400 annual contribution would be $840 ($2,400 × 0.35 = $840).

An important attribute of FSAs is that the entire value of an employee's FSA account must be made available at the beginning of the year. For example, if the same employee discussed above incurred a $3,000 medical expense in March, he or she could use the full $2,400 annual FSA contribution to help pay for that cost, even though only $600 would have been contributed into the account by March.

In 2013, the Internal Revenue Service (IRS) instituted a contribution limit for health care FSAs. The limit is adjusted yearly for inflation; in 2017, it is $2,600 per year per employer. Generally, employees must use the money in a FSA within the plan year, although employers may also offer one of two options:

- Provide a grace period of up to 2.5 months into a new plan year to use FSA money from the preceding plan year.
- Allow the employee to carry over up to $500 per plan year to use in the new plan year.

Key Elements of the U.S. Tax System

How do flexible spending accounts (FSAs) for health care expenses work?

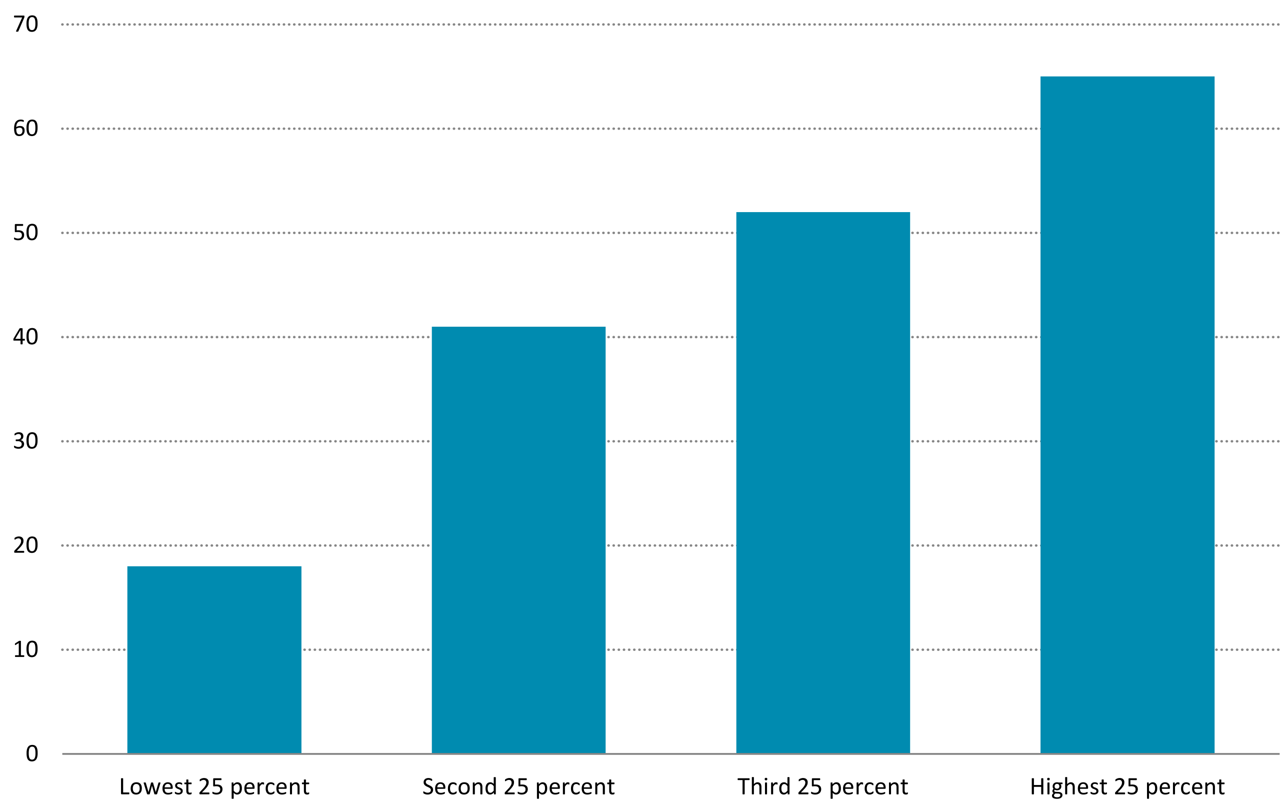
The Bureau of Labor Statistics estimates that about 43 percent of all civilian workers had access to an FSA in 2016 (Bureau of Labor Statistics 2016, 2785). As a whole, high-income employees and employees in larger firms are more likely to have access. Only about 1 in 10 low-income workers had access to a FSA in 2015 compared with about 7 in 10 workers at the top of the earning scale (figure 1).

FIGURE 1

Percentage of Workers with Access to Health Care FSAs, 2016

By wage percentile

Percentage



Source: Table 41 of National Compensation Survey: Employee Benefits in the United States, March 2016 (Bureau of Labor Statistics 2016, 2785).

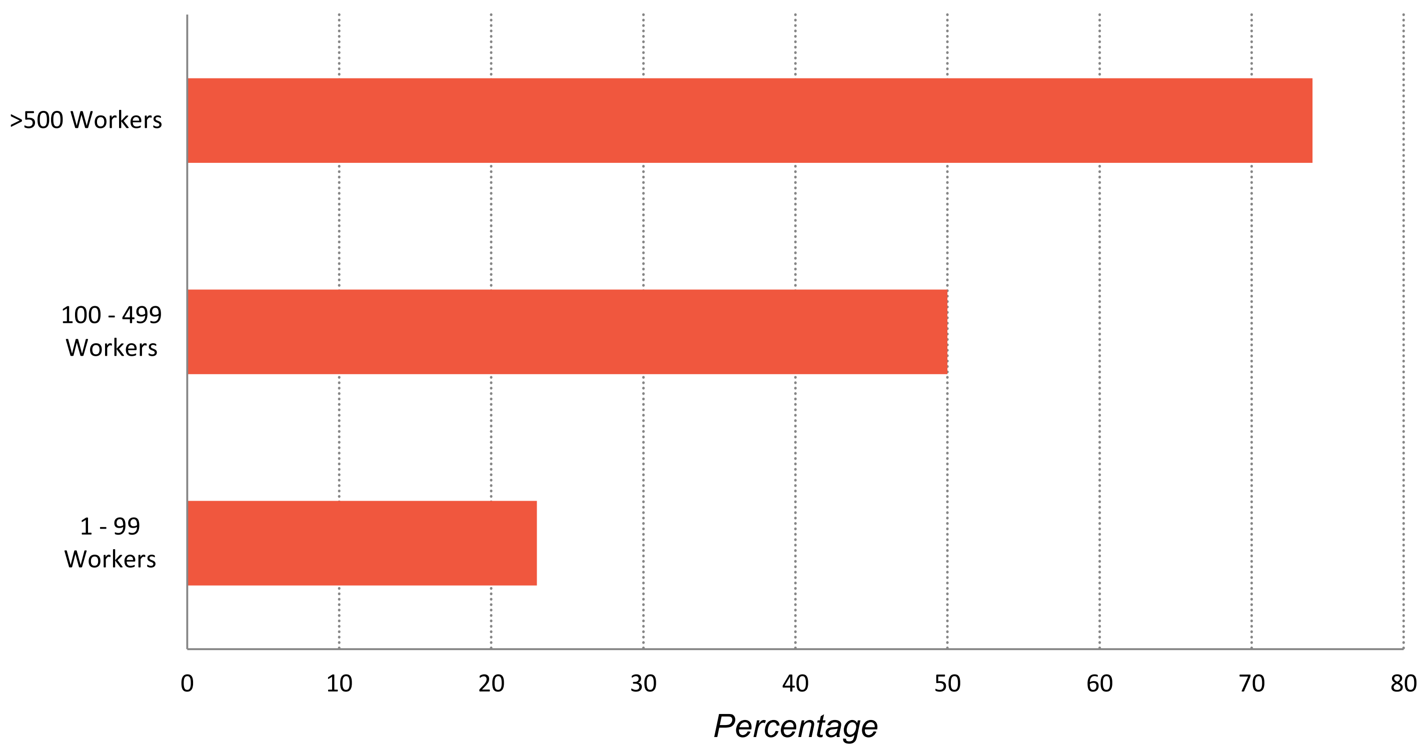
How do flexible spending accounts (FSAs) for health care expenses work?

Employees in larger firms (500 or more workers) are about three times as likely to have access than employees in smaller firms (99 or fewer workers), with 74 percent of the former reporting access versus 23 percent of the latter in 2016 (figure 2). Larger firms are typically better able to handle the complexity and administrative costs of offering FSAs, and low-income jobs often do not offer health insurance, thus eliminating access to flexible benefits, such as FSAs, for such workers.[3]

FIGURE 2

Percentage of Workers with Access to Health Care FSAs, 2016

By firm size



Source: Table 41 of National Compensation Survey: Employee Benefits in the United States, March 2016 (Bureau of Labor Statistics 2016, 2785).

Key Elements of the U.S. Tax System

How do flexible spending accounts (FSAs) for health care expenses work?

[1]Allowable expenses are discussed in the IRS publication Medical and Dental Expenses (IRS 2016).
[2]Contributions to a FSA also are not subject to the employer portion of payroll taxes. The $2,400 reduction in the employee's earnings credited to his or her Social Security accounted could slightly reduce the employee's eventual Social Security benefit.
[3]Only individuals eligible for employer-provided major medical coverage can be offered the FSA. The IRS stipulated this new restriction in 2013 with Notice 2013-54.

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Key Elements of the U.S. Tax System

How do health reimbursement accounts (HRAs) work?

Q. How do health reimbursement accounts (HRAs) work?

A. HRAs are employer-sponsored accounts, funded solely by employers, used to reimburse employees for qualified medical expenses.

HRAs are established by the employer, and only the employer can contribute to the account. Although they have no contribution amount limit, the employer does set a self-designated annual contribution amount. Employers can also restrict the types of medical services that are eligible for reimbursement from the list of qualified services defined by the Internal Revenue Service.

Reimbursements for qualified medical expenses are exempt from federal income and payroll taxes. Any unused funds can carry over indefinitely, although employers may limit the aggregate carryover amount.

Employers need not fund HRAs until employees draw on the funds and, unlike flexible spending accounts, the entirety of the funds do not need to be available from the beginning of the period. HRAs are usually offered in conjunction with a high-deductible health plan, although employers can "integrate" them with other types of qualified group health plans. With the implementation of the Affordable Care Act in 2010, specifically the addition of Section 2711 of the Public Health Service Act, which prohibits group health insurance plans from limiting the dollar value of lifetime and annual "essential health benefits," most HRAs are no longer available as stand-alone accounts, although there are a few exceptions. HRAs, by definition, impose an annual benefit limit as the employer contributes a preset amount every year.

[1]Retiree HRAs and one-person stand-alone HRAs are still compliant with the new ACA ruling.

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Key Elements of the U.S. Tax System

Q. What are the tax benefits of homeownership?

A. The main tax benefit of owning a house is that the imputed rental income homeowners receive is not taxed. Although that income is not taxed, homeowners still may deduct mortgage interest and property tax payments as well as certain other expenses from their federal taxable income. Additionally, homeowners may exclude, up to a limit, the capital gain they realize from the sale of a home.

OVERVIEW

The tax code provides a number of benefits for people who own their homes. The main benefit is that the owners do not pay taxes on the imputed rental income from their own homes. They do not have to count the rental value of their homes as taxable income, even though that value is just as much a return on investment as are stock dividends or interest on a savings account. It is a form of income that is not taxed.

Homeowners may deduct both mortgage interest and property tax payments as well as certain other expenses from their federal income tax. In a well-functioning income tax, all income would be taxable and all costs of earning that income would be deductible. Thus, in a well-functioning income tax, there should be deductions for mortgage interest and property taxes. However, our current system does not tax the imputed rental income that homeowners receive, so the justification for giving a deduction for the costs of earning that income is not clear.

Finally, homeowners may exclude, up to a limit, the capital gain they realize from the sale of a home. All of these benefits are worth more to taxpayers in higher-income tax brackets than to those in lower brackets.

MORTGAGE INTEREST DEDUCTION

Homeowners who itemize deductions may reduce their taxable income by deducting any interest paid on a home mortgage. The deduction is limited to interest paid on up to $1 million of debt incurred to purchase or substantially rehabilitate a home. Homeowners also may deduct interest paid on up to $100,000 of home equity debt, regardless of how they use the borrowed funds. Taxpayers who do not own their home have no comparable ability to deduct interest paid on debt incurred to purchase goods and services.

Key Elements of the U.S. Tax System

What are the tax benefits of homeownership?

The Tax Policy Center (TPC) estimates that 20 percent of all tax units will benefit from the deduction in 2015. The congressional Joint Committee on Taxation (JCT) estimated that the mortgage interest deduction will cost the federal government almost $75 billion in lost revenue in fiscal year 2015.

PROPERTY TAX DEDUCTION

Homeowners who itemize deductions may also reduce their taxable income by deducting property taxes they pay on their homes. That deduction is effectively a transfer of federal funds to jurisdictions that impose a property tax (mostly local but also some state governments), allowing them to raise property tax revenue at a lower cost to their constituents. The JCT estimated that the deduction saved millions of homeowners a total of $34 billion in income tax in fiscal year 2015.

IMPUTED RENT

Buying a home is an investment, part of the returns from which is the opportunity to live in the home rent-free. Unlike returns from other investments, the return on homeownership—what economists call "imputed rent"—is excluded from taxable income. In contrast, landlords must count as income the rent they receive, and renters may not deduct the rent they pay. A homeowner is effectively both landlord and renter, but the tax code treats homeowners the same as renters while ignoring their simultaneous role as their own landlords. The Office of Management and Budget estimates that the exclusion of imputed rent reduced federal revenue by nearly $79 billion in fiscal year 2015.

PROFITS FROM HOME SALES

Taxpayers who sell assets must generally pay capital gains tax on any profits made on the sale. But homeowners may exclude from taxable income up to $250,000 ($500,000 for joint filers) of capital gains on the sale of their home if they satisfy certain criteria: they must have maintained the home as their principal residence in two out of the preceding five years, and they generally may not have claimed the capital gains exclusion for the sale of another home during the previous two years. The JCT estimated that the exclusion provision saved homeowners more than $27 billion in income tax in fiscal 2015.

EFFECT OF DEDUCTIONS AND EXCLUSIONS

The deductions and exclusions available to homeowners are worth more to taxpayers in higher tax brackets than to those in lower brackets. For example, deducting $2,000 for property taxes paid saves a taxpayer in the 39.6 percent top tax bracket $792, but saves a taxpayer in the 15 percent bracket only $300. Additionally, even though they only represent about 20 percent of all tax units, those with more than $100,000 in income receive over 85 percent of the mortgage interest deduction tax benefits. That difference results largely from three factors: compared with lower-income homeowners, those with higher incomes face higher marginal tax rates, typically pay more mortgage interest and property tax, and are more likely to itemize deductions on their tax returns.

Key Elements of the U.S. Tax System

What are the tax benefits of homeownership?

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Q. Do existing tax incentives increase homeownership?

A. Probably not. The US homeownership rate is lower than in many other developed countries such as the United Kingdom or Australia, which do not offer tax subsidies for homeownership, and even lower than some other countries with subsidies. Beyond a base level, US subsidies mainly support larger homes and second homes. Additionally, evidence suggests that the subsidies raise housing costs, thus dissipating their effectiveness in helping people buy their own homes.

Contrary to popular belief, the mortgage interest deduction was not added to the tax code to encourage home ownership. The deduction existed at the birth of the income tax in 1913—a tax explicitly designed to hit only the richest individuals, a group for whom homeownership rates were not a social concern.

The federal government now provides more than $120 billion each year in tax benefits to subsidize homeownership, yet our rate of homeownership differs little from that in countries providing no similar subsidies. The bulk of US subsidies go to middle- and upper-income households that likely would own their homes anyway; thus, these subsidies simply facilitate the consumption of more housing. In addition, evidence suggests that the tax subsidies raise housing costs, thus dissipating their effectiveness in helping people buy their own homes.

The US homeownership rate is lower than that in many other developed countries such as the United Kingdom or Australia that have no such subsidies. The rate is even lower than some in countries that have subsidies, such as Sweden and Norway (figure 1). Other factors, including the ease of obtaining a mortgage, home prices, and cultural patterns play significant roles in determining homeownership rates.

Because tax deductions are worth more to high-income households, which face the highest tax rates, the deductibility of property taxes and mortgage interest most helps households that would likely own their own homes even without a tax subsidy. Low-income households, which typically are most in need of aid to afford homeownership, get little or no benefit from that deductibility.

Beyond a base level, subsidies mainly support larger homes and second homes. In effect, the federal government encourages middle- and upper-income households to consume more housing than they otherwise would. Limits on the amount of mortgage debt for which taxpayers may deduct interest costs do, however, constrain those subsidies to some degree.

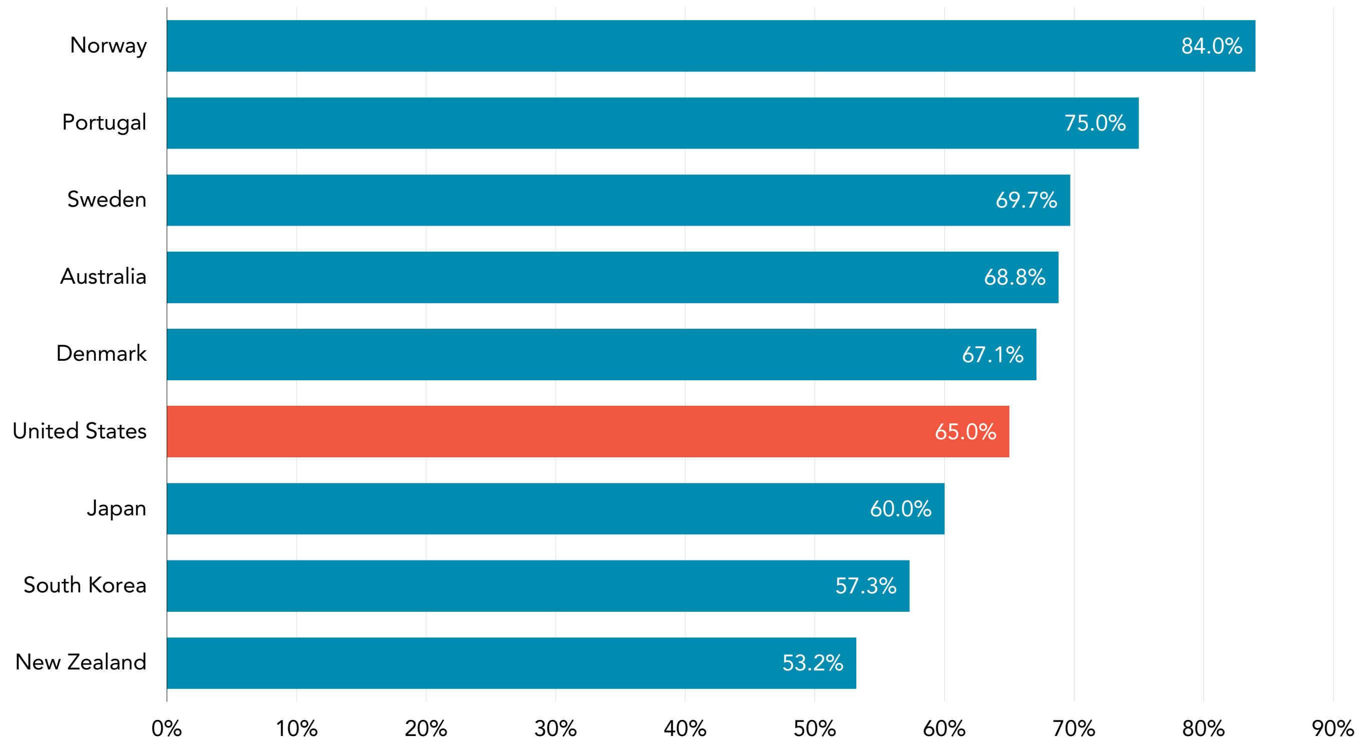
Key Elements of the U.S. Tax System

Do existing tax incentives increase homeownership?

FIGURE 1

Homeownshership Rates in Select Countries

Share of adults who own their homes



Source: Desilver, 2013.

Research suggests that housing subsidies raise housing costs, particularly where land is scarce. By reducing the after-tax cost of housing, the subsidies enable people to pay more than they otherwise would. The resulting increase in demand for housing causes prices to rise, and rise most in markets where supply cannot easily increase to meet that higher demand.

Key Elements of the U.S. Tax System

Do existing tax incentives increase homeownership?

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Q. Why are taxes so complicated?

A. Our tax system could be simple if its only purpose were to raise revenue. But it has other goals, including fairness, efficiency, and enforceability. And Congress has used the tax system to influence social policy as well as to deliver benefits for specific groups and industries.

Almost everyone agrees that the current tax system is too complicated, yet almost every year the system gets more complex, not less. Why? Tax simplicity almost always conflicts with other policy goals.

For example, the simplest—and least distorting—tax is a head tax, a fixed dollar tax on everyone. But a head tax would be unfair, taking no account of differences in the incomes and needs of individuals, families, and businesses.

COMPETING GOALS FOR A TAX SYSTEM

Most people believe taxes should be fair, conducive to economic prosperity, and enforceable, as well as simple. But even people who agree on these goals often disagree about the relative importance of each. As a result, policies usually represent a balance among competing goals, and simplicity often loses out to other priorities.

For example, most countries tailor tax burdens to the characteristics of individual taxpayers. That can make taxes fairer, but more complex. Income has to be traced from businesses to individuals. Individual characteristics such as marital status and number of dependents, as well as the composition of expenditures or income, have to be reported and documented. These conflicting objectives appear to be especially relevant in the current tax code, where desires to channel tax cuts to particular groups have added significant complexity.

POLITICS OF TAX POLICY

Politics compounds complexity. Interest groups—and thus politicians—support tax subsidies for particular groups or activities. And these targeted subsidies inevitably complicate the tax system by creating distinctions among taxpayers, and among sources and uses of income.

Moreover, bowing to pressure from a handful of antitax activists, many members of Congress have signed a pledge to never raise taxes. That promise makes it difficult to get rid of tax preferences that lower taxes for some taxpayers but complicate the tax system. Honoring the pledge means that any simplification that raises taxes must be offset with another change that lowers them. Meeting that goal can often mean further complicating the tax system.

Key Elements of the U.S. Tax System

Why are taxes so complicated?

OTHER GOALS

Some complexity is necessary to deter tax avoidance. Taxpayers, of course, have the right to reduce their taxes by any legal means. But their doing so inevitably raises questions about whether particular activities or expenditures qualify for tax-preferred status. The Treasury Department responds with rules designed to limit avoidance. Taxpayers in turn adapt to skirt the new rules. This can create a vicious cycle that leads to more complicated rules and increasingly complex avoidance strategies beloved by high-priced accountants and lawyers.

Many complicated provisions were enacted to raise revenue or to limit revenue losses during times of rampant budget deficits. For example, the landmark Tax Reform Act of 1986—a remarkable accomplishment in many respects—gave up some simplifying changes to meet the goal of revenue neutrality. The act created several complicated phaseouts and hidden taxes to meet revenue and distributional targets.

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Key Elements of the U.S. Tax System

Q. How costly is complexity?

A. Tax compliance imposes three major costs: taxpayers' time spent filing returns; their out-of-pocket costs of keeping records, hiring preparers, buying software, and the like; and government costs of administering the tax system. All of those costs increase with the complexity of the tax system, but their magnitudes are difficult to measure.

If policymakers knew how much a given change in the tax code would raise or lower taxpayers' compliance costs (and government's administrative costs), they could more easily evaluate the trade-offs between complexity and other goals. But complexity and its costs are hard to quantify. Calculating the total costs of the current tax system requires dividing compliance costs into several components: the value of the time taken to comply with system requirements; the out-of-pocket costs for recordkeeping, outside tax preparation, and the like; and the administrative costs borne by government.

A number of surveys have tried to measure the burden of tax compliance. Most find that the average taxpayer devotes little time to paying taxes, but that a small subset (many of them high-income and self-employed individuals) devotes much more.

COSTS OF FILING TAXES

In a 2013 study, IRS and Treasury analysts estimated that taxpayers spent 1.8 billion hours and $28.3 billion preparing and filing individual income taxes in 2010. These figures correspond to an average of 12.5 hours and $198 per taxpayer. But the numbers varied considerably by taxpayer income and complexity of the tax return. For example, taxpayers with adjusted gross incomes under $30,000 spent an average of about 10 hours and just over $110 preparing their returns, compared with about 14.5 hours and $328 for those with adjusted gross income between $100,000 and $200,000.

Compliance costs vary with the forms needed to file tax returns—simpler forms take less time to complete and require less information. In 2013, 43 percent of taxpayers filed a simplified version of the standard 1040 form, either the 1040A or the 1040EZ. In this group, nearly half did not itemize deductions, less than one-fourth claimed capital gains or losses, and nearly three-fourths had no business income—all factors that complicate tax filing.

Key Elements of the U.S. Tax System

How costly is complexity?

Information on the use of paid preparers gives further hints about how complex taxpayers find the system to be. In 2013, 56 percent of tax filers used paid preparers. Among those who filed the 1040, 62 percent used preparers. Even among 1040A and 1040EZ filers, 46 percent used preparers. It is unclear, however, whether these figures indicate that tax filers are using paid preparers because they cannot navigate the tax code themselves, or whether they simply dislike the paperwork enough to pay others to do the work for them.

The IRS currently uses models from Arthur D. Little consultants to estimate the time required to complete forms and schedules. These estimates are published with the tax forms as part of the Paperwork Reduction Act Notice. For fiscal 2010, the Office of Management and Budget estimated that taxpayers needed 2.4 billion hours to comply with the requirements of all tax forms and IRS regulations (Office of Information and Regulatory Affairs 2011). This estimate applied to both businesses and individuals, and included all federal taxes, not just income taxes.

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Key Elements of the U.S. Tax System

Q. What are the benefits of simpler taxes?

A. Simpler taxes have lower compliance costs—in terms of both time and money—and may encourage taxpayers to use tax provisions aimed at helping people pay for socially desirable activities.

Simplification could improve the tax code in at least two important ways. First, simplicity would lower taxpayers' costs of complying with the tax system in terms of time, money, and mental anguish. Second, simpler tax provisions are more likely to be used. Provisions aimed at encouraging specific activities, such as saving for college, would be more effective if people understood how they work.

Making taxes simpler could raise compliance rates by reducing inadvertent nonpayment of taxes. To some (uncertain) extent, people do not pay taxes because they do not understand the tax law. Evidence also suggests that people are more likely to evade taxes they consider unfair. People who cannot understand tax rules may question the fairness of the tax system and feel that others are reaping more benefits than they are.
are.

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Key Elements of the U.S. Tax System

Q. What policy reforms could simplify the tax code?

A. Reducing the number of distinctions among economic activities and taxpayers' personal characteristics would simplify the code, reducing both compliance costs for taxpayers and administrative costs for the government. The consequent broadening of the tax base would allow lower tax rates while maintaining revenue and also reduce economic distortions caused by taxation.

The key to tax simplification is to make fewer distinctions across economic activities and taxpayers' personal characteristics. This would not only reduce compliance costs, but allow for simpler administration. For example, if everyone paid the same tax rate on dividends, the tax could be collected from dividend payers without having to trace who got what.

The general structure of a simple tax system would be a broad tax base with rates that are the same across different income sources or types of expenditure. Progressivity could be embodied in the rate structure (with rates rising with income, as they do now), a basic exemption amount, and the choice of tax base (income, consumption, or another measure), rather than through specific provisions that treat different levels of income and consumption differently. Universal exemptions, deductions, or credits are much simpler to administer than targeted ones.

Several fairly modest changes could make the current tax system simpler as well as fairer and more conducive to economic growth. One possible focus: the individual alternative minimum tax (AMT). To spare middle-income taxpayers who were never its target, the AMT should allow deductions for dependents and for state and local taxes. Further, all personal credits should be available against the AMT. Any new proposal that cuts regular income tax liabilities should also make conforming adjustments to the AMT so that more taxpayers are not subjected to it.

Another option would coordinate the phaseout of tax credits. Specific tax credits phase out across different income ranges, so that claiming each credit requires a separate worksheet and tax calculation. The phaseouts also create hidden taxes over the phaseout range and diminish the effectiveness of the credits by encouraging the very activities they are designed to spur.

Key Elements of the U.S. Tax System

What policy reforms could simplify the tax code?

Numerous provisions—each with its own rules—apply to the same general activity. Coordinating or consolidating these provisions could simplify taxes with little or no change in revenue or the distribution of taxes. Examples include the various provisions related to families with children (the earned income tax credit, the dependent exemption, and the child credit), tax subsidies for education (the American Opportunity and Lifetime Learning credits, and the deductibility of tuition and fees), and saving incentives (traditional individual retirement accounts, Roth IRAs, education IRAs, and Keogh plans).

Yet another simplification would tax capital gains as ordinary income in return for a reduction in top tax rates. This was the cornerstone of the 1986 deal that allowed substantial simplification of the individual income tax. Returning to this approach would massively reduce incentives to create tax shelters or to engage in complex tax planning.

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Q. How do the estate, gift, and generation-skipping transfer taxes work?

A. The federal estate tax applies to the transfer of property at death. The gift tax applies to transfers made while a person is living. The generation-skipping transfer tax is an additional tax on a transfer of property that skips a generation.

The United States has taxed the estates of deceased people since 1916. In 1976, Congress linked taxes on estates, gifts made during life (inter vivos gifts), and generation-skipping transfers (GST). The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) cut all three taxes sharply, but only through 2010. The act gradually phased out the estate and GST taxes, and repealed both entirely for 2010, leaving only the gift tax (at a reduced rate) in effect that year.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 reinstated the estate and GST taxes for 2010 and extended them through 2012, with a $5 million estate tax exemption (indexed for inflation after 2011) and a top rate of 35 percent, but allowed executors to elect the EGTRRA rules for decedents who died in 2010. The 2012 rules were permanently extended by the American Taxpayer Relief Act of 2012, but the top rate was increased to 40 percent.

Here's how the gift tax works:

- Congress enacted the gift tax in 1932 to prevent donors from avoiding the estate tax by transferring their wealth before they died.
- The tax provides a lifetime exemption of $5.49 million per donor in 2017. This exemption is the same that applies to the estate tax and is integrated with it (i.e., gifts reduce the exemption amount available for estate tax purposes). Beyond that exemption, donors pay gift tax at the same top rate (40 percent) that applies for estate tax purposes.
- An additional amount each year is also exempted from both the gift tax and the lifetime exemption. This exemption, $14,000 in 2017, is indexed for inflation in $1,000 increments and is granted separately for each recipient. Thus, a married couple with three children could give their children a total of $84,000 each year ($14,000 from each parent to each child) without owing tax or counting toward the lifetime exemption.
- Regardless of size, gifts received are not taxable income to the recipient.

Key Elements of the U.S. Tax System

How do to estate, gift, and generation-skipping transfer taxes work?

Here's how the estate tax works:

- The executor of an estate must file a federal estate tax return within nine months of a person's death if that person's gross estate exceeds the exempt amount ($5.49 million in 2017; table 1).
- The estate tax applies to a decedent's gross estate, which generally includes all the decedent's assets, both financial (e.g., stocks, bonds, and mutual funds) and real (e.g., homes, land, and other tangible property). It also includes the decedent's share of jointly owned assets and life insurance proceeds from policies owned by the decedent.
- The estate tax allows an unlimited deduction for transfers to a surviving spouse and to charity. Estates may also deduct debts, funeral expenses, legal and administrative fees, charitable bequests, and estate taxes paid to states. The taxable estate equals the gross estate less these deductions.
- A credit then effectively exempts a large portion of the estate: in 2017, the effective exemption is $5.49 million. Any value of the estate over $5.49 million is generally taxed at the top rate of 40 percent.
- Although tax rates are graduated, all transfers in excess of the exemption are taxed at the top rate because the exemption exceeds the threshold at which the top rate applies.
- Special provisions reduce the tax, or spread payments over time, for family-owned farms and closely-held businesses. Estates that satisfy certain conditions may use a special-use formula to reduce the taxable value of their real estate, often by 40 to 70 percent. Estates where farms or businesses make up at least 35 percent of gross estate may pay the tax in installments over 14 years at reduced interest rates, with only interest due during the first five years.
- Regardless of size, inheritances are not taxable income to the recipient.

And here's how the generation-skipping trust tax works:

- Congress enacted the GST tax in 1976 to prevent families from avoiding the estate tax for one or more generations by making gifts or bequests directly to grandchildren or great-grandchildren. The GST tax effectively imposes a second layer of tax (using the exemption and the top tax rate under the estate tax) on wealth transfers to recipients who are two or more generations younger than the donor.

Key Elements of the U.S. Tax System

How do to estate, gift, and generation-skipping transfer taxes work?

TABLE 1

Estate, Gift, and GST Tax Rates and Exemptions under Current Law

2007-2017

Year	Estate and GST tax rate	Gift tax rate	Estate and GST tax exemptions	Lifetime gift exemptions	Annual gift exemptions
2007	45%	45%	$2 million	$1 million	$12,000
2008	45%	45%	$2 million	$1 million	$12,000
2009	45%	45%	$3.5 million	$1 million	$13,000
2010	0%[a]	35%	N/A[b]	$1 million	$13,000
2011	35%	35%	$5 million	$5 million	$13,000
2012	35%	35%	$5.12 million	$5.12 million	$13,000
2013	40%	40%	$5.25 million	$5.25 million	$14,000
2014	40%	40%	$5.34 million	$5.34 million	$14,000
2015	40%	40%	$5.43 million	$5.43 million	$14,000
2016	40%	40%	$5.45 million	$5.45 million	$14,000
2017	40%	40%	$5.49 million	$5.49 million	$14,000

Source: Internal Revenue Code.

(a) The exemption, which was $10,000 in 1998, is indexed for inflation in $1,000.

(b) Executors can elect to apply the EGGTRA rules, which repealed the estate tax for 2010, but otherwise the 2011 parameters apply.

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Q. Who pays the estate tax?

A. The top 10 percent of income earners pays over 90 percent of the tax, with over one-fourth paid by the richest 0.1 percent. Very few farms or family businesses pay the tax.

TABLE 1

Number of Estate Taxpayers and Distribution of Estate Tax Burden

2017 current law[a]

Source	Expanded Cash Income Category					Businesses and Farms	
	All	Top 10 percent	Top 5 percent	Top 1 percent	Top 0.1 percent	All[b]	Small[c]
Number of returns[d]	11,020	8,430	7,270	3,490	530	1,010	270
Number taxable[d]	5,190	3,600	2,890	1,360	220	370	50
Percent of all taxable returns	100	69	56	26	4	7	1
Estate tax paid ($ millions)[e]	19,680	17,720	16,370	12,310	5,260	2,040	20
Percent of all estate tax paid	100	90	83	63	27	10	0

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1)
(1) Estimates are for estate tax returns filed for individuals who die in 2017.
(2) Estate tax returns on which farm and business assets represent at least half of gross estate.
(3) Estate tax returns on which farm and business assets represent at least half of gross estate and these assets are no more than $5 million.
(4) Number of returns is rounded to nearest multiple of ten.
(5) Estate tax paid is rounded to nearest multiple of ten million.

The Tax Policy Center estimates that some 11,020 individuals dying in 2017 will leave estates large enough to require filing an estate tax return (estates with a gross value under $5.49 million need not file this return in 2017). After allowing for deductions and credits, 5,190 estates will owe tax. Nearly 70 percent of these taxable estates will come from the top 10 percent of income earners and over 25 percent will come from the top 1 percent alone.

Estate tax liability will total an estimated $19.7 billion in 2017. The top 10 percent of income earners will pay 90 percent of this total. The richest 0.1 percent will pay $5.3 billion, or 27 percent of the total.

Only an estimated 50 small farms and closely held businesses—estates with farm and business assets totaling

Who pays the estate tax?

no more than $5 million and making up at least half of gross estate—will pay any estate tax in 2017. Such estates will represent only 1 percent of all taxable estate tax returns.

The Tax Policy Center estimates that small farms and businesses will pay $20 million in estate tax in 2017, one-tenth of 1 percentage of the total estate tax revenue.

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Key Elements of the U.S. Tax System

Q. How many people pay the estate tax?

A. About 9,500 estate tax returns were filed for people who died in 2011, of which only 4,400 were taxable, less than 1 in 500 of the 2.5 million people who died in that year.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) raised the estate tax exemption from $675,000 in 2001 to $1 million in 2002 and to $3.5 million in a series of steps through 2009, sharply reducing the number of estates that have to pay estate taxes. EGTRRA repealed the estate tax for 2010, but after that, the estate tax was scheduled to revert to pre-EGTRRA rules.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 reinstated the estate tax and generation-skipping transfer tax (GST) and extended them through 2012, with a $5 million estate tax exemption (indexed for inflation after 2011) and a top rate of 35 percent. The 2012 rules were permanently extended by the American Taxpayer Relief Act of 2012, but the top rate was increased to 40 percent.

- IRS data show that roughly 109,500 estate tax returns were filed for decedents in 2001, the year before the EGTRRA changes began to go into effect. Fewer than half—about 50,500—of those estates had any estate tax liability after credits. Estate tax liability totaled $23.7 billion.
- For decedents in 2009, the year the final increase in the estate tax exemption under EGTRRA went into effect, only about 12,900 estate tax returns were filed, of which only 5,700 were taxable. Estate tax liability totaled $13.6 billion.
- For those who died in 2010, executors could elect to have the EGTRRA rules apply, which meant that no estate tax was imposed on the estate. However, instead of a full step-up in basis for recipients of bequests, their step-up was limited to $1.3 million (plus an additional $3 million for surviving spouses) with any additional unrealized gains required to be carried over. So some deferred tax on these additional unrealized gains will be paid by recipients of bequests under the income tax.
- For decedents in 2017 (with an exemption of $5.49 million), the Tax Policy Center estimates there will be only about 11,000 estate tax returns filed, of which 5,200 will be taxable. Estate tax liability will total $19.7 billion after credits (table 1).
- To put the number of estate tax returns filed in perspective, the Population Division of the Bureau of the Census projects that 2.7 million people will die in 2017. Thus, an estate tax return will be filed for only 1 in 243 decedents, and only 1 in 517 will pay any estate tax.

Key Elements of the U.S. Tax System

How many people pay the estate tax?

TABLE 1
Estimated Estate Tax Returns and Liability
2001, 2007-2017

	2001	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Estate tax returns	109,600	36,700	29,000	12,900	[2]	9,500	9,900	10,800	10,800	10,800	10,900	11,000
Taxable returns	50,500	16,600	15,100	5,700	[2]	4,400	4,200	5,300	5,300	5,300	5,200	5,200
Estate tax liability ($ millions)	23,700	24,600	18,900	13,600	[2]	10,900	12,400	17,500	17,900	18,400	19,000	19,700

Source: For 2001, 2009 and 2011: Internal Revenue Service, Statistic of Income (SOI) Division of IRS; for 2012-17, the Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).
(1) Figures are for estate tax returns filed for decedents dying in each calendar year.
(2) The estate tax was repealed for 2010 decedents by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), but reinstated by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 with an option for executors to elect the EGTRRA rules. SOI has not published statistics for 2010 decedents.

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Q. What is the difference between carryover basis and a step-up in basis?

A. The difference is whether heirs who sell an inherited asset will pay tax on the capital gains from the time the asset was originally purchased or from the time they inherited it. In some cases, the difference is a lot of tax liability.

A capital gain occurs if a capital asset is sold or exchanged at a price higher than its "basis," the original purchase price with some adjustments. When a person inherits an asset, the basis becomes the fair market value of the asset at the time of the owner's death. This is called a "step-up in basis" because the basis of the decedent's asset is stepped up to market value. With gifts made during the giver's lifetime, the recipient retains the basis of the person who made the gift ("carryover basis").

The unrealized gain (or loss) on assets given by gift or bequest is not included in the income of the donor. The recipient is not subject to income tax on the asset's value at the time it is received, but generally must include any gain if the asset is subsequently sold or otherwise disposed of. The realized gain is the amount received from the sale of the asset less the asset's basis. For most sales, the basis is the amount the taxpayer invested in the asset, adjusted for subsequent improvements, depreciation, and certain other items. For gifts and inheritances, however, special basis rules apply.

For gifts, the basis remains the same as when the asset was held by the person who made the gift ("carryover basis"), but with an adjustment for any gift tax paid. For inheritances, the basis is the fair market value of the asset at the time of the donor's death (or six months afterward, if the alternative valuation date is elected by the executor). This is referred to as "step-up in basis" (or "stepped-up basis") because the previous basis is stepped up to market value.

The effect of carryover basis on gifts is to tax the unrealized gain accrued by the donor when the recipient sells the asset. The effect of step-up in basis on inheritances is to eliminate income tax on any unrealized gain accrued by the decedent.

Key Elements of the U.S. Tax System

What is the difference between carryover basis and a step-up in basis?

The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) repealed the estate tax for 2010. But instead of allowing recipients the full step-up in basis in effect up until that year, it limited their step-up to $1.3 million (plus an additional $3 million for surviving spouses) with any additional unrealized gains carried over. Although the EGTRRA rules for 2010 were subsequently replaced, executors could elect EGTRRA treatment for 2010 decedents (and, in some cases, had a financial incentive to do so). So some deferred tax on the additional unrealized gains of decedents for whom an election was made will be paid by heirs under the income tax.

Further Reading

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Q. How could we reform the estate tax?

A. Possible reforms run the gamut from repeal to modest fixes that would make the tax more difficult to avoid.

Proposals to reform the estate and gift tax range from comprehensive options, such as permanently repealing the estate tax or replacing the existing tax with a tax on inheritances, to more modest options, such as decreasing exemption amounts, increasing tax rates, and blocking avenues for avoiding the tax.

The federal estate and gift taxes (including the generation-skipping tax, or GST) have changed virtually every year since 2001. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) cut these taxes sharply but only through 2010. EGTRRA gradually phased out the estate tax and GST, and eliminated them entirely for 2010, leaving only the gift tax (at a reduced rate) in that year.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 reinstated the estate tax and GST for 2010 and extended them through 2012, with a $5 million estate tax exemption (indexed for inflation after 2011) and a top rate of 35 percent. But it allowed executors to elect the EGTRRA rules for decedents who died in 2010. The 2012 rules were permanently extended by the American Taxpayer Relief Act of 2012 (ATRA), though with a new top rate of 40 percent. In light of numerous recent proposals to repeal these taxes or reform them in some manner, how "permanent" the ATRA changes are remains to be seen.

Many members of Congress have called for the repeal of the estate and gift taxes. That would be expensive, however. The Congressional Budget Office projects that these taxes will raise $250 billion in fiscal years 2017 through 2026.

Repeal would also be regressive—the benefits would go almost entirely to people at the top of the income distribution—and would invite significant sheltering of income. Further, gifts from an estate to charity currently qualify for full deduction from the estate's taxable value, creating a substantial incentive to leave bequests to charities. Prior estimates indicate that repealing the estate tax would reduce charitable donations by 6 to 12 percent.

One option, the substitution of an inheritance tax, would tax wealth transfers somewhat differently. It differs from an estate tax and gift tax in that the tax rate depends on the amount of gifts and bequests the taxpayer receives rather than on how much the donor gives or bequeaths. Unlike estate and gift taxes, a progressive inheritance tax gives donors an incentive to spread their wealth more broadly, because each of any number of recipients can claim an exemption and take advantage of the progressive tax rates, thus reducing their effective tax rate. Most countries that tax wealth transfers do so with inheritance taxes rather than estate taxes.

A more modest reform could address the loopholes, such as special trust arrangements and valuation discounts. Those tax avoidance measures complicate estate planning and result in unequal taxes on comparable estates. Closing loopholes could increase revenues, moreover, allowing a higher estate tax exemption, lower rates, or deficit reduction.

The following reforms would only change the estate tax exemption level and rates, and the treatment of wealth transfer taxes paid to states (figure 1).

- Pre-ATRA Law: The old law had an exemption level of $1 million (not indexed for inflation) and a top statutory rate of 55 percent, along with a 5 percent surtax that phased out the benefit of lower rates for large estates and a credit (rather than a deduction) for state wealth transfer taxes. Making pre-ATRA law permanent starting in 2017 would increase the number of estate tax returns filed between 2017 and 2026 by 1.5 million and increase the estate tax liabilities of these decedents by $405 billion.

- 2012 Law: The estate tax law in effect in 2012 had an exemption of $5 million (indexed for inflation from 2011) and a top rate of 35 percent, so it differs from current law only in the top rate. Making 2012 law permanent starting in 2017 would not affect the number of estate tax returns filed but would decrease estate tax liabilities by about $29 billion for decedents who died between 2017 and 2026.

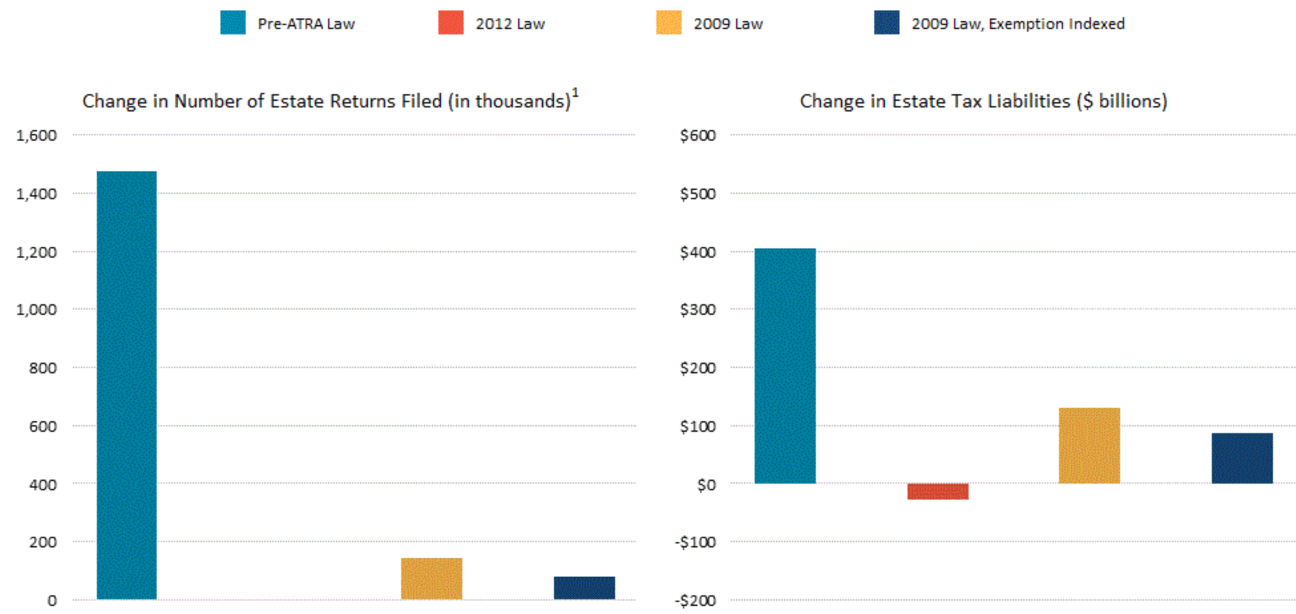
- 2009 Law: The estate tax law in effect under EGTRRA for 2009 had an exemption of $3.5 million and a top rate of 45 percent. If 2009 law were made permanent starting in 2017, the number of estate tax returns filed between 2017 and 2026 would increase by 142,000, and estate tax liabilities of these decedents would increase by $131 billion.

- 2009 Law, Exemption-Indexed: If 2009 law, modified to index the exemption to inflation, were made permanent starting in 2017, the number of estate tax returns filed between 2017 and 2026 would increase by 81,000, and estate tax liabilities of these decedents would increase by $88 billion (about one-third less than the increase without indexing the exemption).

Key Elements of the U.S. Tax System

How could we reform the estate tax?

FIGURE 1
Change in Total Number of Estate Tax Returns Filed and Estate Tax Liability Under Alternative Reforms
2017-2026



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0516-1).
(1) There is no change in the number of returns filed under 2012 law because the exemtpion is the same as under current law.

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Key Elements of the U.S. Tax System

Q. How should wealth be taxed?

A. There are three options: an estate and gift tax (like the current US federal system), an inclusion tax, or an accessions tax.

The transfer of wealth through gifts or bequests can be taxed in three ways: under an estate and gift tax (like the current US federal system), under an inclusion tax, or under an accessions tax.

ESTATE AND GIFT LEVY TAXES

An estate and gift levy taxes the donor or the donor's estate using separate estate and gift tax rate structures. Apart from transfers to spouses and charities, which are generally exempt from tax, and the small annual exemption from the gift tax, the amount of tax imposed on the transfer does not vary with the income or other characteristics of the transfer recipients.

INCLUSION TAXES

An inclusion tax requires recipients to treat transferred assets as taxable income. The amount of tax therefore varies with the recipients' characteristics (e.g., their filing status), the amount of their other income, the amount of their deductions, and other factors that affect income tax liability.

ACCESSIONS TAXES

An accessions tax, like an inclusion tax, taxes recipients on the value of transfers received, but under a rate structure different from the income tax rate structure. The amount of tax imposed on the transfer therefore depends only on the amount received by the recipient in the relevant time period.

CONSIDERATIONS

Under all three approaches, the treatment of the donor's unrealized gains is an important consideration that affects incentives to transfer and the amount of tax revenue produced. A donor's unrealized gains could be taxed as part of his or her income. Alternatively, such gains could be taxed when realized by the recipient if a carryover basis is required. On the other hand, if a step-up in basis is allowed for the recipient such gains could never be taxed at all.

Key Elements of the U.S. Tax System

How should wealth be taxed?

An important consideration for an accessions tax is the relevant time period over which transfers are taxed. If transfers are taxed annually with a graduated rate schedule, much less tax would be paid on lifetime transfers received evenly over many years than if the entire amount was received in one year. These differences could be addressed by taking into account the accumulated transfers recipients received over their lifetimes, much like the lifetime accumulation of gifts and integration with the estate tax under the current federal tax.

The taxation of lifetime transfers can also differ under an inclusion tax because of the graduated income tax rate schedule. One way to address these differences would be to allow averaging of inclusions over several years.

Under an estate and gift tax, the number of recipients doesn't affect the amount of tax paid on transfers. Taxing inheritances under an inclusion tax or an accessions tax may encourage broader transfers of wealth because broader transfers would generally reduce the total amount of tax paid.

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Q. What is an inheritance tax?

A. A type of wealth transfer tax in which the recipient, rather than the donor's estate, is taxed.

An inheritance tax applies to the amount of gifts and bequests a taxpayer receives. Unlike estate and gift taxes, a progressive inheritance tax gives donors an incentive to spread their wealth more broadly because recipients can claim an exemption and take advantage of the progressive tax rates, thus reducing their effective tax rate. Currently the United States has no federal inheritance tax, but several states do.

The economic burden of wealth transfer taxes falls on recipients rather than donors; recipients receive a smaller after-tax gift or inheritance than they would without the tax. However, the burden on individual recipients varies depending on whether the tax is an inheritance tax or an estate and gift tax.

Inheritance taxes come in three principal forms. An accessions tax applies to the amount an individual receives by gift or bequest over a lifetime. An annual inheritance tax applies to the gifts and bequests a person receives in a given year. An inclusion tax counts gifts and bequests as income and taxes them as such. Thus, the tax rate depends on the size of the gift or bequest as well as the recipient's other income. An inclusion tax could be combined with either of the other two types of inheritance taxes into a single tax that takes advantage of the strengths of each.

Most countries rely on inheritance taxes rather than on estate and gift taxes. More than half of the 34 countries in the Organisation for Economic Co-Operation and Development have an annual inheritance tax (figure 1); a few use accessions and inclusion taxes. Only three (besides the United States) have estate taxes. The past several decades have seen a shift away from estate taxes: Australia, Canada, and New Zealand repealed their estate taxes, and Ireland replaced its estate tax with an inheritance tax.

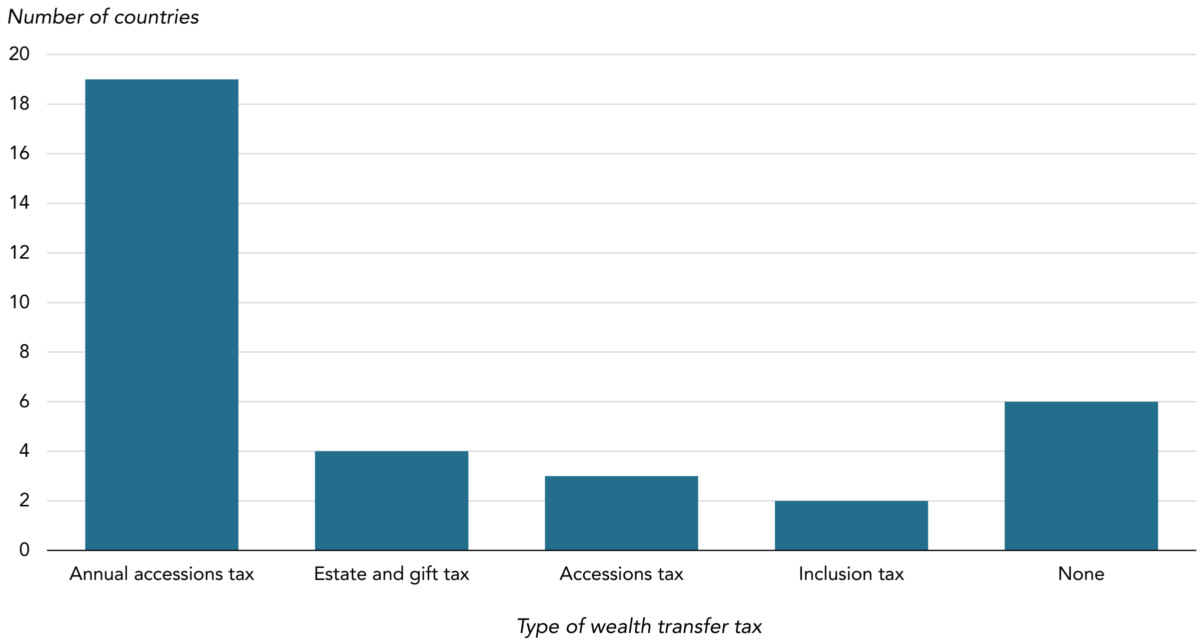
Some analysts argue that inheritance taxes are simpler to administer than estate taxes because they curtail strategies used to avoid estate taxes, such as moving assets into complicated trusts that falsely suggest that a decedent's estate will go to a person or entity exempt from the tax. Others argue that estate taxes are simpler because they require less record keeping.

What is an inheritance tax?

FIGURE 1

Type of Wealth Transfer Tax in 34 Countries

2007



Source: Lily L. Batchelder, "How Should an Ideal Consumption Tax or Income Tax Treat Wealth?" (2007).

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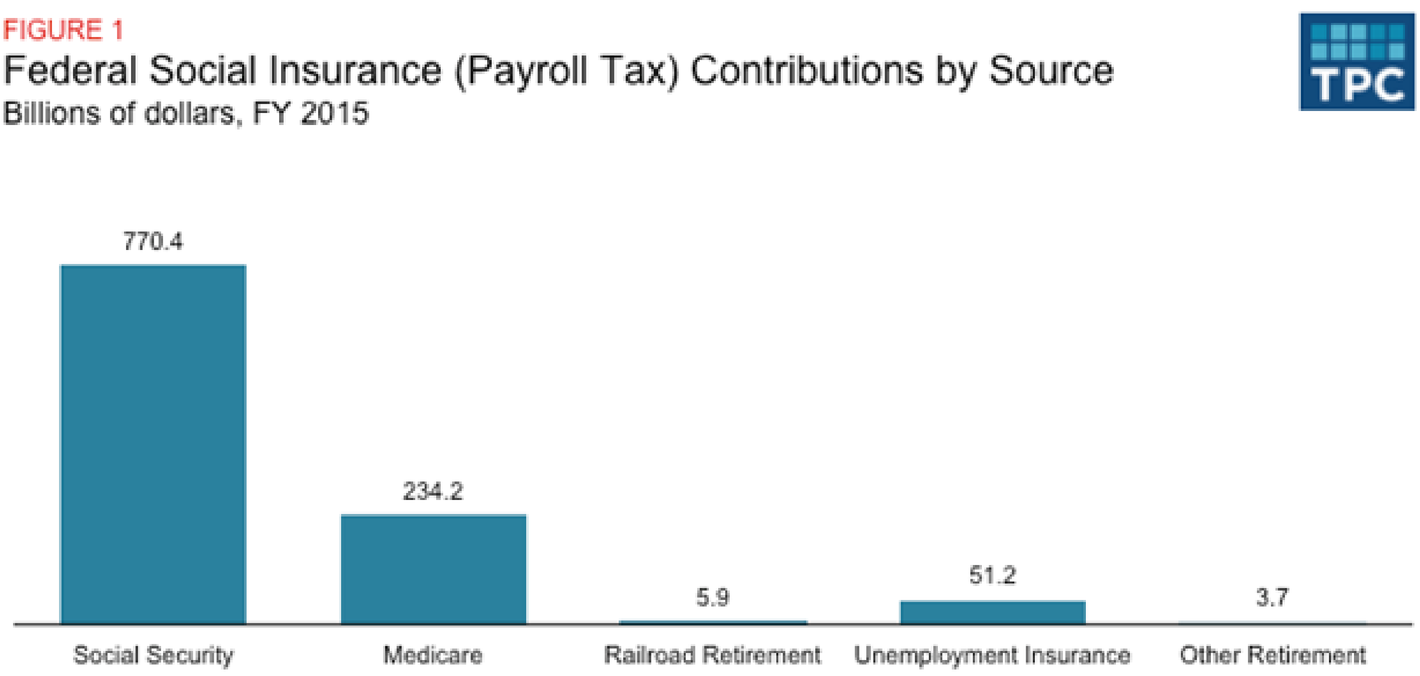
Key Elements of the U.S. Tax System

Q. What are the major federal payroll taxes, and how much money do they raise?

A. Payroll taxes are levied to finance Social Security, the hospital insurance portion (Part A) of Medicare, and the federal unemployment insurance program. Revenue totaled just over $1 trillion, or about 6 percent of GDP, in fiscal year (FY) 2015 (figure 1).

FIGURE 1
Federal Social Insurance (Payroll Tax) Contributions by Source
Billions of dollars, FY 2015



Source: OMB Historical Table 2.4.

Key Elements of the U.S. Tax System

What are the major federal payroll taxes, and how much money do they raise?

TABLE 1
Major Federal Payroll Tax Rates and Bases
2017

Source	Wage base	Employer rate	Employee rate	Total rate
Old Age and Survivors Insurance (OASI)	127,200	5.3	5.3	10.6
Disability Insurance (DI)	127,200	0.9	0.9	1.8
Hospital Insurance (HI)	No limit	1.45	1.45	2.9
Federal Unemployment Insurance (UI)	7,000	0.6	-	0.6

Source: Social Security Administration 2017 program fact sheet and Office of Unemployment Insurance program information.
Note: Wage bases for OASI and DI are adjusted each year to account for wage growth. The Bipartisan Budget Act of 2015 reallocated a portion of the OASI tax to DI in 2016-2018. The rates in those years are OASI: 5.015 (employer and employee), DI: 1.185 (employer and employee).

SOCIAL SECURITY

Social Security, or more formally, Old-Age, Survivors, and Disability Insurance (OASDI), provides benefits to elderly and disabled workers, their spouses, and surviving spouses or dependents. It is one of the largest items in the federal budget, with outlays of $897 billion in 2015.

Benefits are mainly financed by a payroll tax on cash wages up to an annual threshold indexed to average wage growth (table 1). In 2017, the maximum taxable wage was $127,200. Employers and employees each contribute 6.2 percent of the workers' wages for a combined 12.4 percent—usually 10.6 percent for the OASI trust fund (retirement and survivors) and 1.8 percent for the DI trust fund (disability). The Bipartisan Budget Act of 2015 temporarily reallocated a portion of the OASI tax to the DI trust fund for 2016-2018 to shore up the DI trust fund, which faced insolvency. For those years, the combined employer and employee rates are 10.03 percent for OASI and 2.37 percent for DI. Most economists believe that the employer portion of the tax, just like the employee portion, is borne by employees in the form of lower compensation.

Over time, Social Security taxes have become a major share of federal revenues. When first collected in 1937, the combined payroll tax rate was 2.0 percent; it raised $765 million (about $12.6 billion in 2015 dollars). In 2015, OASDI taxes totaled over $770 billion and represented 23.7 percent of federal receipts.

HOSPITAL INSURANCE

The hospital insurance (HI) program, or Part A of Medicare, covers inpatient hospital visits and other health care services for the elderly and some others suffering from specified maladies. Federal costs for other parts of Medicare, such as Part B, which covers doctors' and other providers' fees, are not covered by payroll taxes but mainly by general revenues.

The HI program is financed mainly through payroll taxes on workers. Employers and employees each contribute 1.45 percent of the worker's wages toward the HI trust fund for a combined rate of 2.9 percent (table 1). The cap on wages subject to the HI tax was removed in 1994. Also, beginning in 2013, single households

Key Elements of the U.S. Tax System

What are the major federal payroll taxes, and how much money do they raise?

earning more than $200,000 and married households earning more than $250,000 contributed an additional 0.9 percent of earnings over those thresholds (there is no employer portion for this "surtax").

In 1966, the first year of HI tax collections, the combined tax rate was 0.7 percent, and collections totaled $1.9 billion (about $13.9 billion in 2015 dollars). In 2015, HI taxes surpassed $234 billion.

UNEMPLOYMENT INSURANCE

Unemployment insurance (UI) provides insured workers with benefits if they are involuntarily unemployed and meet eligibility requirements. Unemployment insurance programs are run by the states in partnership with the federal government. To finance benefits and program expenses, payroll taxes levied by both the states and the federal government are paid into a federal trust fund.

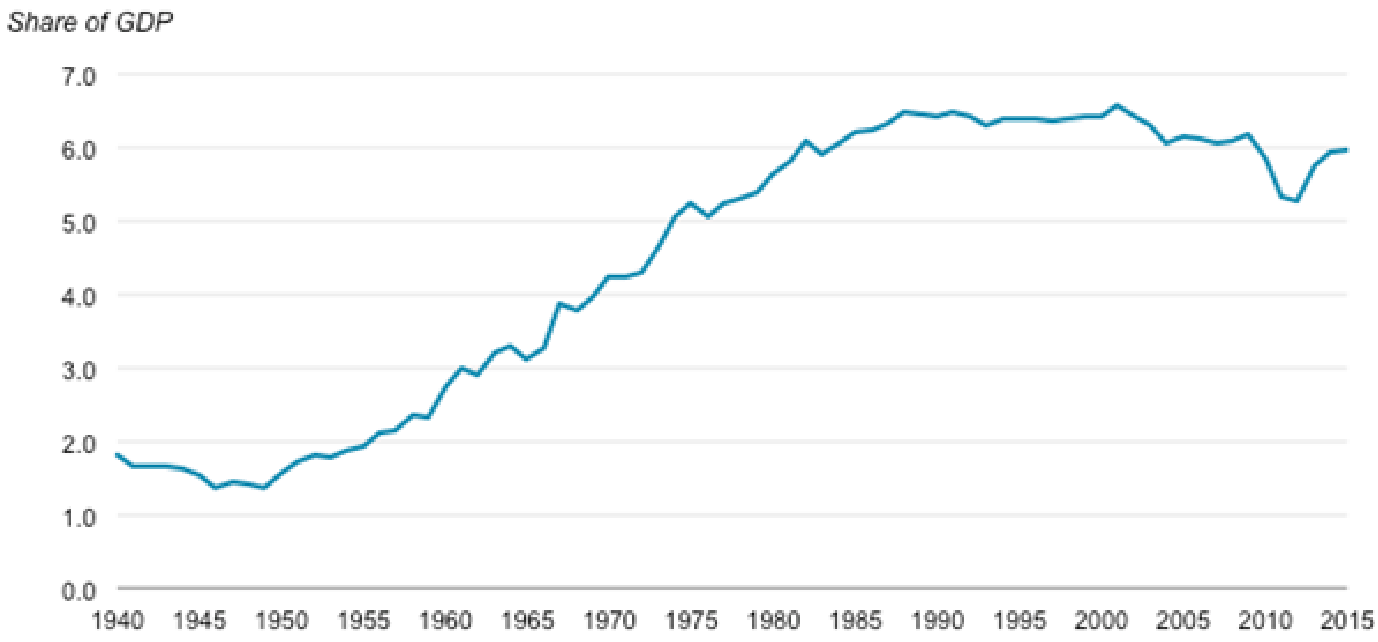
The federal payroll tax rate is 6.0 percent on the first $7,000 of covered wages, but tax credits reduce the effective federal tax rate to 0.6 percent. State unemployment tax rates and wage bases vary, but are usually below 4 percent and are on relatively low wage bases.

In 2015, federal UI taxes totaled about $51 billion.

FIGURE 2

Federal Payroll Tax Receipts as a Percentage of GDP

1940-2015



Source: Calculations from OMB Historical Tables 2.4 and 10.1.

Key Elements of the U.S. Tax System

What are the major federal payroll taxes, and how much money do they raise?

OTHER RETIREMENT PROGRAMS

A handful of other retirement programs are funded by payroll taxes. The largest of these is a retirement program for the railroad industry operated by the Social Security Administration, which functions similarly to Social Security. Retirement programs for federal employees absorb most of the rest of payroll tax receipts.

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Key Elements of the U.S. Tax System

Q. What is the unemployment insurance trust fund, and how is it financed?

A. Unemployment insurance assists workers who become involuntarily unemployed and meet specified eligibility requirements. Unemployment insurance programs are run as federal-state partnerships financed through payroll taxes.

The federal unemployment insurance (UI) trust fund finances the costs of administering unemployment insurance programs, loans made to state unemployment insurance funds, and half of extended benefits during periods of high unemployment. Unemployment insurance programs pay benefits to covered workers who become involuntarily unemployed and meet specified eligibility requirements, such as actively looking for work.

Unemployment insurance is structured as a partnership between the federal government and states and territories. States and territories set the parameters of their unemployment programs within federal guidelines, including payroll tax rates and wage bases for covered workers. State unemployment insurance taxes are paid by employers and remitted to the federal UI trust fund, where each state has a separate account for covering normal unemployment insurance benefits.

IIn addition, a 6 percent federal payroll tax, known as the Federal Unemployment Insurance Tax Act (FUTA) tax, is levied on the first $7,000 of covered workers' earnings. Employers remit the tax, but can claim credits against 5.4 percentage points of FUTA taxes paid in states with unemployment programs that meet federal standards (currently all states), reducing the effective tax rate to 0.6 percent, or a maximum of $42 per worker. The federal fund is used to cover administrative expenses, make loans to states if they deplete their own reserves, and cover half of extended unemployment benefits made available when states experience prolonged periods of high unemployment. States cover the other half of these extended benefits.

States can borrow from the federal fund if their own reserves are insufficient. The Great Recession hit state UI reserves particularly hard and 36 states borrowed from the federal fund. By December 2016, all states but California and the US Virgin Islands had repaid their outstanding balances. Loans from the federal fund can be repaid by reducing the credit that employers can claim against FUTA taxes and through other add-ons.

Key Elements of the U.S. Tax System

What is the unemployment insurance trust fund, and how is it financed?

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Key Elements of the U.S. Tax System

Q. What are the Social Security trust funds, and how are they financed?

A. They provide cash benefits to the elderly and disabled as well as their spouses and dependents, and they are funded chiefly through payroll taxes.

There are two Social Security trust funds: Old-Age and Survivors Insurance (OASI) and Disability Insurance (DI), though the two are often analyzed together as Old-Age, Survivors, and Disability Insurance (OASDI). The funds finance benefits for eligible retired and disabled workers and their spouses, dependents, and survivors. When revenue dedicated to financing the programs exceeds program expenses, the surplus is credited to their respective trust funds, which invest in special interest-bearing Treasury bonds. When program costs exceed receipts, the Social Security Administration can redeem its bonds to cover expenses, until it runs out of bonds. The US Treasury pays its obligation to the trust funds from general government funds (table 1).

TABLE 1

Social Security Trust Fund Receipts and End of Year Assets

Billions of dollars, 2015

Source	OASI	DI	Total
Net payroll tax contributions	679.5	115.4	794.9
Income from taxation of benefits	30.6	1.1	31.7
Reimbursements from the general fund of the Treasury	0.3	-	0.3
Net interest	91.2	2.1	93.3
Total income	801.6	118.6	920.2
Assets at end of the year	2,780.3	32.3	2,812.6

Source: Social Security Annual Trustees Report, 2016.

PAYROLL TAXES: FICA AND SECA

The Social Security trust funds are financed chiefly through payroll taxes on workers covered by the OASDI program. Employers and employees each contribute 5.3 percent of the employee's taxable wages for OASI and 0.9 percent of the employee's taxable wages for DI coverage as part of what are sometimes called Federal Insurance Contribution Act (FICA) taxes. Up to $127,200 in wages is subject to FICA taxes, a threshold that is updated for average wage growth each year. (A portion of FICA taxes dedicated to the separate Medicare hospital insurance trust fund is not subject to this wage cap.) Because the employer portion represents the cost of hiring workers, economists believe that this tax is passed on to workers in the form of lower compensation. Thus workers effectively bear the entire tax.

Self-employed workers covered by Social Security contribute both the employer and employee portions of the tax under the Self-Employment Contribution Act (SECA) but are allowed to deduct the employer portion from their federal taxable income, just as other employers and employees can deduct or exclude employer FICA contributions from their taxable income.

OTHER FINANCING SOURCES

Social Security benefits are partially taxable for beneficiaries whose incomes exceed a threshold. The revenues are remitted to the OASI, DI, and hospital insurance (HI) trust funds. The trust fund balances also earn interest from the special interest-bearing Treasury bonds. Congress sometimes adds to the trust funds directly from general funds. For example, when the payroll tax was cut temporarily as a stimulus measure in 2011 and 2012, the trust funds were reimbursed for the lost revenue.

TRUST FUND SOLVENCY AND GOVVERNMENT-WIDE DEFICITS

Both the OASI and DI trust funds face shortfalls as benefits currently exceed taxes paid in each; in the near future, benefits from the combined OASDI trust fund will exceed revenues, including interest payments from the Treasury. Considered separately, Social Security's actuaries projected in the 2016 Trustees' Report that the DI trust fund will be exhausted by 2023 and the OASI trust fund will be exhausted by 2035. If either event occurs, the Social Security Administration will only be able to pay a portion of benefits from payroll taxes collected, about three-quarters of promised benefits in the case of Social Security.

When the DI fund came close to depletion in 1994, Congress diverted some of the OASI fund's payroll tax receipts to the DI fund to maintain its solvency. Legislators took this step again in 2015, transferring funds from the OASI trust fund to the DI trust fund to keep the DI fund solvent through 2023.

To restore long-term trust fund solvency, policymakers will have to make changes to the program through some combination of raising the payroll tax rate, reducing benefits, and tapping other sources of revenue. To avoid the effect of the ever-growing deficit of benefits relative to taxes already occurring, which add to the unified government deficits, policymakers need to act soon. The sooner policymakers make adjustments, the less dramatic those adjustments will need to be.

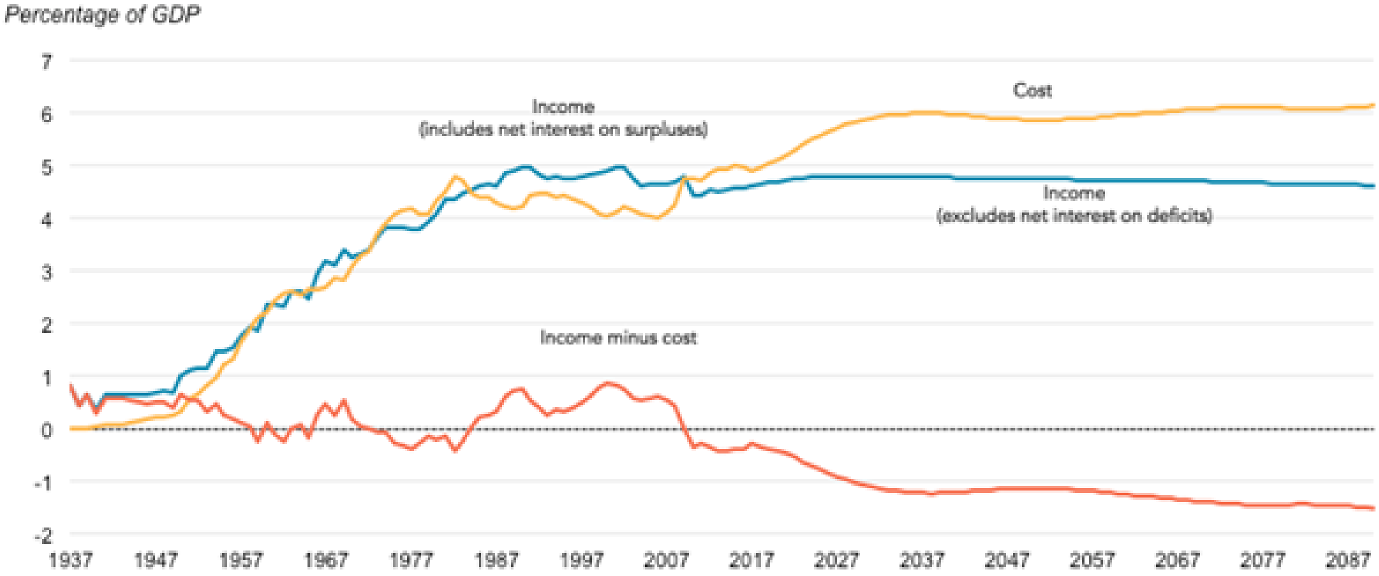
Key Elements of the U.S. Tax System

What are the Social Security trust funds, and how are they financed?

FIGURE 1

OASDI Cost and Income as a Percentage of GDP

1937-2090



Source: Calculations from data from 2016 OASDI Trustees' Report, *Annual Supplement to the Social Security Bulletin*, and BEA.

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Key Elements of the U.S. Tax System

Q. Are the Social Security trust funds real?

A. Social Security trust funds are real and hold real Treasury securities for which the federal government has an obligation to pay. They reflect any accumulated excess of Social Security taxes plus other revenues, such as interest received, over expenditures. At the same time, the trust funds "fund" only a tiny portion of outstanding obligations. The trust funds are invested in special-issue Treasury securities backed by the full faith and credit of the federal government.

Social Security was designed primarily as a "pay-as-you-go" system. Instead of prefunded accounts for individuals, benefits are paid mainly out of contributions from current workers. For the most part, money going into the system immediately goes out to pay for benefits.

When Social Security's receipts from payroll taxes and other sources exceed program costs, as it has while the large baby boom generation dominated the workforce, excess funds have been used to purchase special-issue U.S. Treasury bonds that bear interest. In effect, the Social Security trust fund lends the money to the general fund.

Where does the money go? When the non–Social Security part of government is running deficits, the money funds all other government activities. When the trust funds themselves run deficits, they add to these other non–Social Security deficits to produce an even larger unified fund deficit. Because these special-issue bonds are essentially both sold and held by the government, aren't publicly traded like other financial assets, and represent IOUs from the government, some people believe that the trust funds are nothing more than an accounting fiction.

Another factor further confuses the issue. Because the trust funds represent an asset to one side of government (the Social Security Administration) and a liability to another side of government (the general fund), some accounting presentations make the overall effect of the trust funds on the budget look "neutral," when in fact there are future obligations to be paid.

So are the trust funds real? Yes. They have legal consequences for the Treasury and are backed by the full faith and credit of the federal government, just like any other Treasury bond. If and when the Social Security Administration redeems the bonds, the government has a legal obligation to pay the money back with interest, with no additional appropriation by Congress required.

Key Elements of the U.S. Tax System

Are the Social Security trust funds real?

To be clear, the trust funds are not a free lunch for taxpayers. Money from the general fund used to repay debts to the trust funds cannot be used for other purposes, like building roads or providing for national defense. And as an additional outlay for the government, those general fund payments increase the Treasury's need to borrow from the public, increasing federal deficits and adding burdens on future taxpayers.

For all the heat about whether the trust funds exist, the debate misses a larger issue: the long-term fiscal challenges posed by Social Security and Medicare are not due to inadequate trust funds, which will be depleted after only a few years of draw-down, but to decades-long imbalances between promised benefits and the revenues required to fund those benefits.

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Q. What is the Medicare trust fund, and how is it financed?

A. The Medicare trust fund finances health services for beneficiaries of Medicare, a government insurance program for the elderly, the disabled, and people with qualifying health conditions specified by Congress. It is financed by payroll taxes, general tax revenue, and premiums paid by enrollees.

The Medicare trust fund comprises two separate funds. The hospital insurance trust fund is financed mainly through payroll taxes on earnings and income taxes on Social Security benefits. The Supplemental Medical Insurance trust fund is financed by general tax revenue and premiums paid by enrollees.

HOSPITAL INSURANCE TRUSTFUND

The hospital insurance (HI) trust fund, also known as Part A of Medicare, finances health care services related to stays in hospitals, skilled nursing facilities, and hospices for eligible beneficiaries, who are mainly people over age 65 with a sufficient history of contributions to the program.

The HI trust fund had receipts of $275 billion and a balance of $205 billion in 2015 (table 1). The fund's chief revenue sources are payroll taxes and income from the taxation of Social Security benefits. Interest payments on trust fund balances, premiums from voluntary enrollees who are not eligible for Medicare coverage based on their earnings records, transfers from the general fund and the Railroad Retirement account, and miscellaneous receipts supply the remainder of revenues.

SUPPLEMENTAL MEDICAL INSURANCE TRUST FUND

The Supplemental Medical Insurance (SMI) trust fund finances two voluntary Medicare programs: Part B, which mainly covers physician services and medical supplies, and Part D, the newer prescription drug program.

The SMI trust fund received $369 billion in revenues and had $69.5 billion in assets in 2015 (table 2). Unlike the HI fund, there are no dedicated payroll taxes for SMI. Instead, the fund's chief revenue sources are contributions from the general fund (receipts from other sources, such as individual income taxes, corporate taxes, and excise taxes), premiums from participants (there are separate premiums for Parts B and D), and a small amount of interest on trust fund balances and miscellaneous receipts. Because the bulk of SMI's funding comes from the general fund, the trust fund balance mainly serves to cover temporary shortfalls, and is kept relatively low. High reserves are not required as long as general fund revenues and borrowing automatically rise with costs.

Key Elements of the U.S. Tax System

What is the Medicare trust fund and how is it financed?

TABLE 1

Hospital Insurance Trust Fund Receipts and End of Year Assets

Millions of dollars, 2015

Sources	Receipts and assets
Payroll taxes	241,075
Income from taxation of benefits	20,208
Transfers from Railroad Retirement accou	595
General fund reimbursements	187
Premiums from voluntary enrollees	3,206
Interest on investments and other income	10,081
Total income	275,352
Assets at end of the year	205,366

Source: 2016 Medicare Trustees Report expanded and supplemental tables, https://www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/ReportsTrustFunds/TrusteesReports.html

SOLVENCY AND BUDGET PRESSURES

Like the Old-Age and Survivors Insurance (OASI) and Disability Insurance (DI) trust funds, the HI trust fund faces long-term deficits (figure 1). (The SMI fund, primarily financed by the general revenue, does not face these trust fund imbalances, though it still adds growing pressure to the overall budget.) As the number of Medicare beneficiaries increases from about 55 million in 2015 to 81 million by 2030, the number of workers per beneficiary will decline from 3.1 to 2.4. The cost of health care has increased rapidly as well—though this dynamic has slowed but not stopped in recent years, during and following the Great Recession—putting further pressure on program costs. The HI trust expenditures exceeded taxes for several years up to 2014, and though its outflows and inflows have roughly stabilized for a few years, it is projected to be exhausted by 2028. These pressures now and in the future will force lawmakers to find ways to finance promised benefits or make cuts in services or provider payment rates.

TABLE 2

Supplementary Medical Insurance Trust Fund Receipts and End of Year Assets

Millions of dollars, 2015

Sources	Receipts and assets
Premiums from enrollees	82,204
General fund transfers	272,245
Transfers from states	8,900
Interest and other income	5,738
Total income	369,087
Assets at end of the year	69,470

Source: 2016 Medicare Trustees Report expanded and supplemental tables, https://www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/ReportsTrustFunds/TrusteesReports.html

Q. What are the major federal excise taxes, and how much money do they raise?

A. Federal excise tax revenues—mostly collected from sales of motor fuel, airline tickets, tobacco, alcohol, and health-related goods and services—totaled $98.3 billion in fiscal year 2015, or 3 percent of federal tax receipts.

Excise taxes are narrowly based taxes on consumption, levied on specific goods, services, and activities. They can be either a per-unit tax (such as the per-gallon tax on gasoline) or a percentage of price (such as the airline ticket tax). Generally, excise taxes are collected from producers or wholesalers, and are embedded in the price paid by final consumers.

Federal excise tax revenue has declined over time relative to the size of the economy. As a percentage of gross domestic product (GDP), excise tax revenue fell from 2.7 percent in 1950 to 0.7 percent by 1979 (figure 1). Receipts temporarily increased as a result of the crude oil windfall profit tax imposed in 1980, but excluding that tax, revenue held fairly steady (the dashed line in figure 1) at about 0.7 percent of GDP through the 1980s and 1990s. Excise tax revenues as a percent of GDP gradually declined again throughout the 2000s to roughly 0.5 percent in recent years.

This revenue is either transferred to the general fund or allocated to trust funds dedicated to specified purposes. General fund excise taxes account for roughly 40 percent of total excise receipts, with the remaining 60 percent going to trust funds.

General fund excise taxes are imposed on many goods and services, the most prominent of which are alcohol, tobacco, and health insurance. Other general fund excise taxes include taxes on local telephone service, vehicles with low-mileage ratings ("gas guzzlers"), ozone-depleting chemicals, indoor tanning services, and medical devices.

Excise taxes dedicated to trust funds finance transportation and well as environmental- and health-related spending. The Highway Trust Fund and the Airport and Airway Trust Fund account for over 90 percent of trust fund excise tax receipts, mostly from taxes on gasoline and other transportation fuels (Highway Trust Fund), and air travel (Airport and Airway Trust Fund). Five categories of excise taxes—highway, tobacco, air travel, health, and alcohol—accounted for 94 percent of total excise tax receipts in fiscal year (FY) 2015 (figure 2).

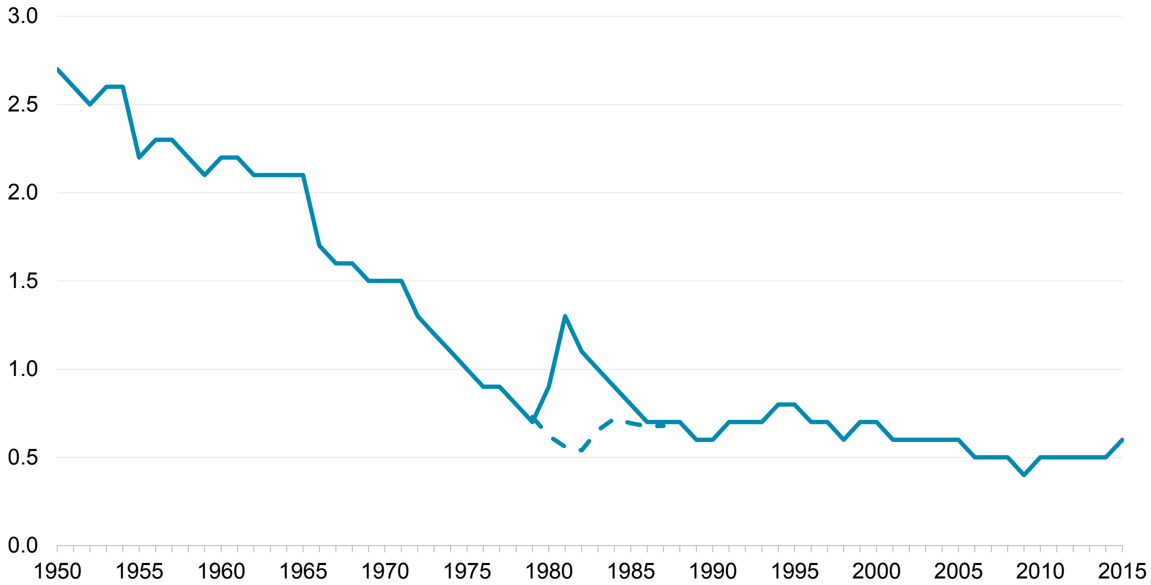
Key Elements of the U.S. Tax System

What are the major federal excise taxes, and how much money do they raise?

FIGURE 1

Federal Excise Tax Revenue as a Share of GDP

1950-2015



Source: Office of Management and Budget, Historical Tables 2.3 and 2.4.
Note: The dashed line excludes receipts from the Crude Oil Windfall Profit Act of 1980.

EXCISE TAXES DEDICATED TO THE HIGHWAY TRUST FUND

Highway-related excise tax revenue totaled $37.4 billion in FY2015, 38.1 percent of all excise tax revenue. Gasoline and diesel taxes, which are 18.4 and 24.4 cents per gallon, respectively, make up over 90 percent of total highway tax revenue, with the remaining from taxes on other fuels, trucks, trailers, and tires. (The tax rates for gasoline and diesel include a 0.1 percent tax that is earmarked for the Leaking Underground Storage Tank Trust Fund.) Most other motor fuels are also subject to excise taxes, although "partially exempt" fuels produced from natural gas are taxed at much lower rates. Tax credits for producers of certain fuels deemed environmentally superior—including biodiesel, renewable diesel mixtures, alternative fuel, and alternative fuel mixtures —expired at the end of 2014 but were extended retroactively to January 1, 2015, and through 2016.

TOBACCO EXCISE TAXES

Revenue from tobacco taxes totaled $14.5 billion in FY2015, accounting for 14.7 percent of all excise tax revenue. Federal excise taxes are imposed on tobacco products, which include cigarettes, cigars, snuff, chewing tobacco, pipe tobacco, and roll-your-own. The tax is calculated per thousand cigars or cigarettes, or per pound of tobacco, depending on the product. The tax equals about $1.00 per pack of 20 cigarettes. Cigarette papers and tubes are also subject to tax. Tobacco taxes are collected when the products leave bonded premises for domestic distribution. Exported products are exempt. Unlike other excise taxes that are collected by the IRS, alcohol and tobacco taxes are collected by the Alcohol and Tobacco Tax and Trade Bureau of the US Treasury Department.

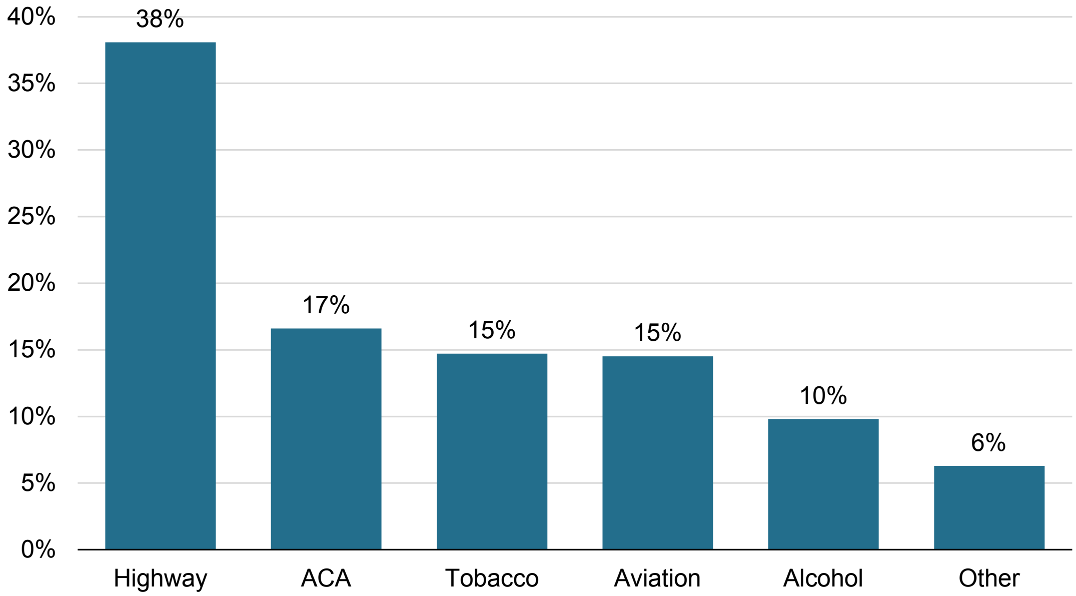
Key Elements of the U.S. Tax System

What are the major federal excise taxes, and how much money do they raise?

FIGURE 2

Composition of Total Federal Excise Tax Revenue

FY2015



Source: Office of Management and Budget, Historical Table 2.4.

EXCISE TAXES DEDICATED TO THE AIRPORT AND AIRWAY TRUST FUND

Revenue from excise taxes dedicated to the Airport and Airway Trust Fund totaled $14.3 billion in FY2015, accounting for 14.5 percent of all excise tax receipts. According to Congressional Budget Office data, more than 90 percent of aviation excise taxes came from taxing passenger air fares, with the remaining coming from taxes on air cargo and aviation fuels.

Domestic air travel is subject to a 7.5 percent tax based on the ticket price plus $4.00 (in 2016) for each flight segment (one takeoff and one landing). A 6.25 percent tax is charged on domestic cargo transportation. International arrivals and departures are taxed at $17.80 per person (in 2016); there is no tax on international cargo. Both the domestic segment fee and the international arrivals and departures fee are indexed for inflation.

What are the major federal excise taxes, and how much money do they raise?

HEALTH CARE RELATED EXCISE TAXES ENACTED BY THE AFFORDABLE CARE ACT

The Affordable Care Act (ACA) legislation passed in 2010 contained several health-related excise taxes. Currently, the largest is an annual fee on health insurance providers. This fee represents a fixed aggregate amount for each calendar year ($11.3 billion for 2015), which is imposed on insurance providers according to their market share. Starting in 2014, an annual fee also applies to manufacturers and importers of branded prescription drugs ($3 billion per year in 2014 through 2016). A 40 percent excise tax on certain high-cost employer sponsored health insurance plans (the "Cadillac tax") was scheduled to begin in 2018 but Congress passed a two-year postponement of the excise tax, which will now begin in 2020. Other health care–related excise taxes include a 2.3 percent tax on medical devices and a 10 percent tax on indoor tanning services. Congress suspended the excise tax on medical devices for two years for medical device sales in 2016 and 2017. In addition, the ACA imposes excise taxes on individuals without essential health insurance coverage (the "individual mandate") as an incentive to buy it, and on large employers that choose not to offer health care coverage (the "employer mandate").

ACA-related excise tax revenue totaled $16.3 billion in FY2015, 16.6 percent of total excise receipts. Revenue from these excise taxes is scheduled to increase significantly over the 10-year budget window and will account for about 22 percent of all federal excise tax revenue from 2017 through 2026.

ALCOHOL EXCISE TAXES

Excise tax revenue from alcoholic beverages amounted to $9.6 billion in FY2015, 9.8 percent of total excise receipts. There are different tax rates for distilled spirits, wine, and beer. Distilled spirits are taxed at $13.50 per proof gallon (a proof gallon is one liquid gallon that is 50 percent alcohol); tax rates on wines vary based on type and alcohol content, ranging from 22.6 cents per gallon for hard cider to $3.40 per gallon for sparkling wines; beer is typically taxed at $18.00 per barrel (31 gallons), although a reduced rate of $7.00 per barrel applies to the first 60,000 barrels for breweries that produce less than two million barrels. Note that the alcohol content of beer and wine is taxed at a much lower rate than the alcohol content of distilled spirits. Alcohol products can be exported or delivered for nonbeverage uses without incurring the tax.

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What is the highway trust fund, and how is it financed?

Q. What is the Highway Trust Fund, and how is it financed?

A. The Highway Trust Fund finances most federal government spending for highways and mass transit. Revenues for the trust fund come from transportation-related excise taxes, primarily federal taxes on gasoline and diesel fuel. In recent years, however, the trust fund has needed significant transfers of general revenues to remain solvent.

The federal Highway Trust Fund tracks federal spending and revenue for surface transportation. The trust fund has separate accounts for highways and mass transit. Because obligations from the trust fund generally are for capital projects that take several years to complete, outlays reflect projects authorized by Congress in previous years.

Most spending from the Highway Trust Fund for highway and mass transit programs is through federal grants to state and local governments. The federal government accounts for about one-quarter of all public spending on roads and highways, with the remaining three-quarters financed by state and local governments.

Financing the Trust Fund

The Congressional Budget Office estimates that Highway Trust Fund tax revenue will total $40.9 billion in fiscal year 2017 (Congressional Budget Office 2017). Revenue from the federal excise tax on gasoline ($25.7 billion) and on diesel fuel ($9.6 billion) accounts for 86 percent of the total. The remaining trust fund tax revenue comes from a sales tax on tractors and heavy trucks, an excise tax on tires for heavy vehicles, and an annual use tax on those vehicles. In addition to dedicated tax revenue, the trust fund receives a small amount of interest on trust fund reserves.

The current tax rate is 18.4 cents per gallon for gasoline and ethanol-blended fuels and 24.4 cents per gallon for diesel (0.1 cent of each tax is dedicated to the Leaking Underground Storage Tank Trust Fund). The tax rates on motor fuels have not changed since 1993 and thus have failed to keep pace with price increases for gasoline and diesel fuel. If tax rates had been indexed for inflation since 1993, the current tax on gasoline would be about 31 cents per gallon and the tax on diesel fuel would be about 42 cents per gallon. Although the current taxes on motor fuels (except for a residual tax of 4.3 cents per gallon) are set to expire at the end of September 2020, Congress has routinely extended the taxes in the past.

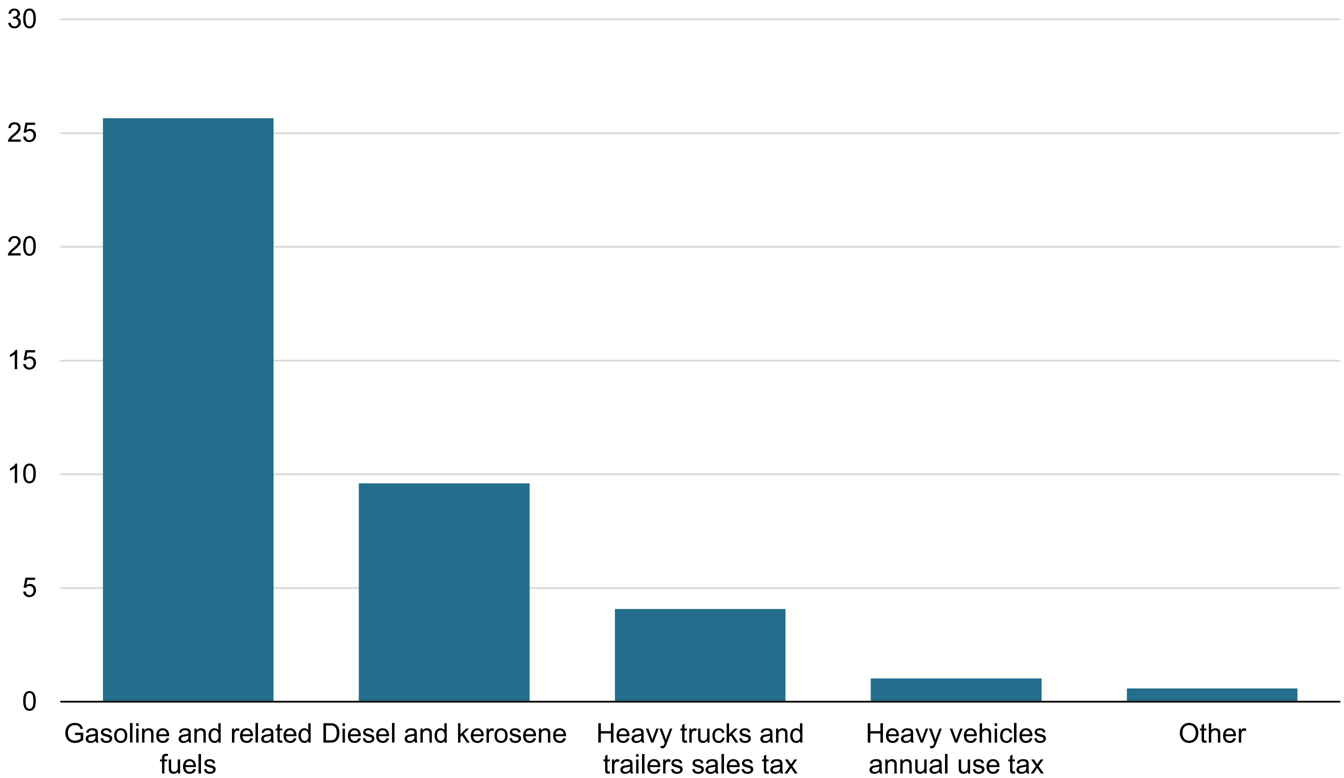
Key Elements of the U.S. Tax System

What is the highway trust fund, and how is it financed?

FIGURE 1

Highway Trust Fund Revenue by Source, 2017

Billions of dollars



Source: Congressional Budget Office. 2017. *An Update to the Budget and Economic Outlook: 2017 to 2027*. Washington, DC: Congressional Budget Office.

Trust Fund Balances

Before 2008, highway tax revenue dedicated to the trust fund was sufficient to pay for outlays from the fund, but that has not been true in recent years. Since 2008, Congress has sustained highway spending by transferring $143 billion of general revenues to the fund, including $70 billion in 2016 as a result of legislation enacted at the end of 2015.

Those transfers will enable the trust fund to meet spending obligations through 2020, but projected shortfalls will appear again starting in 2021. The Congressional Budget Office projects that outlays from the Highway Trust Fund will exceed trust fund reserves by a cumulative $75 billion for the highway account and by $32 billion for the mass transit account from 2016 through 2026, even assuming that expiring trust funds taxes are extended (Congressional Budget Office 2016).

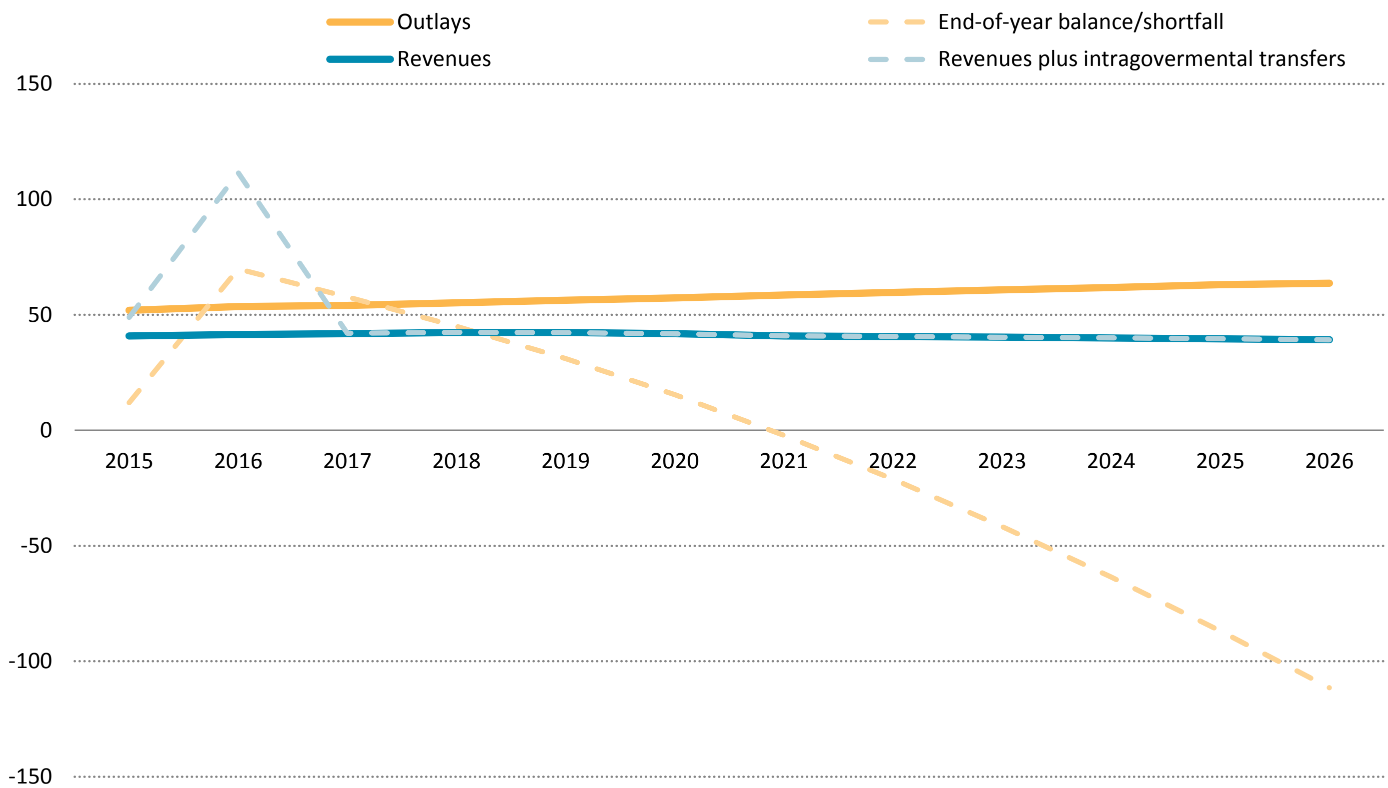
Key Elements of the U.S. Tax System

What is the highway trust fund, and how is it financed?

FIGURE 2

Highway Trust Fund Account Projections, 2015-2016

Billions of dollars



Source: Congressional Budget Office. 2016. *An Update to the Budget and Economic Outlook: 2016 to 2026*.
Notes: Revenues include a small amount of interest on trust fund reserves. Under current law, the Highway Trust Fund cannot incur negative balances.

Options for Financing Federal Spending on Highways and Mass Transit

Drivers likely would respond to an increase in motor fuels taxes by driving less, which would reduce pollution and lessen the need for highway construction and maintenance. But drivers may also respond by driving more fuel-efficient vehicles, which would weaken the incentive to reduce miles driven.

Motor fuels taxes link highway use with the associated costs of building and maintaining roads as well other costs associated with fuel consumption, such as pollution and dependence on foreign oil. But motor fuels taxes are an imperfect user fee because they do not differentiate among vehicles that cause greater or lesser road wear for the same amount of fuel consumed or between travel on crowded and uncrowded roads.

Key Elements of the U.S. Tax System

What is the highway trust fund, and how is it financed?

A tax on vehicle miles driven would provide a more direct link to the cost of highway use but, unlike an increase in the tax on motor fuels, would be difficult to implement, requiring new tolls or electronic motoring of vehicles. An advantage of a vehicle mileage tax is that it could adjust to reflect the additional costs of congestion by increasing tolls or the tax rate in certain locations and at certain times of the day. A vehicle mileage tax would not, however, provide an incentive for driving more fuel-efficient vehicles.

Alternatively, Congress could abandon the user-pay principle and simply pay for highways through general revenues. Highway spending would no longer have a dedicated source of revenue and would instead compete with other spending programs for general revenue funding through the annual appropriations process. Or Congress could decide to limit federal highway spending to the amount of revenue collected from exiting motor fuels taxes. This would require curtailing some existing highway projects and not starting others, at a time when the nation's infrastructure is already in need of repair.

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Q. What tax incentives encourage energy production from fossil fuels?

A. Provisions of the federal income tax that subsidize domestic production of fossil fuels include the expensing of exploration, development, and intangible drilling costs; the use of percentage depletion instead of cost depletion to recover drilling and development costs of oil and gas wells and coal mining properties; and numerous smaller incentives for production and distribution of oil, coal, and natural gas.

Various tax incentives promote investment in fuel development, presumably diverting capital from investments in other assets with higher pretax yields. Several studies have found that the effective marginal tax rate—the extent to which all applicable tax provisions reduce the after-tax return on new investment—is much lower for oil, gas, and coal development than for other assets. The Obama administration proposed eliminating these incentives in most of their budgets, but Congress took no action.

Supporters justify these tax incentives as a means of reducing US dependence on imported oil. But they also encourage more rapid exhaustion of domestic supplies, which may increase dependence on imports in the long run. The three largest energy tax incentives are expected to reduce federal tax revenue by between $11 billion and $26 billion from 2015 to 2019, depending on the agency doing the estimate (figure 1).

Intangible drilling costs cover the labor, machinery, and materials needed for drilling and developing oil and gas wells and coal mines. Independent oil and gas producers (i.e., those without related refining and marketing operations) may deduct these costs from income in the year incurred, even though, as capital investments, they produce returns over many years. Integrated oil and gas companies may deduct 70 percent of these costs in the first year and recover the remaining 30 percent over the next five years.

With percentage depletion, producers can deduct a fixed percentage of gross revenue from a property as capital expenses each year; in contrast, with conventional cost depletion, producers deduct their actual outlays as the resources from a well or mine are depleted. The federal income tax allows independent producers—but not integrated companies—to deduct 15 percent of gross revenue from their oil and gas properties as percentage depletion, without regard to how much they have invested in the properties. Percentage depletion is permitted only on the company's first 1,000 barrels per day from a property and is limited to net income from oil and gas properties. Percentage depletion is also available for coal and other minerals at varying rates.

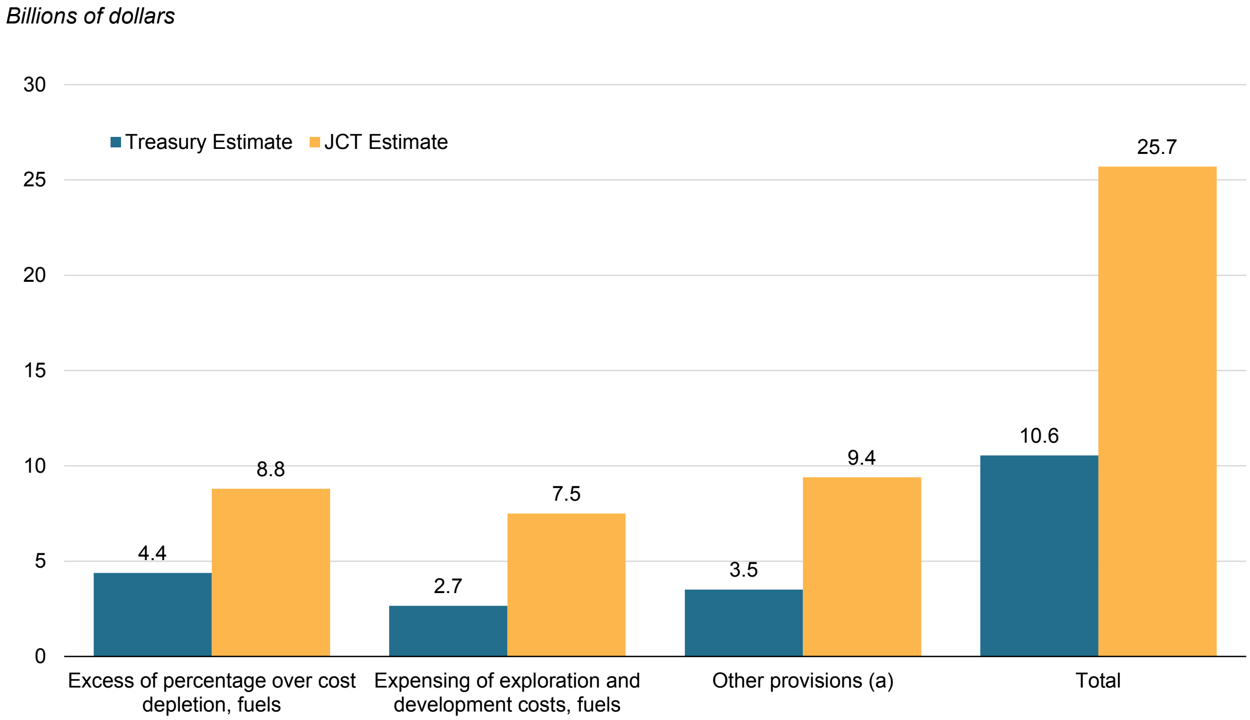
The tax law includes several smaller (but hardly trivial) incentives for investments in refineries, pipelines, oil

What tax incentives encourage energy production from fossil fuels?

FIGURE 1

Revenue Losses from Largest Tax Incentives for Energy Production from Fossil Fuels

2015-19



Sources: Office of Management and Budget, Fiscal Year 2017, Analytical Perspectives Tax Expenditures, Table 14-1, Estimates of Total Income Tax Expenditures for Fiscal Years 2015-2025; Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 2015-1019, JCX-141R-15, December 7, 2015.
Note: (a) Includes exemption from passive loss limitations for working interests in oil and gas properties, capital gains treatment of royalties on coal, exclusion of interest on energy facility bonds, credit for investment in clean coal facilities, treatment of natural gas distribution facilities as 15-year property, and amortization of all geological and geophysical expenditures over 2 years.

and gas exploration, and selected coal technologies. In addition, domestic energy properties benefit from the domestic production deduction provided in the American Jobs Creation Act of 2004. The Obama administration has proposed denying oil and gas companies the benefits of the domestic production deduction, even though the deduction does not favor oil and gas over other domestic manufacturing.

Subsidizing domestic production of fossil fuels is inconsistent with the policy goal of reducing fossil fuel use to counter global climate change. But the adverse effects of the incentives on climate change are minor because any increase in domestic production they induce mostly displaces imports rather than raising domestic fuel consumption.

Some prior research concludes that the incentives reduce the world market price of oil by less than 0.1 percent, which would barely effect consumption of gasoline and other oil-based products. Moreover, a recent study by the National Academy of Sciences finds that subsidies for oil and gas production may slightly reduce greenhouse gas emissions by accelerating the conversion of electricity production facilities from coal to natural gas.

Key Elements of the U.S. Tax System

What tax incentives encourage energy production from fossil fuels?

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Q. What is a carbon tax?

A. Emissions of carbon dioxide and other greenhouse gases are changing the climate. A carbon tax puts a price on those emissions, encouraging people, businesses, and governments to produce less of them. A carbon tax's burden would fall most heavily on energy-intensive industries and lower-income households. Policymakers could use the resulting revenue to offset those impacts, lower individual and corporate taxes, reduce the budget deficit, invest in clean energy and climate adaptation, or for other uses.

WHY TAX CARBON, AND HOW MUCH?

Emissions of carbon dioxide, methane, nitrous oxide, and other greenhouse gases are increasing global temperatures, raising sea levels, shifting rainfall patterns, boosting storm intensity, and harming coral reefs and other marine life. Greenhouse gas emissions thus create a host of potential economic and environmental threats including property damage from storms, human health risks, reduced agricultural productivity, and ecosystem deterioration.(Environmental Protection Agency 2015; National Aeronautics and Space Administration 2015).

Energy prices do not currently reflect these costs of greenhouse gas emissions. Those who benefit from burning fossil fuels generally do not pay for the environmental damage the emissions cause. Instead, this cost is borne by people around the world, including future generations. Imposing a carbon tax can help to correct this externality by raising the price of energy consumption to reflect more of its social cost. The most efficient way to collect such a tax would be upstream from a limited number of fuel producers and importers, rather than downstream from fuel users.

Estimates of the environmental cost of carbon emissions are sensitive to scientific and economic assumptions and thus differ greatly. One prominent estimate, developed by an interagency working group of the United States government, is that carbon dioxide emissions impose social costs of about $40 per metric ton.(US Interagency Working Group on Social Costs of Carbon 2015).

What is a carbon tax?

HOW WOULD A CARBON TAX AFFECT WELFARE?

A carbon tax would increase the price of burning fossil fuels and any resulting goods or services. A tax of $40 per ton would add about 36 cents to the price of a gallon of gasoline, for example, or about 2 cents to the average price of a kilowatt-hour of electricity (Marron, Toder, and Austin 2015). Higher energy prices would raise costs for industry and households, resulting in lower profits, wages, and consumption.

The impact of a carbon tax would differ among economic groups depending on the extent of energy price changes and on regional energy production and consumption patterns. Clearly, a carbon tax would fall more heavily on workers and investors in carbon-intensive industries as well as on regions that depend heavily on carbon-intensive fuels, particularly coal.

The distributional impact of a carbon tax would depend on the extent to which businesses could pass on higher energy costs to their customers. If demand for goods is less "elastic" (that is, responds less) to price changes than the supply of goods, then consumers will bear more of the carbon tax burden than investors and workers.

Since low-income households consume a more energy-intensive basket of goods than wealthier households do, a carbon tax would be regressive; it would cost poorer households a higher share of their income than wealthier households (Marron, Toder, and Austin 2015). A carbon tax of $20 per ton would account for about 0.8 percent of pretax income for households in the lowest income quintile, as compared to 0.5 percent in the highest income quintile.

The environmental benefits from reduced emissions would be shared by people around the world. Combatting climate change thus poses a fundamental collective action problem. American reductions will be most valuable if they are accompanied by comparable reductions in other nations.

DEPLOYING THE REVENUE

A carbon tax could raise substantial revenue. The Congressional Budget Office estimated, for example, that a broad-based carbon tax starting at $20 per ton in 2011 and rising to $34.4 per ton over a decade would have raised $1.2 trillion during that period (Congressional Budget Office 2013). This is close to the amount that the US currently raises with all its other excise taxes—about 0.5 percent of GDP per year.

The welfare impact of a carbon tax package would depend on how those revenues are used. Using some revenues to increase transfers, reduce Social Security contributions from low-income households, or compensate workers in carbon-intensive industries could soften the regressive impact of the carbon tax. Revenues from a carbon tax could also be used to finance cuts in taxes that act as a disincentive to growth, such as the corporate income tax (Marron and Toder 2015). However, because tax cuts on profits would largely benefit the wealthy, this would exacerbate the regressivity of the carbon tax. Revenues could also be used to reduce personal income and payroll taxes, to reduce future deficits, or to invest in clean energy and climate adaptation. What combination of those uses to choose depends on political, social, and economic considerations (Marron and Morris 2016).

Key Elements of the U.S. Tax System

What is a carbon tax?

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Key Elements of the U.S. Tax System

Q. How does the corporate income tax work?

A. The United States imposes a tax on the profits of US resident corporations up to a maximum rate of 35 percent. The corporate income tax is the third largest source of federal revenue, after the individual income tax and payroll taxes, and raised $343.8 billion in fiscal 2015.

The United States taxes the profits of US resident corporations at graduated rates ranging from 15 to 35 percent. Most corporate income is taxed at the maximum rate.

Taxable corporate profits are equal to a corporation's receipts less allowable deductions—including the cost of goods sold, wages and other employee compensation expenses, interest, nonfederal taxes, depreciation, and advertising. US resident multinationals pay tax on their worldwide profits, but tax on the profits of their controlled foreign subsidiaries is deferred until those profits are repatriated (that is, paid back as dividends) to the US parent corporation. To avoid double taxation, US multinationals may claim a credit for taxes paid to foreign governments on income earned abroad, but only up to their US tax liability on that income. US-based corporations owned by foreign multinational companies face the same US corporate tax rules on their profits from US business activities as do US-owned corporations.

The corporate income tax is an entity-level tax that applies to C corporations (named after the relevant subchapter of the Internal Revenue Code). Corporate profits can also be subject to a second layer of taxation at the individual shareholder level, both on dividends when distributed and on capital gains from sale of shares. The maximum tax rate on both dividends and capital gains is currently 23.8 percent (including the 3.8 percent tax on net investment income).

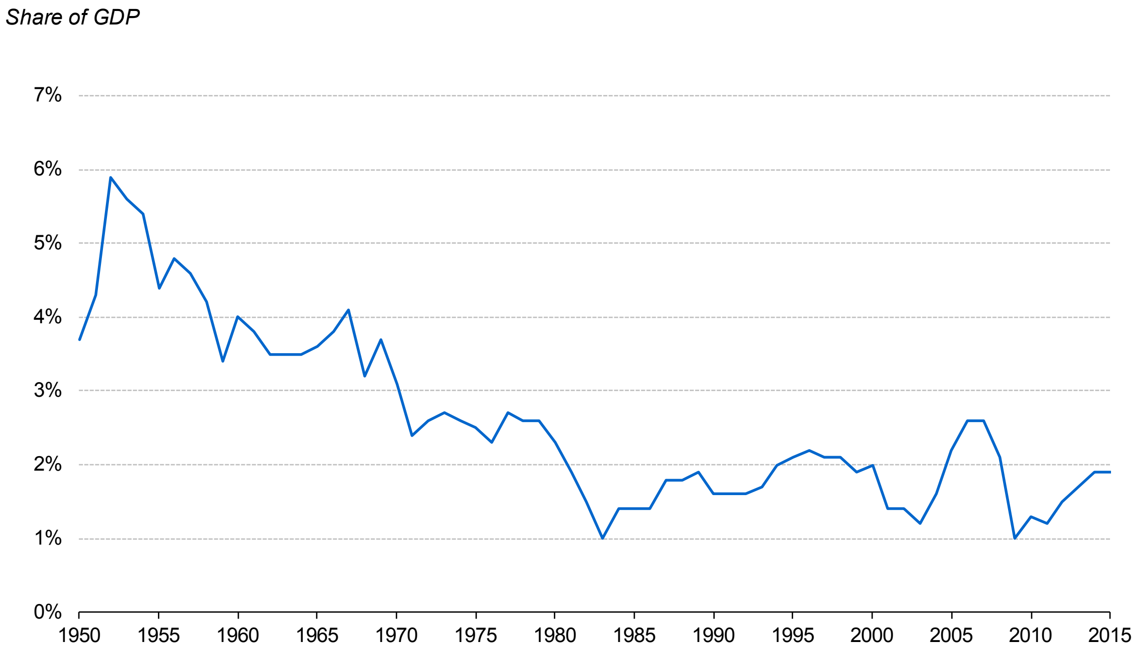
Many US businesses are not subject to the corporate income tax; rather they are taxed as "flow-through" entities. Flow-through businesses do not face an entity-level tax. But their owners must include their allocated share of the businesses' profits in their taxable income under the individual income tax. Flow-through entities include sole proprietorships, partnerships, and eligible corporations that elect to be taxed under subchapter S of the Internal Revenue Code (S corporations).

The corporate income tax is the third largest source of federal revenue, after the individual income tax and payroll taxes. It raised $343.8 billion in fiscal 2015, 10.6 percent of all revenue, and 1.9 percent of gross domestic product. The relative importance of the corporate tax as a source of revenue declined sharply between the 1950s and 1980s, but over the past quarter century it has brought in revenues equal to about 2 percent of gross domestic product (GDP), with some fluctuations mostly associated with the business cycle (figure 1).

Key Elements of the U.S. Tax System

How does the corporate income tax work?

FIGURE 1
Corporate Income Tax Revenue as a Share of GDP
FY 1950–2015



Source: Office of Management and Budget, Historical Table 2.3.

Data Sources

Office of Management and Budget. Historical table 2.3. *Historical Tables*. "Receipts by Source as Percentage of GDP: 1934–2020."

Key Elements of the U.S. Tax System

Q. What are flow-through enterprises and how are they taxed?

A. Most US businesses are not subject to the corporate income tax. Rather, profits flow through to owners and are taxed under the individual income tax. Flow-through businesses include sole proprietorships, partnerships, and S corporations.

Many businesses are taxed as flow-through entities that, unlike C corporations, are not subject to the corporate income tax. Instead their owners include their allocated shares of profits in taxable income under the individual income tax, which is taxed as ordinary income up to the maximum 39.6 percent rate. Flow-through businesses include sole proprietorships, partnerships, and S corporations.

ADVANTAGES OF FLOW-THROUGH ENTITIES

Flow-through businesses generally face the same tax rules as C corporations for inventory accounting, depreciation, and other provisions affecting the measurement of business profits. But organizing as a flow-through business has several advantages. The first is that income is only subject to a single layer of income tax, unlike C corporation profits, which are first subject to the corporate income tax (at rates up to 35 percent) and then taxed again when paid out as dividends to shareholders or when shareholders realize capital gains arising from retained earnings (at rates up to 23.8 percent). In contrast, profits from flow-through businesses are taxed just once, at the owner's individual tax rate for ordinary income.

Another benefit of flow-through status is that individuals may deduct business losses against current income from other sources, subject to some limitations for "passive losses." In contrast, C-corporation losses cannot be used to offset income earned outside the corporation. C-corporation losses may, however, be carried back (up to two years) or carried forward (up to 20 years) and deducted against profits in previous or future years. To the extent corporations are unable to claim loss carrybacks, the tax benefit from these losses is delayed and reduced in terms of present value.

TYPES OF FLOW-THROUGH ENTITIES

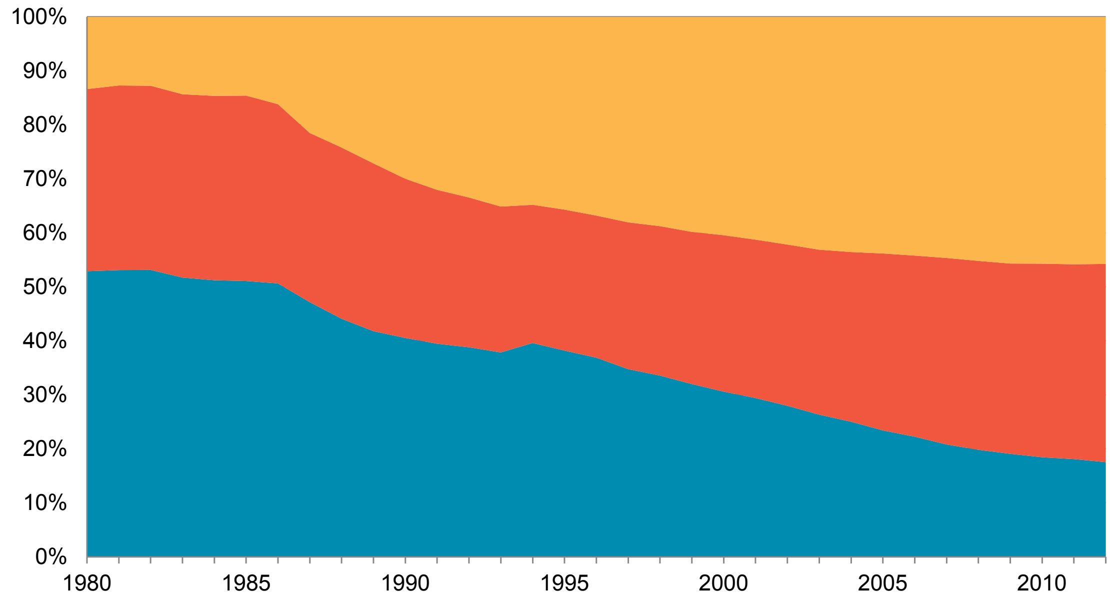
Sole Proprietorships: A business with a single owner does not file a separate tax return, but rather reports its net income on Schedule C of the owner's individual tax return. Generally all net income from sole proprietorships is also subject to payroll taxes under the Self Employed Contributions Act (SECA).
Partnerships: Partnerships file an entity-level tax return (Form 1065), but profits are allocated to owners who

Key Elements of the U.S. Tax System

What are flow-through enterprises and how are they taxed?

report their share of net income on Schedule E of their individual tax returns. Under "check the box" regulations instituted by the Treasury Department in 1997, limited-liability companies (LLCs) can elect to be taxed as partnerships. General partners are subject to SECA tax on all their net income, while limited partners are only subject to SECA tax on "guaranteed payments" that represent compensation for labor services.
S Corporations: Eligible domestic corporations that elect S-corporation status file a corporate tax return (Form 1120S), but profits flow through to shareholders and are reported on Schedule E of the shareholders personal income tax. S corporations cannot have more than 100 shareholders, and those shareholders must be US citizens or resident individuals (although certain estates, trusts, and tax-exempt organizations are also allowed). In addition, S corporations may have only one class of stock. S corporation owners do not pay SECA tax on their profits, but are required to pay themselves "reasonable compensation," which is subject to the regular Social Security tax (i.e., the Federal Insurance Contributions Act or FICA).

FIGURE 1
Share of Business Returns by Type
1980–2012



Source: Internal Revenue Service, Statistics of Income Division, Integrated Business Data, Table 1.

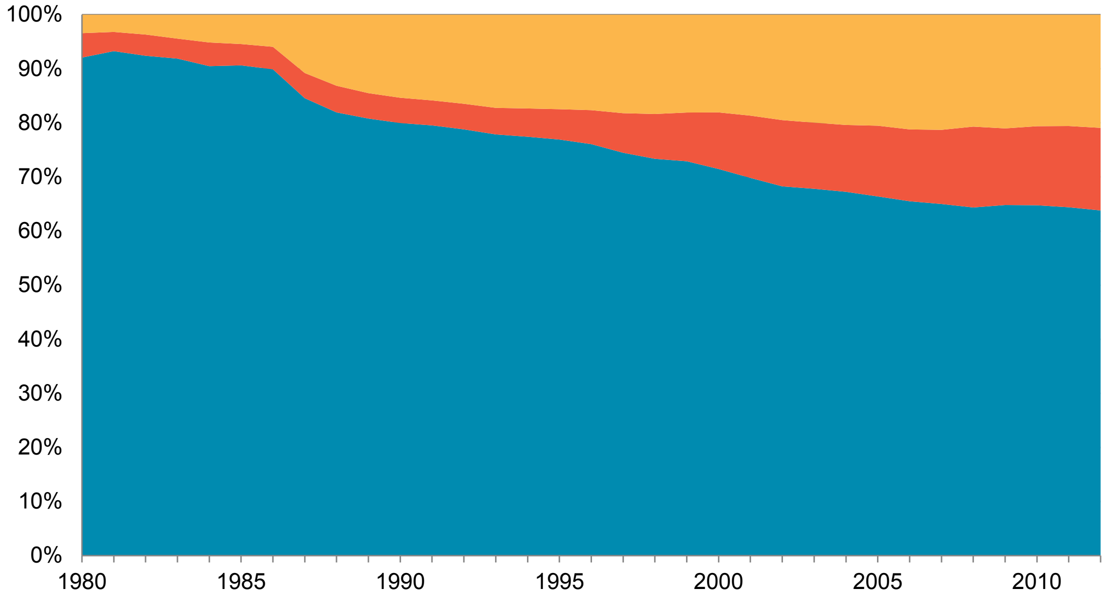
Key Elements of the U.S. Tax System

What are flow-through enterprises and how are they taxed?

FIGURE 2

Share of Business Receipts by Type

1980–2012



Source: Internal Revenue Service, Statistics of Income Division, Integrated Business Data, Table 1.

GROWTH IN FLOW-THROUGH BUSINESSES

The share of business activity represented by flow-through entities has been rising since the passage of the Tax Reform Act of 1986. Excluding sole proprietorships (which receive just 4 percent of total business revenue), more than 80 percent of businesses were organized as flow-through entities in 2012—up from 49 percent in 1985 (figure 1). During that same period the share of business receipts going to flow-through entities increased from 9 percent to 36 percent (figure 2).

Recent research using IRS tax data found that fully half of all business profits are earned by pass-through entities, and that the average federal income tax rate paid is 19 percent (Cooper et al. 2015).

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Q. Is corporate income double-taxed?

A. Yes, as a general rule. A corporation pays tax on its income, and its shareholders pay tax again when the income is distributed. But in practice, not all corporate income is taxed and many corporate shareholders are exempt from income tax.

Since 1909, corporate income has been subject to a federal tax (currently at a top rate of 35 percent). This income is generally taxed a second time when it is distributed as dividends that are liable to the individual income tax.

Suppose a corporation earns $1 million in profits this year and pays $350,000 in federal taxes. If the corporation distributes the remaining $650,000 to its shareholders, the distribution would be taxable to shareholders. Dividends are taxed at a top rate of 23.8 percent. As a result, only $495,300 would be left (assuming the dividends went to high-income individuals), and the combined tax rate on the income would be greater than 50 percent.

Some analysts consider this double-taxation inequitable. It discourages businesses from organizing as C corporations (which are subject to the corporate tax), encouraging them to be S corporations, partnerships, or sole proprietorships. Profits of an S corporation, partnership, or sole proprietorship are taxed only once (at a top rate of 43.4 percent), because the income is automatically passed through to the owners. By no coincidence, in recent years an increasing portion of businesses have been organized as pass-through entities (figure 1).

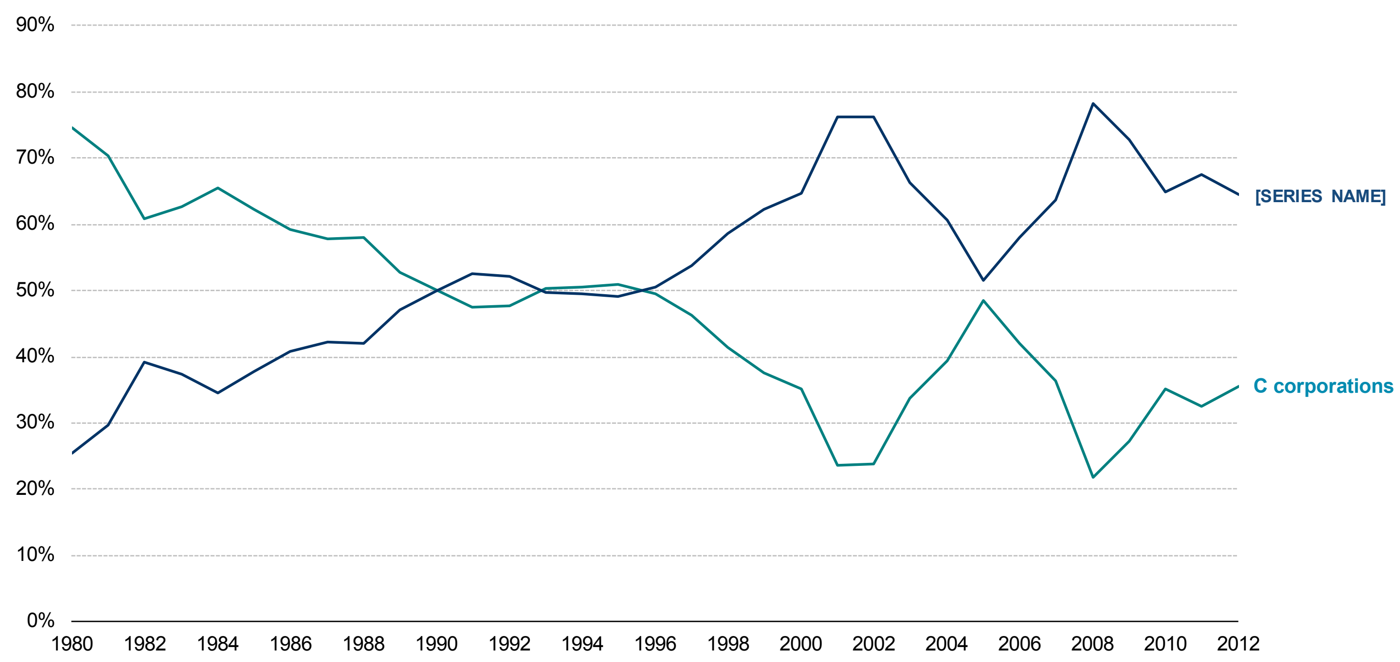
Key Elements of the U.S. Tax System

Is corporate income double-taxed?

FIGURE 1

Net Business Income (Less Deficit) as Share of Total

1980-2012



Source: IRS, Statistics of Income

In some instances, corporations can reduce the double-taxation of their income. For example, a corporation may issue debt instead of stock to finance an investment and deduct the interest payments in the calculation of taxable income. Alternatively, a corporation can retain its earnings and not pay dividends. The corporation would still pay tax on its earnings, but the shareholders would defer the second round of taxation until the corporation distributed the earnings or the shareholders sold their stock at a price that reflected the value of the retained earnings.

But these choices distort business behavior. They encourage debt financing over equity, which creates a riskier capital structure for the corporation. And they encourage a corporation to retain earnings that might better be used by its shareholders.

In addition, there often is not a second level of tax. Many shareholders, such as retirement accounts, educational institutions, and religious organizations, are exempt from income tax; the earnings distributed to these shareholders are not double-taxed. By some recent estimates, the share of U.S. corporate stock held in taxable accounts has fallen from over 80 percent in 1965 to about 25 percent today (Rosenthal and Austin 2016).

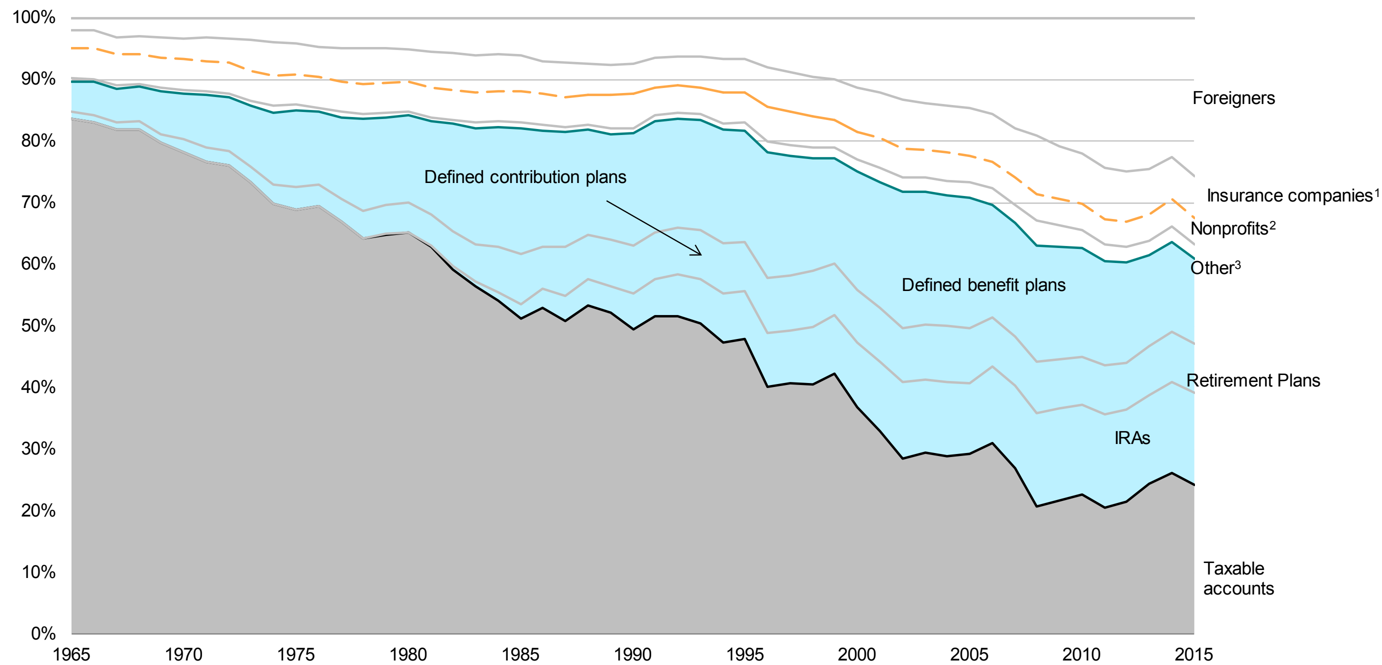
Key Elements of the U.S. Tax System

Is corporate income double-taxed?

FIGURE 2

Ownership of U.S. Corporate Stock, Direct and Indirect Holdings 1965-2015

Percent of U.S. Corporate Equity



Source: Board of Governors of the Federal Reserve System, "Financial Accounts of the United States;" Investment Company Institute. 2016, "The U.S. Retirement Market, Fourth Quarter 2015;" Barclay Hedge; Preqin; Tax Policy Center calculations.
(1) Stock held in non-taxable segregated reserves to fund annuity contracts and whole life insurance.
(2) Dashed lines indicate TPC estimates
(3) Primarily government holdings, but includes equities in 529 savings plans.

Many other countries have "integrated" their corporate and shareholder taxes. Some countries permit corporations to deduct the dividends they pay to shareholders. Other countries give shareholders full or partial credit for taxes paid at the corporate level, or they permit shareholders to exclude dividends from their taxable income. There are pros and cons to each approach, but one thing is clear: integrating the two taxes would cost a lot of revenue.

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Q. What is the New Markets Tax Credit and how does it work?

A. The credit provides an incentive for investment in low-income com-munities. The US Treasury competitively allocates tax credit authority to intermediaries that select in-vestment projects. Investors receive a tax credit against their federal income tax.

BACKGROUND

The New Markets Tax Credit (NMTC) was established in 2000. Congress authorizes the amount of credit authority, which is then allocated to qualified applications by the Treasury Department. Since 2003, the pro-gram has parceled out credits worth nearly $20 billion. The NMTC has supported over 4,800 projects in all 50 states, the District of Columbia, and Puerto Rico. Some 41 percent of US census tracts qualify for NMTC in-vestments. The credit expired at the end of 2014 but Congress extended the credit ret-roactively to 2015 and through 2019.

WHO INITIATES NMTC PROJECTS?

Community development entities (CDEs) are intermediaries that make loans or invest-ments. They apply to the Treasury Department's Community Development Financial Institutions (CDFI) Fund to receive tax credit authority. CDEs sell these tax credits to investors and use the funds to make debt or equity investments in entities located in qualified low-income communities. CDEs are encouraged to make deals and offer pref-er-ential rates and terms in areas that are more highly distressed. CDEs frequently use other public subsidies and private sector funds to invest in projects.

Many enterprises, including banks, developers, and local governments can qualify to become CDEs. The Urban Institute found in its 2013 evaluation of the first years of the New Markets program that for-profit non-financial institutions (such as developers and other private corporations) were awarded the highest share of NMTCs, followed by CDFIs and other mission-driven lending institutions. The third highest share went to for-profit financial institutions. Nonprofit nonfinancial institutions and government and quasi-government CDEs were awarded fewer and smaller NMTC allocations.

What is the New Markets Tax Credit and how does it work?

WHO INVESTS IN NMTC PROJECTS?

NMTC investors provide capital to CDEs, and are awarded credits against their federal tax obligations in exchange. Investors can claim their allotted tax credits in as little as seven years—5 percent of the investment for each of the first three years and 6 percent of the project for the remaining four years—for a total of 39 percent of the NMTC pro-ject. A CDE can be its own investor or find an outside investor. Investors are primarily corporate entities—often large international banks or other regulated financial institu-tions—but any entity or person is eligible to claim NMTCs.

WHO RECEIVES NMTC INVESTMENTS?

"Qualified active low-income businesses" (QALICBs) are the recipients of NMTC in-vestments. While called "businesses," QALICBs can be for-profit or nonprofit enterpris-es. The Urban Institute found in its 2013 evaluation that about 60 percent of projects in the first years of the NMTC program went to for-profit QALICBs, and most of the rest went to nonprofits. (The remaining 2 percent of projects were linked to tribal or other government organizations.)

The study found that QALICBs ranged in size—as measured by annual gross revenues or operating budgets at the start of their NMTC projects—from zero for start-ups to $7 billion for a large for-profit parent entity in the natural resources business, with a median of $740,000.

WHAT TYPES OF PROJECTS DOES THE PROGRAM FUND?

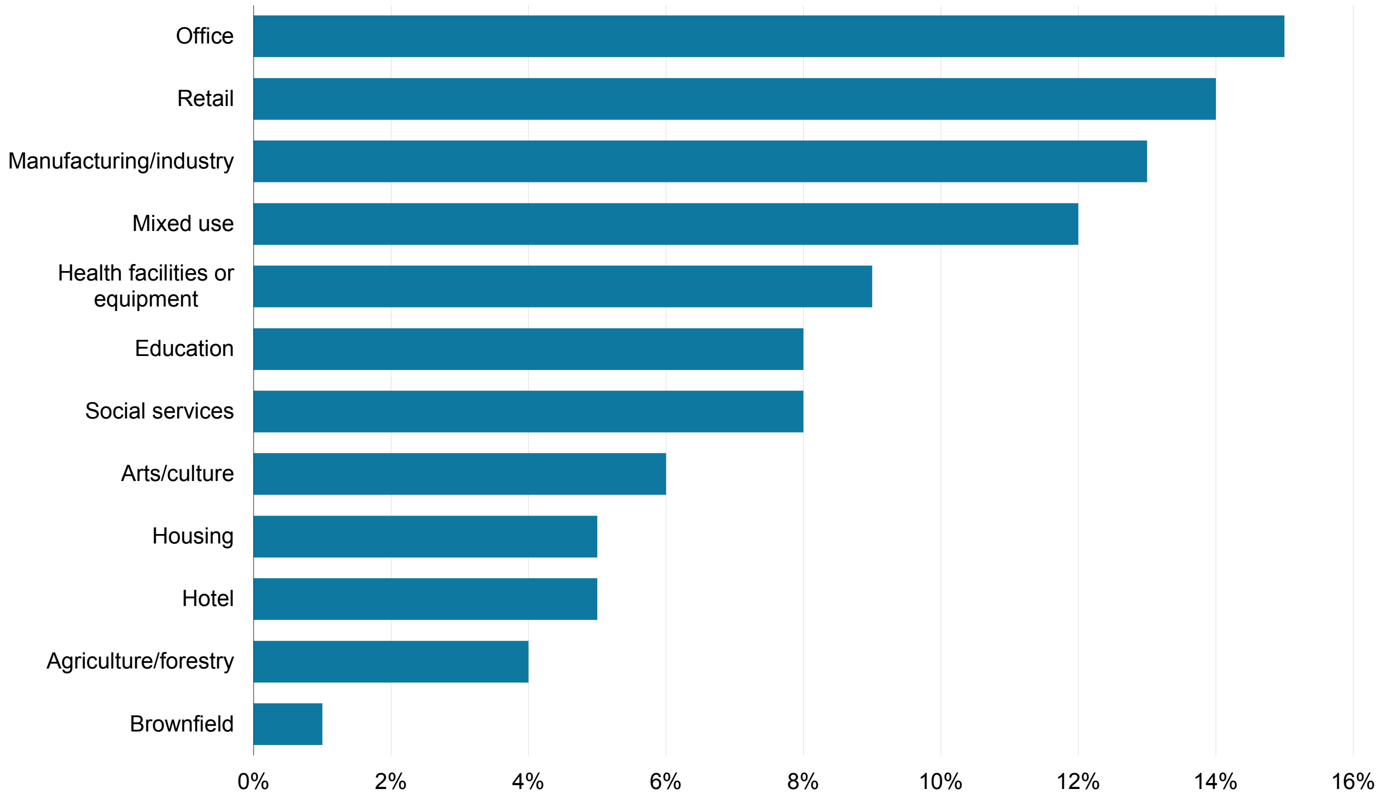
The NMTC program is flexible with regard to project type and purpose. QALICBs can be used to finance equipment, operations, or real estate. The real estate financing can be for the purchase or rehabilitation of retail, manufacturing, agriculture, community facili-ties (e.g., health services, museums, or charter schools), rental or for-sale housing, or combinations of these.

In its 2013 evaluation, the Urban Institute categorized project types (table 1 and figure 1). Although no project type dominated early-year projects, the most prevalent were office, retail, manufacturing/industrial, and mixed-use.

Key Elements of the U.S. Tax System

What is the New Markets Tax Credit and how does it work?

FIGURE 1
New Market Tax Credit Projects by Share
2003-2007



Source: Abravanel et al. 2013.

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Abravanel, Martin D., Nancy M. Pindus, Brett Theodos, Kassie Dumlao Bertumen, Rachel Brash, and Zachary J. McDade. 2013. "New Markets Tax Credit Program Evaluation." Washington, DC: Urban Institute.

Q. How does the current system of international taxation work?

A. All countries tax income earned by multinational corporations within their borders. The United States also taxes the foreign-source income of US-based multinationals when it is repatriated to the US parent, with a credit for foreign income taxes they've paid. Most other countries simply exempt the foreign-source income of their multinationals.

HOW THE UNITED STATES TAXES FOREIGN-SOURCE INCOME

The federal government taxes US resident multinational firms on their worldwide income at the same rates applied to domestic firms; the current maximum tax rate—the rate that applies to most corporate income—is 35 percent. US multinationals may claim a credit for taxes paid to foreign governments on income earned abroad, but only up to their US tax liability on that income. Firms may, however, take advantage of cross-crediting, using excess credits from income earned in high-tax countries to offset US tax due on income earned in low-tax countries.

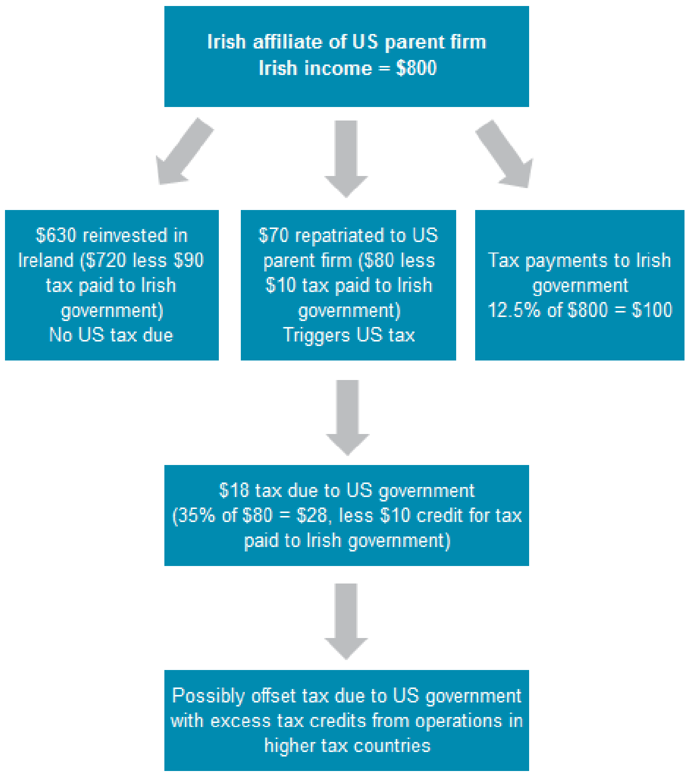
US multinationals generally pay tax on the income of their foreign subsidiaries only when they repatriate the income, a delay of taxation termed "deferral." Deferral, the credit limitation, and cross-crediting all provide strong incentives for firms to shift income from the United States and other high-tax countries to low-tax countries.

Suppose, for example, a US-based multinational firm facing the 35 percent maximum corporate income tax rate earns $800 in profits in its Irish subsidiary (figure 1). The 12.5 percent Irish corporate tax reduces the after-tax profit to $700. Suppose the firm then repatriates $70 of this profit and reinvests the remaining $630 in its Irish operations. The firm must then pay US tax on a base of $80 (the $70 plus the $10 in Irish tax paid on that portion of its profits), or $28, but it claims a credit for the $10 Irish tax, leaving a net US tax of $18. If the firm has excess foreign tax credits from operations in high-tax countries, it can offset more (or possibly all) of the US tax due on its repatriated Irish profit. Meanwhile, deferral allows the remaining profit ($630) to grow abroad, free of US income tax until it is repatriated.

Key Elements of the U.S. Tax System

How does the current system of international taxation work?

FIGURE 1
Example for Taxing a US-Based Multinational Firm
2015



Most countries, including all other countries in the G7 (Canada, France, Germany, Italy, Japan, and the United Kingdom), use a territorial system that exempts most so-called "active" foreign income from taxation. Still others have hybrid systems that, for example, exempt foreign income only if the foreign country's tax system is similar to that in the home country. In general, an exemption system provides an even stronger incentive than the current US tax system to earn income in low-tax countries because there is no residual domestic tax due upon repatriation of foreign profits.

Most countries, including the United States, also have rules in place intended to limit the ability of their resident corporations to shift profits to low-income countries. These rules, called Controlled Foreign Corporation (CFC) rules, tax some forms of income, typically "passive income," such as interest and dividends from portfolio investments, on a current basis. In that sense, even countries with a formal territorial system use a hybrid approach that subjects some foreign-source income to domestic tax.

Because of deferral, cross-crediting, and imperfect anti-avoidance rules, US multinationals pay little residual tax on their foreign-source income, making the system arguably no less favorable to US multinationals than a territorial system with stronger CFC rules.

How does the current system of international taxation work?

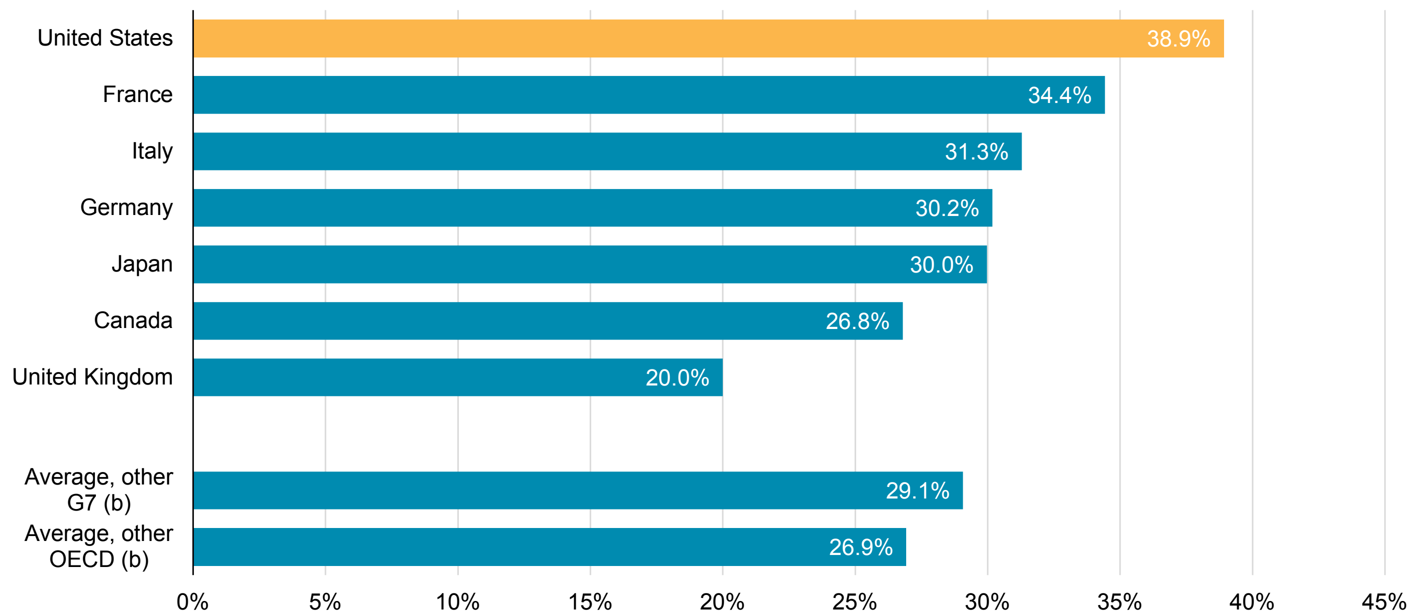
CORPORATE TAX RATES AND REVENUES

The US statutory corporate tax rate has changed little since 1986. Meanwhile, most other advanced industrial countries have lowered their tax rates. As a result, the top US corporate tax rate, including the average state corporate rate, is now higher than the top corporate tax rate of the other leading economies in the G7 and over 10 percentage points higher than the GDP-weighted average rate in the other Organisation of Economic Co-Operation and Development (OECD) countries (figure 2).

FIGURE 2

Maximum Corporate Tax Rates by Country[a]

Among leading economies, 2016



Sources: OECD (2014); TPC calculations.
(a) Includes taxes of sub-national governments.
(b) Weighted by GDP.

Despite its relatively high corporate tax rate, the United States raises less revenue from corporate income tDespite its relatively high corporate tax rate, the United States raises slightly less revenue from corporate income taxes as a share of GDP than the average of other countries in the OECD (figure 3). In recent years, revenue has increased as a share of GDP in most OECD countries because base-broadening measures that subject more income to tax have more than offset the cuts in tax rates. In the United States, revenue has varied significantly from year to year with economic conditions and the vagaries of temporary investment incentives, but revenue has remained at slightly over 2 percent of GDP in most years since the 1980s. The Congressional Budget Office, however, projects that corporate revenues will decline to about 1.5 percent of GDP at the end of the next decade due to continued shifting of reported profits of overseas, increases in the share of business activity originated in partnerships and corporations, and the permanent extension of some corporate tax incentives that Congress enacted at the end of 2015.

US corporate tax revenues lag behind other developed countries' because of a narrower tax base compared with other countries, an increasing share of business activity originating in businesses not subject to corporate tax (partnerships and subchapter S corporations), and increased incentives and opportunities for US companies, especially those with significant assets in intangible property, to shift reported income abroad.

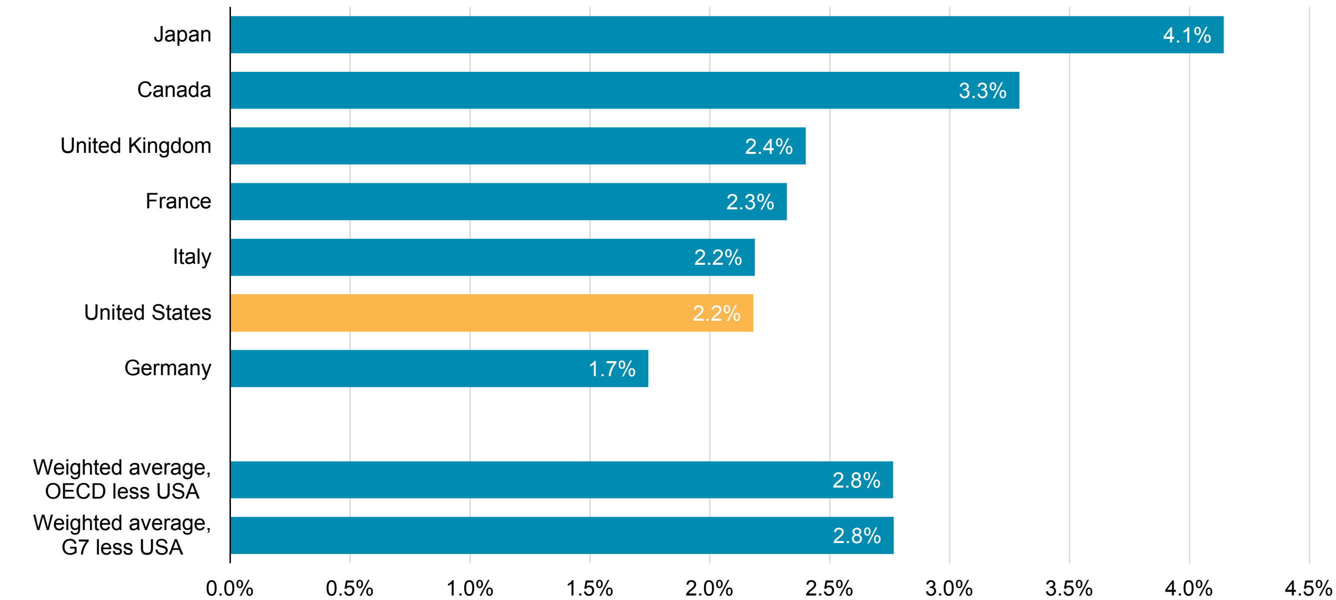
Key Elements of the U.S. Tax System

How does the current system of international taxation work?

FIGURE 3

Corporate Tax Revenue as Share of GDP by Country

Among leading economies, 2014



Sources: OECD (2014); TPC calculations.

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Q. What are the consequences of the US International Tax System?

A. Current rules encourage US multinational firms to earn and report profits in low-tax foreign countries, enable both US- and foreign-based firms to shift profits earned in the United States to other countries, and encourage companies to incorporate in foreign jurisdictions.

INCENTIVES TO EARN AND REPORT PROFITS IN LOW-TAX COUNTRIES

Multinational corporations typically operate overseas through foreign subsidiaries that are mostly taxed as independent corporate entities. This separate entity system gives multinationals incentives to shift reported profits to their affiliates in low-tax jurisdictions by underpricing sales to them and overpricing purchases from them.

For tax reporting purposes, most governments require firms to use an “arm’s length” standard, setting prices for transactions within the corporate group (“transfer prices”) equal to the prices that would prevail if the transactions were between independent entities. Yet ample room remains for firms to manipulate transfer prices, especially for intangible assets such as patents that are unique to the firm and for which there is no easily established market price.

Leading multinationals often shift the ownership of their intangibles, which generate a large share of their worldwide profits, to affiliates in very low tax jurisdictions, such as Ireland and Singapore. Typically, multinationals generate very little real economic activity—as measured by output, sales, or investments in plant and equipment—in these jurisdictions.

Multinationals can reduce their taxable income further through debt-equity swaps that strip profits from higher-tax countries where production facilities are located. US laws make it easier for US firms to strip profits from high-tax foreign countries than from the United States, which creates an incentive for firms to locate production facilities overseas.

US multinationals book a disproportionate share of profits in low-tax locations. In 2013, US multinationals reported over one-fourth of their overseas profits in three low-tax countries: the Netherlands, Ireland, and Bermuda (figure 1). The top ten foreign locations of their profits, including other low-tax countries such as Switzerland, Singapore, the UK Caribbean Islands, and the United Kingdom itself accounted for just over 60 percent of their non-US profits.

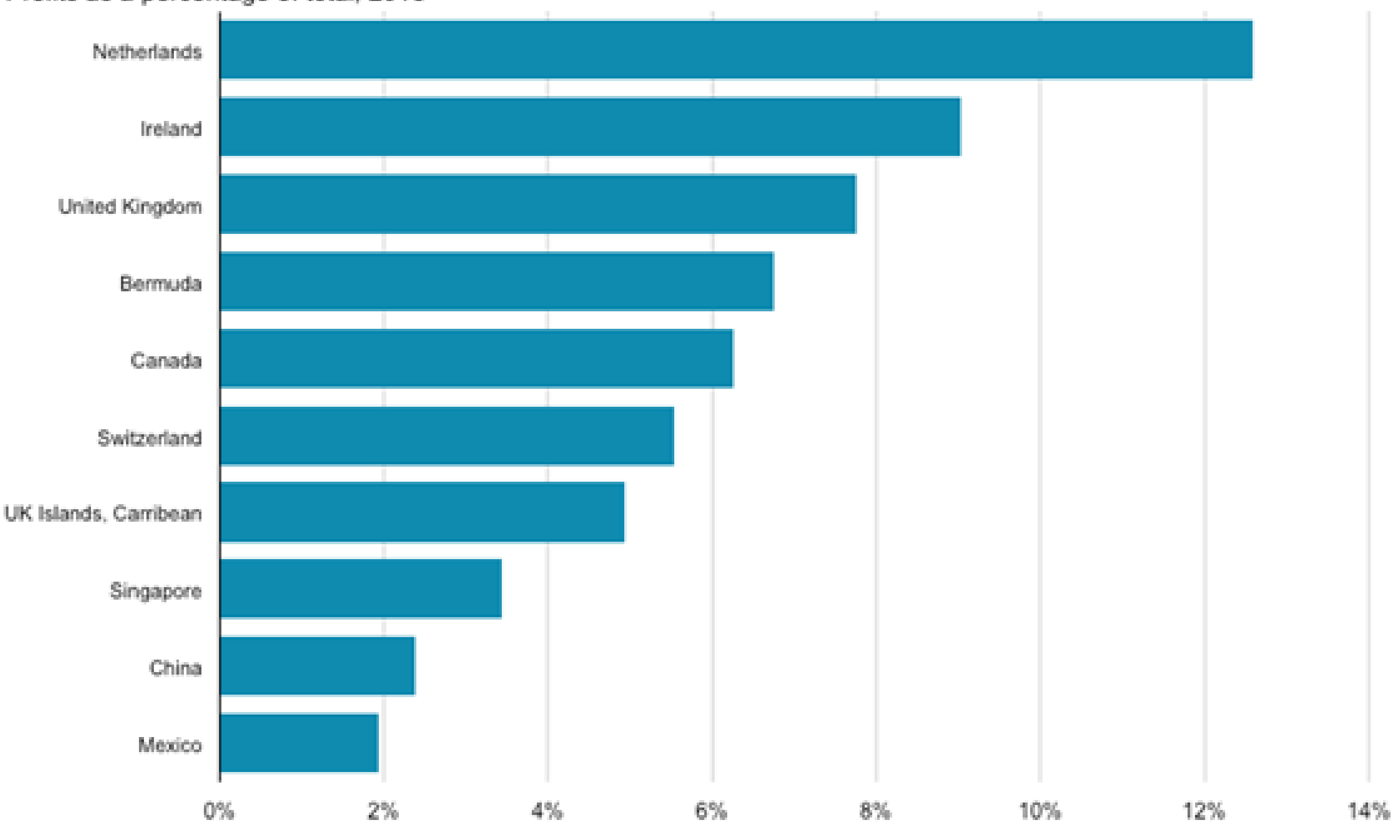
Key Elements of the U.S. Tax System

What are the consequences of the US International Tax System?

FIGURE 1

Top Countries for Non-US Profits of US Multinationals

Profits as a percentage of total, 2013



Source: Bureau of Economic Analysis, 2015.

Most of the advanced industrial countries have lowered their corporate income tax rates in recent years at least in part to attract multinational businesses, while US rates have changed little. The increasing discrepancy between US and foreign rates has strengthened incentives to shift income and has reduced US tax revenue.

Despite evidence that firms shift the location of real investment in response to tax rate differences among countries, a substantial share of real activity of US multinationals remains in high-tax countries. These tend to be large economies with close economic ties to the United States (figure 2). Although their statutory rates have declined over time while the US corporate rate has remained unchanged, some of them allow less generous rules for capital recovery than the United States. As a result, for most of these countries, their effective corporate tax rates on new investments are only slightly lower than the US rate.

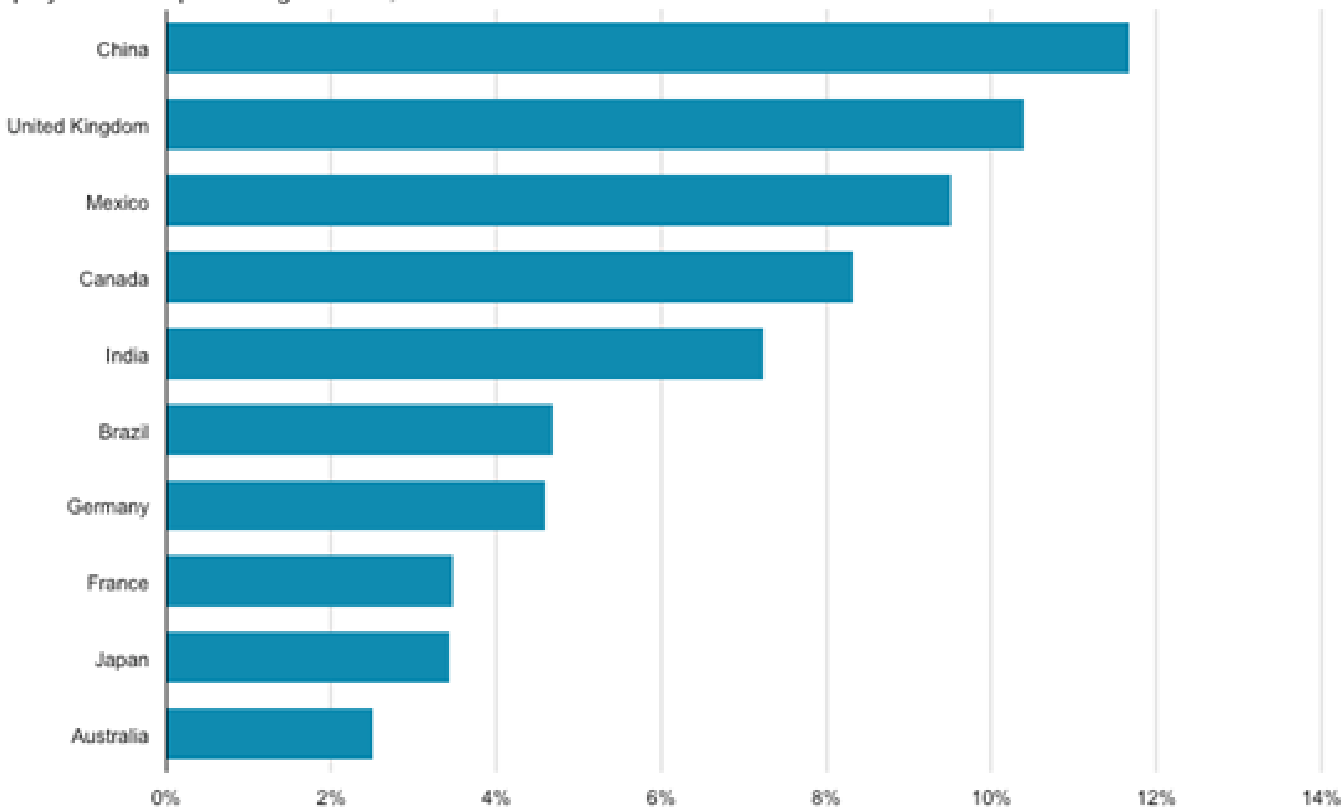
Key Elements of the U.S. Tax System

What are the consequences of the US International Tax System?

FIGURE 2

Top Foreign Locations for Employment in US Multinationals

Employment as a percentage of total, 2013



Source: Bureau of Economic Analysis, 2015.

INCENTIVES TO ACCRUE CASH OVERSEAS

The combination of deferral and increased reporting of US multinationals' income in low-tax jurisdictions has led to a large buildup of overseas assets, as many firms no longer have enough foreign tax credits to offset US taxes when they repatriate foreign profits. Recent research suggests that this "lock-out" of foreign profits is equivalent to an implicit tax of between 5 and 7 percent on foreign-source income.

INCENTIVES TO INCORPORATE OVERSEAS

The current US system treats multinational enterprises whose parent companies are incorporated in the United States (US-resident multinationals) differently from those that are resident elsewhere. The United States taxes its multinationals on dividends they receive from their foreign affiliates, while our major trading partners have so-called territorial systems that exempt these dividends. In addition, US anti-abuse rules limit the ability of US-based multinationals to use debt-equity swaps to shift reported income out of the United States but do not apply similar limits to foreign-resident multinationals. The Treasury Department (2016), however, has recently issued new regulations to deter this form of earnings-stripping.

Key Elements of the U.S. Tax System

What are the consequences of the US International Tax System?

The United States bases its definition of corporate residence on place of incorporation. This definition need not be consistent with where a company's production is located, where its sales take place, where its shareholders reside, or even where its top managers live.

The benefits of foreign residence, combined with the lack of economic substance to the residence definition, have led some US-based multinationals to shift the formal incorporation of their parent companies overseas. This type of transaction ("inversion") can often be accomplished without changing the location of any real business activities.

Over the years, Congress has enacted rules to limit inversions. A company can still "re-domicile," though, by merging with a foreign-based company under certain conditions, including a requirement that the original foreign company contribute at least 20 percent of the shares of the new merged company if other conditions are not met.

A recent wave of inversion transactions, like previous waves, has generated considerable concern among US policymakers and led to proposals for additional limits on merger transactions. However, the formal residence of a corporation may be losing significance in an increasingly global economy where capital flows freely and a firm's research and development, production, and sales are often spread worldwide. The location of investment, jobs, research and development, and tax revenue matter more than the site of a multinational firm's parent company, although corporate residence does have some effect on US tax revenues and arguably may matter for research and development and other high-value activities often associated with a company's headquarters.

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Q. How does the tax system affect US competitiveness?

A. The international tax policies that best encourage firms to invest in the United States are not necessarily the policies that best help US multinational companies compete with foreign-based multinationals. Policymakers face a trade-off among goals.

WHAT IS COMPETITIVENESS?

Many—really all—politicians favor "international competitiveness," but the term means different things to different people. To some, it is the ability of domestic firms or industries to compete with their foreign counterparts in a global marketplace. For them, this translates into support for "mercantilist" policies that seek to increase exports, reduce imports, or promote more US activity in certain sectors, such as manufacturing.

An alternative form of mercantilism seeks to promote the growth of a country's resident multinational corporations without regard to whether they produce at home or overseas. Concerns about the competitiveness of US multinationals often follow from an assumption that these firms generate spillover benefits for the economy in which they are headquartered. For example, the knowledge created by the research and development (R&D) that these firms conduct (typically at headquarters) often gets diffused to other domestic producers, boosting their competitiveness.

By contrast, many economists view free trade and capital movements as mutually beneficial because they tend to raise living standards in all countries. These economists define "competitive" policies as those that increase the standard of living of Americans over the long run, without regard to their effects on the balance of trade, the net direction of international capital flows, or success in expanding specific activities, such as manufacturing or R&D.

Global international tax practices seek to promote free capital movements by preventing double taxation of international capital flows. These same practices assign rights to tax profits to the capital-importing countries (i.e., the country where production facilities are located).

The capital-exporting country has two ways to avoid double taxation. The first is simply to exempt taxation of the foreign-source income of its residents. The second is to tax the worldwide income of its residents but to allow credits for foreign income taxes they pay so that their income is taxed at the home-country rate rather than the rate in the country where the income is earned. These two approaches have very different implications for a country's attractiveness as a location for productive investment or as a place for multinational corporations to establish residence.

Key Elements of the U.S. Tax System

How does the tax system affect US competitiveness?

Although the promise of beneficial spillovers from R&D and other headquarters activities is a strong argument for using the tax code to promote them, lower taxes on such activities might lead to a shortchanging of other activities in the economy (such as education, health, and infrastructure) that also provide beneficial external effects. More direct incentives, such as subsidies for R&D, might better encourage the desired spillovers.

TAX POLICIES TO ATTRACT INVESTMENT

The US corporate tax system discourages investment in the United States by both US- and foreign-based corporations because the top corporate tax rate in the United States (if state-level taxes are included) is higher than the top corporate tax rate in all of our major trading partners. However, this disadvantage to US investment is partially offset by capital recovery provisions that are more generous in the United States than in many other countries and by provisions that make it easier in the United States than in most other countries to establish businesses whose owners benefit from limited liability without being subject to corporate-level taxation.

The US tax system also encourages US-based multinationals to invest overseas instead of at home because US multinationals can defer US tax on the income of their foreign-owned subsidiaries in low-tax countries until that income is repatriated to the US parent firm. The effects of this incentive for foreign investment are partially offset, though, if the shift of investment overseas by US multinationals raises pre-tax returns on investment in the United States and thereby encourages an inflow of capital from foreign-based firms.

TAX POLICIES TO ATTRACT CORPORATE HEADQUARTERS

The US tax system arguably places US multinationals at a competitive disadvantage with foreign-based multinationals with income from low-tax countries because US companies must pay the difference between the US tax rate and foreign tax rates when they repatriate profits from their foreign affiliates. In contrast, most countries in the Organisation for Economic Co-operation and Development and all the other countries in the G7 (Canada, France, Germany, Italy, Japan, and the United Kingdom) have exemption systems that allow their resident multinationals to pay only the foreign-tax rate on their overseas profits.

In addition, the US controlled foreign corporation (CFC) rules tax some forms of foreign-source income of US multinationals as it accrues in their foreign subsidiaries. The goal is to prevent schemes that strip reported profits from US tax jurisdiction to low-tax foreign countries. The CFC rules, however, only apply to US-resident multinationals and do not prevent similar schemes by foreign-resident multinationals to strip profits from their US affiliates.

Others argue that US multinationals are not, on balance, put at a disadvantage by the US tax system. They point to the ability of US companies, especially those with significant assets in intellectual property, such as firms in the high-tech and pharmaceutical sectors, to shift reported profits to low-tax jurisdictions. They also note that since 1997, “check-the-box” regulations have effectively enabled US multinationals to shift reported profits from production in high-tax foreign jurisdictions to tax havens without being subject to US CFC rules.

WOULD A VALUE-ADDED TAX INCREASE US COMPETITIVENESS?

Some commentators argue that substituting a value-added tax (VAT) for all or part of the corporate income tax would improve the US trade balance because, unlike the corporate income tax and other levies imposed on income earned in the United States, VATs typically exempt exports and tax imports.

Key Elements of the U.S. Tax System

How does the tax system affect US competitiveness?

But most economists dispute the claim that a VAT would improve the trade balance, arguing that any benefit to net exports from a VAT would be offset by a resulting appreciation of the US dollar relative to other currencies. In fact, some research suggests that countries that rely heavily on VATs for revenue have lower net exports than those that don't.

Replacing some or all of the corporate income tax with a VAT would, however, affect the trade position of some industries relative to others. Exemptions and lower rates within a VAT affect the relative prices consumers pay for different goods and services but do not distort trade patterns because VAT burdens do not depend on where goods and services are produced. In contrast, preferences within the corporate income tax do affect production location, improving the competitiveness of some US producers while worsening the competitiveness of others because the tax does affect relative costs of production.

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Q. How would formulary apportionment work?

A. Under the current global system, multinational firms determine their profits separately in each tax jurisdiction in which they operate. A system that apportioned profits by formula would allocate a firm's worldwide income across countries based on its sales, assets, and payroll in each jurisdiction.

HOW IT WORKS

Under formulary apportionment, a multinational corporation would allocate its profits across countries based on its sales, payroll, and capital base in each jurisdiction. It would pay domestic corporate taxes on the share of its worldwide income that is allocated to each jurisdiction. An alternative would base a corporation's taxes only on the fraction of its worldwide sales destined for domestic consumers, a so-called "destination-based" corporate profits tax.

Many states in the United States use a formulary apportionment system to determine their taxable share of US-source corporate profits. The formulas have been historically based on a weighted average of the shares of sales, payroll, and assets in the state. But recently, some states have shifted to a sales-only apportionment system in order to remove any incentive to shift employees or facilities to other jurisdictions.

The adoption of formulary apportionment by states was motivated by the widespread perception that states are so highly integrated economically that it is impractical to try to determine how much of a firm's income is earned by an affiliate in one state and how much by an affiliate in another.

ADVANTAGES OF FORMULARY APPORTIONMENT

Formulary apportionment would remove the current artificial incentive for multinationals to shift reported income to low-tax locations because tax liabilities would be allocated by a measure (or measures) of their real economic activity in each location. These measures are far more difficult to manipulate for tax purposes than the division of profits among separate entities within a firm.

Key Elements of the U.S. Tax System

How would formulary apportionment work?

Formulary apportionment would also reduce the tax system's complexity and the administrative burden it imposes on firms. Firms would no longer have to allocate income or expenses across countries for tax purposes. There would no longer be a need for controlled foreign corporation rules because all profits assigned to foreign activities would be exempt. For this reason, there would also no longer be a need for foreign tax credits, so firms would have no incentive to manage profit repatriation to maximize the availability of offsetting tax credits. Because intra-firm transactions would not affect the measure of domestic profits, there would be no need for transfer-pricing rules for intra-firm transactions, which would remove a major source of dispute between corporations and tax authorities.

The United States and other high-tax countries would gain substantial revenue under formulary apportionment because firms' shares of real economic activity in these countries typically exceed the shares of income they now report as originating there. The move to formulary apportionment could therefore be made revenue-neutral by substantially reducing corporate tax rates. Moreover, because it would make a multinational corporation's tax liability independent of both its legal residence and its legal form (for example, branch or subsidiary), formulary apportionment would also remove any incentive for corporate inversions in which firms from two countries merge to move around their tax liabilities.

PROBLEMS AND DISADVANTAGES

Formulary apportionment would require an agreement among the major economies to scrap the current separate-entity system and to agree on how to allocate corporate income among jurisdictions. It would also require agreement on common accounting methods for measuring corporate profits.

A unilateral move by the United States to formulary apportionment would result in double taxation of some income of multinationals and exemption of other income. That's because different countries would use radically different methods of allocating income among jurisdictions.

A formulary apportionment system would introduce new boundary problems between high-tax and low-tax activities. While the current separate-entity system creates incentives to shift reported profits among separate firms within a multinational corporation, formulary apportionment provides incentives to shift profits between multinationals and separately owned firms. For example, if physical assets are one of the determinants of the location of a multinationals' profits, a firm might well have an incentive to contract out its manufacturing to independently owned firms in high-tax jurisdictions instead of establishing a manufacturing subsidiary within the firm.

Formulary apportionment does not provide an answer to how to locate a firm's intangible assets, which are a significant share of the value of some of the leading multinationals, especially in the high-tech and pharmaceutical sectors.

Some analysts and commentators favor sales- or destination-based allocation of corporate profits because firms are least likely to reduce sales in a jurisdiction simply to reduce tax liability. A problem with a sales-based allocation, however, is that multinationals can then avoid tax on the profits from their intangible assets by selling their products to independent distributors in low-tax countries, who would then resell them throughout the world. Although rules could be written to prevent abuses of this type, they would be cumbersome and hard to enforce because most of the output of multinationals is sold primarily to other companies in complex supply chains rather than directly to final consumers.

Key Elements of the U.S. Tax System

How would formulary apportionment work?

Further Reading

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Q. What are inversions, and why do they happen?

A. An inversion is a transaction in which a US-based multinational company merges with a smaller foreign company and then establishes a foreign residence. As a foreign resident, the company can significantly reduce its taxes without changing the location of any real business activities.

The current US system treats multinational enterprises whose parent companies are incorporated in the United States (US-resident multinationals) differently from those that are resident elsewhere. The United States taxes its multinationals on dividends they receive from their foreign affiliates, while our major trading partners have so-called territorial systems that exempt these dividends. In addition, US anti-abuse rules limit the ability of US-based multinationals to use debt-equity swaps to shift reported income out of the United States, but do not apply similar limits to foreign-resident multinationals.

The United States bases its definition of corporate residence on place of incorporation. This definition need not be consistent with where a company's production is located, where its sales take place, where its shareholders reside, or even where its top managers live.

The tax benefits of foreign residence, combined with the residence definition's lack of economic substance, have led some US-based multinationals to shift the formal incorporation of their parent companies overseas. This type of transaction ("inversion") can often be accomplished without changing the location of any real business activities. Some recent research (Rao 2015), however, finds that inverted companies over time increase their shares of employees and investment overseas compared to companies that did not invert.
In recent years, US multinationals have accumulated a large amount of un-repatriated foreign cash, increasing the motivation for inversion transactions (Clausing 2014). The shift of reported income to low-tax foreign countries is responsible for much of the accruals. As a result, taxes on dividends paid back to the US parent will not be shielded by foreign income tax credits.

Over the years, Congress has enacted rules to limit inversions. Simple inversions—a US company establishes a foreign affiliate, which then becomes the parent company—no longer work because the United States would continue to treat the new company as US resident. A company can still "re-domicile," though, by merging with a foreign-based company under certain conditions; these include a requirement that the original foreign company contribute at least 20 percent of the shares of the newly merged company if other conditions are not met.

Key Elements of the U.S. Tax System

What are inversions and why do they happen?

A recent wave of inversion transactions, like previous waves, has generated considerable concern among US policymakers and has led to proposals for additional limits on merger transactions. Legislative proposals that have recently been considered in Congress and discussed in the Presidential campaign would have required that the original foreign company contribute at least 50 percent of the shares of the merged company, would have placed new limits on interest deductions by US subsidiaries of foreign multinationals to prevent income stripping through debt-equity swaps, and would have imposed a one-time exit tax on the accrued foreign profits of inverting companies (Rosenthal 2015). In addition, the Treasury in 2014 issued new regulations to prevent ways of avoiding the 20 percent threshold on foreign ownership and to make it more difficult for the newly merged companies to repatriate earnings they accrued prior to the merger tax-free.

In 2016, Treasury issued additional regulations (U.S. Treasury Department, 2016) that used its current authority (Shay, 2014) to reclassify certain debt transactions between related parties as equity instead of debt to deter income stripping by foreign-based multinationals. These regulations are controversial and may not survive the change in Administration following the 2016 Presidential election.

New proposed anti-inversion legislation could stem the latest types of inversions, as past legislation halted earlier transactions. Changes in the residence of existing US corporations, however, are not the only way the share of world output by US-based multinationals can decline over time. Foreign-based multinationals can purchase smaller US companies or divisions of larger ones. New companies can be chartered overseas instead of in the United States. And foreign-based multinationals can expand faster than US-based companies if US tax laws place US multinationals at a disadvantage. In the long run, new limits on inversions, like previous ones, may be ineffective if tax laws continue to place some US-resident companies at a disadvantage compared with foreign-resident companies.

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Q. What are the options for reforming our international tax system?

A. On its face, reforms that would remove the incentive for US corporations to move abroad and lower corporate tax rates to make US corporate activity more competitive seem straightforward. In fact, unraveling the Gordian knot created by taxation-as-usual would be far from simple.

FLAWS OF CURRENT US INTERNATIONAL TAX RULES

There's seemingly no end to complaints about the impact of the US corporate tax in the context of an increasingly integrated global economy. Among them are the following:

- Deferral of foreign-source income until it is repatriated encourages multinationals to locate business activity and to report profits in low-tax countries.
- The taxation of foreign-source income of US-based firms when repatriated, along with the controlled foreign corporation (CFC) rules that tax some foreign-source income as it is accrued, place US-resident multinationals at a competitive disadvantage with firms resident in countries that exempt most foreign-source income and have weaker CFC rules.
- The timing of tax liability when income is repatriated, combined with rules that allow US firms to report their accumulated foreign profits as permanently invested overseas, have in recent years encouraged US resident multinationals to accumulate substantial assets abroad, some of which could be more effectively deployed if invested in the United States or paid as dividends to shareholders.
- The complexity of the various rules apportioning income by jurisdiction and preventing tax avoidance by limiting deferral and the use of offsetting foreign tax credits raise compliance costs. Yet they still offer substantial opportunities for legal tax avoidance.
- Taxes on foreign-source income of US multinationals raise relatively little revenue, even though the US corporate tax rate exceeds the tax rate in other countries in which US firms report profits.

REFORM OPTIONS: ELIMINATE DEFERRAL

Eliminating the deferral of US tax liability on the non-repatriated foreign-source income of US-based multinationals would increase revenue and substantially reduce firms' incentives to earn income in (or to shift profits to) low-tax countries. However, eliminating deferral could put US-based multinationals at an additional competitive disadvantage by raising the tax rate they pay on income earned in low-tax countries compared with taxes paid by foreign-based multinationals. And that, in turn, would create greater incentives for US firms to change their tax residence through mergers with foreign-based firms.

Key Elements of the U.S. Tax System

What are the options for reforming our international tax system?

Congress could enact additional rules to discourage these “inversion” transactions. But they could not foreclose every option that allows US firms to shift corporate activity to foreign-resident multinationals.

Competitiveness concerns could be allayed, but only in part, by combining the elimination of deferral with a large (but still revenue-neutral) reduction in the US corporate income tax rate. Indeed, that is the centerpiece of tax reform plans introduced by Senate Finance Committee ranking Democrat Ron Wyden along with current and former Republican senators Dan Coats and Judd Gregg. It would have eliminated deferral while substantially reducing the top corporate tax rate.

REFORM OPTION: TERRITORIAL SYSTEM

A territorial system would exempt the foreign income of US multinational firms from US taxation. Such a system would likely enhance the competitiveness of US-based multinationals compared with foreign-based firms and reduce (but not entirely eliminate) the incentive for inversions.

The most important argument against a territorial system is that by exempting foreign income, it would reinforce the already strong tax incentive to locate economic activity and to report profits in low-tax countries. Such tax-motivated changes in behavior are generally economically inefficient and could further erode the US corporate income tax base.

That’s a fair point: Depending on its design, a territorial system could bring in less tax revenue than the existing system. Harry Grubert and John Mutti (2007) have suggested, however, that revenue could actually increase under a territorial system if royalty income from abroad were defined as domestic-source income and interest allocation rules were changed.

A territorial system could simplify taxation of international income because exempting foreign income from taxation would reduce the sort of tax planning now needed to optimize the use of foreign tax credits to shield repatriated foreign income from US taxes. However, under the new system, firms would still have to distinguish between foreign and domestic income, identify passive income that is subject to CFC rules, and appropriately allocate expenses to their operations in different countries. In addition, the stronger incentives to shift income produced by eliminating the repatriation tax would further strain the rules in place to prevent bogus profit shifting through inappropriate transfer pricing.

REFORM OPTION: HYBRID SYSTEM

President Obama and congressional leaders from both parties have proposed variants of a “hybrid” system that would continue to impose a lower effective tax rate on foreign-source income than domestic-source income of US multinationals but eliminate the tax on repatriated profits. These proposals, while different, have three main elements in common:

- They would eliminate taxation of repatriated foreign-source profits of US multinational corporations.
- They would impose a one-time transition tax on currently accrued overseas profits of US multinationals, to be collected over several years.
- Going forward, they would impose a low rate tax on accrued foreign-source “intangible” profits of US multinationals in order to discourage the sort of income-shifting to low-tax countries that a pure territorial system would encourage.

Key Elements of the U.S. Tax System

What are the options for reforming our international tax system?

On the plus side, the hybrid proposals would remove the incentive for US corporations to accrue assets overseas by eliminating taxation upon repatriation. But they would not resolve the tension between reducing the incentive for US companies to invest and report income overseas and improving the competitiveness of US-based multinationals. Depending on design details, a proposal in this form could either raise or lower the effective tax rate on foreign-source income.

REFORM OPTION: DESTINATION-BASED TAXES

A more fundamental reform option would replace the current corporate income tax with a destination-based tax. A destination-based tax is based on where a corporation's products are purchased rather than where they are produced, where the corporation is located, or where the corporation records its income. The major benefits of a destination-based tax from an international point of view is that it would eliminate incentives under the U.S. corporate income tax for firms to invest and report income overseas instead of at home and eliminate incentives for U.S. firms to "re-domicile" themselves as foreign-based firms.

Some examples of destination based taxes are a value added tax (VAT) or a business cash-flow tax. Under a VAT, border adjustments would impose the tax on imports but exempt exports by rebating any VAT previously collected at earlier stages of production. Under a destination-based business cash-flow tax border adjustments would exempt export sales from tax and not allow firms to deduct the cost of imports. The destination-based cash flow tax, however, raises its own issues, including whether the border adjustments would be acceptable to the World Trade Organization and whether it would be politically feasible to pay large rebates to export firms who would experience tax losses under the plan and impose large new taxes on importers.

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