



URBAN-BROOKINGS TAX POLICY CENTER

Tax Proposals in the 2010 Budget

The Tax Policy Center offers the table below as a guide to the tax provisions of President Obama's 2010 Budget. Subsequent pages provide detailed descriptions and brief commentaries on each provision. Linked tables show the distributional effects of the overall proposal and of major elements of the plan. Further details on the analysis appear on the next page.

Individual Tax Provisions		
Provisions Affecting Lower- and Middle-Income Households		Provisions Affecting High-Income Households
Provide Making Work Pay Credit	-535	Reinstate 36 and 39.6 percent rates for high-income taxpayers ¹
Expand Earned Income Tax Credit	-21	Reinstate personal exemption phaseout and limitation on itemized deductions for high-income taxpayers ¹
Expand refundability of Child Tax Credit	-71	Impose 20 percent rate on capital gains and dividends for high-income taxpayers ¹
Expand saver's credit and automatic enrollment in IRAs and 401(k)s	-60	Limit value of itemized deductions to 28%
Provide American Opportunity Tax Credit	-49	
Eliminate Advanced Earned Income Tax Credit	1	
Business Tax Provisions		
Eliminate capital gains taxes on small businesses	-6	Tax carried interest as ordinary income
Make research and experimentation credit permanent	-74	Codify "economic substance" doctrine
Expand net operating loss carryback	-19	Reform U.S. international tax system
Reinstate Superfund Taxes	17	Repeal LIFO
Business provisions not evaluated ²		-41
Individual and Business		
Continue remaining expiring provisions through CY 2010	-17	Reduce the tax gap and make reforms
		Make reforms to close tax loopholes
Total, all tax provisions		363
Climate revenues		624
Tax revenue adjustments to baseline ³		
Index 2009 parameters of the AMT to inflation	-576	Continue the 2001 and 2003 tax cuts
Make 2009 estate tax permanent	-172	-2,484

1. Couples with income over \$250,000 and single people with income over \$200,000.

2. Require information reporting for rental payments (\$3 billion), eliminate oil and gas company references (\$31 billion), modify FAA financing (-\$77 billion) and modify alternative fuel mixture credit (\$1 billion).

3. The Administration baseline continues the 2001 and 2003 tax cuts (with the estate tax fixed at 2009 law) and indexes the 2009 AMT parameters for inflation.

Descriptions of tax provisions and revenue estimates come from Office of Management and Budget, [A New Era of Responsibility: Renewing America's Promise](#), 2009.

Revenue effects shown in the table cover 11 years—2009-2019—even though the budget would begin in 2010 and most of the tax changes would take effect in 2011. Some proposed tax changes would affect revenue in 2009 because of behavioral changes.

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

The administration assumes a baseline that permanently extends the 2001-2003 tax cuts, makes the estate tax permanent with 2009 parameters, and indexes the exemption for the alternative minimum tax (AMT) from its 2009 level. Most of our distribution tables compare the effects of tax proposals separately both against the administration’s baseline and against a current law baseline that assumes that the 2001-2003 tax cuts expire in 2011 as scheduled and that the AMT exemption reverts to its permanent value after 2009.

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

Because some of the tax proposals are not indexed for inflation, their real effects of many tax proposals would change over time. The value of most unindexed proposals would decline in real terms, either because their values are fixed in nominal dollar amounts or because nominal phaseout thresholds would affect more taxpayers. [Click here to read a more complete discussion of the impact of indexing.](#)

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



Tax Policy Center

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Tax Proposals in the 2010 Budget*

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Introduction

The Tax Policy Center has examined the key tax proposals in President Obama's 2010 budget. Separate discussions below describe each of the proposals including current law, proposed changes, and, when appropriate, the distributional effects. The budget as presented by the president lacks complete details on many of the tax proposals. Some provisions had virtually no detail and our discussion of them is necessarily limited.

The budget assumes a baseline in which the 2001-2003 tax cuts are permanent and the exemption in the alternative minimum tax (AMT) is permanently indexed for inflation from its 2009 level. Those provisions would reduce revenues by \$3.3 trillion over the 2009-2019 period. TPC's analysis measures the impact of the tax proposals not against the administration baseline but rather against a current law baseline that assumes the 2001-2003 tax cuts expire as scheduled in 2011 and that the AMT exemption is not indexed. Against that baseline, the administration's tax proposals would cause much greater revenue losses than official budget estimates show.

The distributional effects of the tax proposals would change over time because most of them are not indexed for inflation. As a result, some of the proposed tax cuts would benefit fewer taxpayers in future years and the value of some of the cuts would shrink.

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

Note: This paper cites “10-year” revenue estimates but, because significant revenue effects occur in 2009, the 10-year values reported include both the 10-year budget window—2010-2019—and 2009.

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Make Permanent the “Making Work Pay” Credit

The economic stimulus act (“American Recovery and Reinvestment Act of 2009,” or ARRA) created the “Making Work Pay” (MWP) tax credit, an Obama campaign proposal to offset part of the Social Security taxes paid by low- and middle-income workers. The president proposes to make the credit permanent, index the maximum credit annually for inflation, and lower the phaseout rate from ARRA’s 2 percent to 1.6 percent.

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

Under ARRA, the credit phases out at a rate of 2 percent of income over \$150,000 for married couples filing joint tax returns and \$75,000 for others. Therefore, couples with income above \$190,000 and others with income above \$95,000 are not eligible to receive the credit. The president proposes to reduce the phaseout rate to 1.6 percent and to index the phaseout thresholds annually to take account for inflation. The lower phaseout rate would widen by 25 percent the income range over which the credit phases out.

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

MWP would reduce income taxes for three-fourths of all tax units in 2012 by an average of \$385, raising average after-tax income by 0.7 percent. The credit is highly progressive: after-tax income would rise by 2.3 percent for the poorest 20 percent (quintile) of households, compared with 1 percent for the middle quintile and 0.2 percent for the top quintile.

Because the maximum credit would not be indexed, it would decline in real value over time. As a result, the credit would provide a diminishing percentage increase in after-tax income in future years, even though indexing phaseout thresholds would maintain the real income range over which taxpayers could claim the credit.

Distribution tables

Making Work Pay Credit

[2012 versus current law by cash income](#)

[2012 versus current law by cash income percentiles](#)

[2012 versus Administration baseline by cash income](#)

[2012 versus Administration baseline by cash income percentiles](#)

Additional Resources

Stimulus Act Report Card: "Making Work Pay" Tax Credit

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

Permanently Expand the Earned Income Tax Credit

The economic stimulus act (“American Recovery and Reinvestment Act of 2009”) increased the earned income tax credit rate for working families with three or more children from 40 percent to 45 percent, thus raising the maximum credit for families with three or more children from \$5,028 to \$5,657 in 2009. The act also increased the phaseout income levels for all married couples filing a joint tax return (regardless of the number of children) to \$5,000 above the thresholds for single filers. The president proposes to make both changes permanent and to index for inflation the \$5,000 higher phaseout threshold for married couples filing jointly.

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

Additional Resources

Tax Policy Briefing Book: Taxes and the Family: What is the earned income tax credit?

<http://www.taxpolicycenter.org/briefing-book/key-elements/family/eitc.cfm>

Stimulus Act Report Card: Increase in Earned Income Tax Credit

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

Permanently Expand Refundability of the Child Tax Credit

Families with children under age 17 can claim a Child Tax Credit (CTC) of up to \$1,000 per child. If the credit exceeds taxes owed, families can receive some or all of the balance as a refund, known as the Additional Child Tax Credit (ACTC). The ACTC is limited to 15 percent of earnings above a threshold that is indexed to inflation. The economic stimulus act (“American Recovery and Reinvestment Act of 2009”) temporarily set that threshold at \$3,000 so that families would start getting at least a partial credit at lower earnings levels than they did under prior law (\$12,550 in 2009). The president proposes to make the lower threshold permanent and no longer index the threshold for inflation.

Lowering the threshold for refundability would encourage low-income workers to work more by increasing their after-tax wage but the effect would likely be small. Not indexing the threshold would cause the threshold to decrease in real terms over time, making more families eligible for the refundable credit and increasing the size of the credit for many families.

Additional Resources

Tax Policy Briefing Book: Taxes and the Family: What is the child tax credit?

<http://www.taxpolicycenter.org/briefing-book/key-elements/family/ctc.cfm>

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

Expand saver's credit and automatic enrollment in IRAs and 401(k)s

Under current law, low- and middle-income taxpayers may claim a saver's credit of up to \$1,000 (\$2,000 for couples) if they contribute to retirement savings plans. The credit equals the credit rate times up to \$2,000 of contributions to IRAs, 401(k)s, or certain other retirement accounts by each taxpayer and spouse. The credit rate for 2008 depends on income and tax filing status as shown in the following table. (For 2009, couples filing jointly must have income below \$55,500, heads of household income below \$41,625, and other tax filers income below \$27,750 to claim any credit.) The credit is not refundable and therefore has limited value for people with little income tax liability.

Saver's Credit Rates by Tax Filing Status and Adjusted Gross Income			
Credit Rate (percent)	Income Tax Filing Status		
	Married filing jointly	Head of household	Single, Married filing separately, or Qualifying widow(er)
50	Up to \$32,000	Up to \$24,000	Up to \$16,000
20	\$32,000 - \$34,500	\$24,000 - \$25,875	\$16,000 - \$17,250
10	\$34,500 - \$53,000	\$25,875 - \$39,750	\$17,250 - \$26,500
No credit	Over \$53,000	Over \$39,750	Over \$26,500

Source: Internal Revenue Service Form 8880 Credit for Qualified Retirement Savings Contributions—2008 at <http://www.irs.gov/pub/irs-pdf/f8880.pdf>

The president proposes to make the saver's credit refundable as a 50-percent credit up to \$500 per individual (indexed for inflation). The full credit would go to families with income below \$65,000 (\$48,750 for heads of household and \$32,500 for singles and married couples filing separately) and would be automatically deposited into the qualified retirement plan or IRA. The credit would phase out when income exceeds those limits; the maximum credit would be reduced by 5 percent of income over the relevant limit.

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

The president also proposes to establish automatic enrollment in IRAs and 401(k)s. Currently most employment-based retirement savings plans require workers to make a positive choice to contribute to the plan. The default option is not to contribute. Under the president's proposal, employers in business at least two years and with ten or more workers would have to enroll every

worker automatically in a workplace pension plan unless the worker opts not to participate. Employers who do not currently offer retirement plans would have to enroll employees in a direct-deposit IRA account unless the worker opts out. Research has shown that changing from a default opt-in provision to an opt-out provision markedly increases worker participation. The administration suggests that its proposal would increase the savings participation rate for low- and middle-income workers from the current 15 percent level to around 80 percent.

Additional Resources

Tax Policy Briefing Book: Key Elements of the U.S. Tax System: Savings and Retirement:
What is an automatic 401(k)? <http://www.taxpolicycenter.org/briefing-book/key-elements/savings-retirement/401k.cfm>

Tax Policy Briefing Book: Key Elements of the U.S. Tax System: Savings and Retirement:
How might saving be encouraged for low- and middle-income households?
<http://www.taxpolicycenter.org/briefing-book/key-elements/savings-retirement/encourage.cfm>

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

Make Permanent the American Opportunity Tax Credit

The economic stimulus act (“American Recovery and Reinvestment Act of 2009”) established for two years the “American Opportunity” tax credit (AOTC) as a replacement for the Hope credit. The president proposes to make the credit permanent and index for inflation both the maximum expenditures eligible for the credit and the income thresholds above which the credit phases out. The AOTC is a partially refundable tax credit equal to 100 percent of the first \$2,000 plus 25 percent of the next \$2,000 spent on tuition, fees, and course materials during each of the first four years of postsecondary education (double the two years allowed for the Hope credit) for students attending school at least half time. The maximum credit would thus be \$2,500 a year. As was the case for the Hope credit, taxpayers could not claim the credit for any expenses paid using funds from other tax-preferred vehicles such as 529 plans and Coverdell Savings Accounts, nor could they use more than one of the AOTC, the lifetime learning credit, and the deduction for tuition expenses for a student in a given year.

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

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

The larger, refundable credit would extend educational assistance to low-income students, making it easier for them to afford college and thus encouraging attendance, but the credit’s phaseout would boost marginal tax rates for affected taxpayers. Because most students would qualify for the credit, colleges might react by raising tuition, thus reducing the credit’s value for students. Indexing both the credit and the phaseout ranges would maintain the real value of the credit over time. However, because the cost of higher education has risen much faster than the overall inflation rate, the credit would still likely cover a smaller share of education costs in future years.

Additional Resources

Stimulus Act Report Card: “American Opportunity” Tax Credit

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

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

Eliminate the Advance Earned Income Tax Credit

Low-income workers with children may choose to receive the Earned Income Tax Credit (EITC) throughout the year as Advance Earned Income Tax Credit (AEITC). The AEITC comes as a regular addition to take-home pay through reduced withholding or, for those with too little withholding, added pay. In 2009, the maximum AEITC a family may get is \$1,826. Few eligible workers opt to receive the AEITC: less than 2 percent of workers who claim the EITC on their tax returns get advance payments. Surveys indicate that most eligible workers prefer to get large refunds when they file their tax returns or worry about having to repay excess advance payments.

The president proposes to eliminate the AEITC starting in 2010 on the argument that few people use it and the program has high error rates. OMB Director Peter Orszag asserted, “This budget proposes eliminating it, not because we don’t support work incentives for low- and moderate-income workers, but rather because that program simply does not work well.” (February 26, 2009, press briefing http://www.whitehouse.gov/the_press_office/Press-Briefing-by-OMB-Director-Peter-Orszag-and-CEA-Chair-Christina-Romer/)

Additional Resources

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

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

Tax Increases on High-Income Taxpayers

Under current law, the 2001 and 2003 tax cuts nearly all expire in 2011, returning the individual income tax to its pre-2001 level (except for a few permanent changes). In defining the baseline for his budget, the president assumes that, rather than ending in 2011, the tax cuts will become permanent. From that baseline, he would increase taxes in 2011 for high-income taxpayers—couples with income over \$250,000 and single people with income above \$200,000. Specifically, he would raise the top two tax rates back to their pre-2001 levels, change the income threshold for the next-to-highest rate, reinstate the personal exemption phaseout and the limitation on itemized deductions, and impose a 20 percent tax rate on long-term capital gains and qualified dividends.

Those tax increases would essentially leave income tax rates for high-income taxpayers at the levels scheduled after 2010 under current law. People with qualified dividend income would pay less tax because the proposed 20 percent rate would be lower than their regular tax rate, the rate that would apply to dividend income if Congress let the 2001-2003 tax cuts expire. Others would pay more tax because the 20 percent rate on capital gains exceeds the 18 percent rate that would apply to gains on assets held more than five years and because the phaseout of personal exemptions would begin at a lower income than under current law.

Relative to current law, under which the 2001-2003 tax cuts would virtually all expire after 2010, these proposals would increase income taxes for about 5 percent of all taxpayers with most of the increase toward the upper end of the income distribution. About one-sixth of those in the top quintile and one-fourth of those in the top 1 percent would experience a tax increase.

Distribution tables

Tax increases on high-income taxpayers

[2012 versus current law by cash income](#)

[2012 versus current law by cash income percentile](#)

[2012 versus Administration baseline by cash income](#)

[2012 versus Administration baseline by cash income percentile](#)

- **Reinstate 39.6 percent rate in 2011**

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

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

The president proposes to return to the 22 percent tax rate to its pre-2001 level of 36 percent and change the lower bound for taxable income subject to that rate. For married couples filing jointly, the 36 percent bracket would begin when taxable income exceeds \$250,000 minus the sum of the standard deduction for couples plus twice the personal exemption.¹ For single filers, the threshold

¹ The Treasury Department description of this proposal does not say at what income the 36 percent bracket would begin for married couples filing separately. In keeping with other provisions in the individual income tax, however, that threshold would be half of the threshold for married couples filing jointly.

would start at \$200,000 minus the sum of the standard deduction for single filers plus the personal exemption.²

Increasing the threshold would reduce the current 33 percent tax rate on income between the old and the new thresholds to 28 percent, reducing the tax liability of people with taxable income in that range. That tax reduction would also offset some or all of the tax increase for people with taxable income above the new thresholds. For example, the Tax Policy Center projects that the 2011 threshold for the next to the highest tax bracket for married couples filing jointly will be \$210,400 under the budget's extend baseline but would increase to \$232,950 under the president's proposal (see the tax rate table). People with taxable income between the two thresholds would see their tax rate on that income fall from 33 percent to 28 percent under the proposal, reducing their regular tax liability by up to \$1,128. Everyone with taxable income at or above the new threshold who does not pay the alternative minimum tax (AMT) would get the maximum tax cut on income in that range.³ Those with taxable income above the new threshold would incur a tax increase above the threshold because the top two tax rates would increase. The tax savings from the wider 28 percent bracket would fully compensate for the rate increases for couples with taxable income up to \$270,533 and single filers with income up to \$224,000, giving those taxpayers a net tax cut.⁴ People with income above those levels would see their tax liability rise.

² A similar calculation would presumably apply in setting the tax bracket's threshold for heads of household – that is, the threshold would equal \$200,000 minus the standard deduction for heads of household and one personal exemption. The Treasury Department's description of the proposal says only that the threshold applies "for single filers". Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals*, May 2009, p. 74. See further discussion below.

³ Taxpayers who owe AMT would not get a tax cut under the proposal since their tax liability is determined by the AMT, not their regular tax liability. A significant number of taxpayers with income in the affect ranges, particularly married couples, are on the AMT.

⁴ The widening of the 28 percent bracket would cut the tax rate for married couples filing jointly from 33 percent to 28 percent on up to \$22,550 of taxable income, yielding a maximum tax saving of \$1,127.50. The increase in the tax rate on additional income from the 33 percent to 36 percent would raise tax liability by an equivalent amount when income equals \$270,533. (The increase is 3 percent of taxable income over \$232,950) = .03 times \$377,583 = \$1,127.50.)

2011 Tax Rates under Extended Baseline and as Proposed in 2010 Budget

Taxable Income		Marginal Tax Rate	
Over	But not over	Extended Baseline	Budget Proposal
Single			
\$0	\$8,425	10%	10%
\$8,425	\$34,200	15%	15%
\$34,200	\$82,850	25%	25%
\$82,850	\$172,800	28%	28%
\$172,800	\$192,000	33%	28%
\$192,000	\$375,700	33%	36%
\$375,700	---	35%	39.6%
Married Filing Jointly			
\$0	\$16,850	10%	10%
\$16,850	\$68,400	15%	15%
\$68,400	\$138,050	25%	25%
\$138,050	\$210,400	28%	28%
\$210,400	\$232,950	33%	28%
\$232,950	\$375,700	33%	36%
\$375,700	---	35%	39.6%
Head of Household			
\$0	\$12,000	10%	10%
\$12,000	\$45,800	15%	15%
\$45,800	\$118,300	25%	25%
\$118,300	\$189,350	28%	28%
\$189,350	\$191,600	28%	36%
\$191,600	\$375,700	33%	36%
\$375,700	---	35%	39.6%
		Tax rate would decrease	
		Tax rate would increase	

That situation would reverse for heads of household, for whom the threshold for the new 36 percent tax bracket would fall rather than rise (assuming the threshold is set in a manner similar to that for singles and married couples filing jointly).⁵ Heads of household with taxable income between \$181,350 and \$191,600 would see the tax rate on income in that range rise from 28 percent

⁵ TPC assumes that the 2009 threshold for the proposed 36 percent tax bracket would equal \$200,000 minus the standard deduction for heads of household minus one personal exemption. The 2011 threshold would be that threshold indexed for inflation between 2009 and 2011.

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

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

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

In its full form, the personal exemption phaseout (PEP) reduces the value of each personal exemption from its full value (\$3,650 in 2009 and indexed for inflation) by 2 percent for each \$2,500 or part thereof above specified income thresholds that depend on filing status. Personal exemptions are thus fully phased out over a \$122,500 range (see phaseout table).

Filing Status	AGI Begin Phaseout	AGI Maximum Phaseout
Married, filing joint or surviving spouse	\$250,200	\$372,700
Heads of household	\$208,500	\$331,000
Single	\$166,800	\$289,300
Married, filing separate	\$125,100	\$186,350

In 2009, the reduction is limited to one-third of its full value so the minimum value of personal exemptions is two-thirds of \$3,650, or \$2,433.

The limitation on itemized deductions—known as Pease after the congressman who introduced it—cuts itemized deductions by 3 percent of adjusted gross income above specified thresholds but not by more than 80 percent. The income threshold—\$166,800 in 2009 (\$83,400 for married couples filing separately)—is indexed for inflation. As is the case for PEP, the 2009 reduction is limited to one-third of its full amount so taxpayers cannot lose more than 26.7 percent of their itemized deductions -1/3 of 80 percent.

The president proposes to restore both PEP and Pease in full in 2011. The threshold for the phaseouts would begin at 2009 levels of \$250,000 for couples⁶ and \$200,000 for other taxpayers, with both values indexed for inflation. TPC estimates that 2011 thresholds would be \$254,850 and \$203,850 for couples and others, respectively. Personal exemptions would thus phase out for couples with income between \$254,850 and \$377,350 and for others with income between \$203,850 and \$326,350.⁷ Taxpayers would have their itemized deductions reduced in 2011 by 3 percent of their income over \$203,850 (for single filers; the threshold would be \$254,850 for cou-

⁶ PEP would start at \$125,000 for couples filing separately.

⁷ The values for married couples filing separately would be half those for joint filers.

ples filing jointly⁸) but not by more than 80 percent. Both phaseouts would increase marginal tax rates for taxpayers in the affected income ranges.

Additional Resources

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

• Impose 20 percent rate on capital gains and dividends

Under current law, long-term capital gains (on assets held at least a year) and qualified dividends face a maximum tax rate of 15 percent. Taxpayers with regular tax rates of 15 percent or less pay no tax on that income. Tax rates on both long-term gains and dividends are scheduled to revert to their pre-2003 levels in 2011: 20 percent on gains (10 percent for taxpayers in the 15 percent bracket and below)⁹ and regular tax rates on dividends. The president would make permanent the current maximum 15 percent rate on both kinds of income but would raise the rate to 20 percent for high-income taxpayers starting in 2011. The proposal would define high-income taxpayers as those in the top two tax brackets – couples with 2011 taxable income above \$232,950 and single people with income over \$192,000, with both values indexed for inflation.

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

Additional Resources

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

Limit the value of itemized deductions to 28 percent

Taxpayers may reduce their taxable income by subtracting either the appropriate standard deduction or their itemized deductions for medical expenditures, state and local taxes, mortgage interest, charitable contributions, and other allowed expenses. Because deductions reduce taxable income, their effect on tax liability depends on the taxpayer's tax bracket. For example, itemized deductions totaling \$10,000 reduce taxes for a person in the 15 percent bracket by \$1,500 (15 percent of \$10,000) but cut taxes by \$3,500 for a person in the 35 percent bracket (35 percent of \$10,000).

⁸ The proposal does not say what the Pease thresholds would be for heads of household or for married couples filing separately. The current threshold for heads of household is the average of the thresholds for singles and married couples filing jointly; that for married couples filing separately is half that for couples filing jointly. If the same relationships applied to the 2010 budget proposals, the 2011 thresholds for heads of household and married filing separately would be \$229,350 and \$127,425, respectively.

⁹ Lower rates would apply to assets held for more than five years. The budget proposal would repeal that lower rate on long-held assets.

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

The president proposes limiting the value of deductions to no more than 28 percent starting in 2011. That limit would increase taxes for taxpayers whose tax rate exceeds 28 percent—those in the current 33 percent and 35 percent tax brackets. The president wants to use the revenue raised by this change to help pay for healthcare reform.

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

The tax treatment of itemized deductions reduces the after-tax cost of allowed expenditures. For example, a taxpayer in the 35 percent bracket who donates to a charity effectively pays only 65 cents for each dollar she gives because giving a dollar reduces her tax bill by 35 cents (35 percent of the deductible one-dollar donation). That lower after-tax price of giving provides the taxpayer with an incentive to give more to charitable causes than she would in the absence of the deduction and consequent tax savings. The same outcome obtains for other itemizable spending; for example, people may buy more or better housing because the deductibility of mortgage interest and property taxes reduces their after-tax costs. Limiting the value of deductions to 28 percent would increase the after-tax cost of charitable giving and other itemizable expenses for high-income taxpayers and would therefore reduce the amount of those activities.

The President's Advisory Panel on Federal Tax Reform proposed replacing itemized deductions with a 15 percent credit on most itemizable expenditures. That change would give all taxpayers the same tax savings for a given deductible expenditure, severing the connection between tax rates and the value of deductions. It would recognize the public value attached to particular expenditures but remove those expenditures from the determination of ability-to-pay.

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

Distribution tables

Limit the value of itemized deductions to 28 percent

[2012 versus current law by cash income](#)

[2012 versus current law by cash income percentiles](#)

[2012 versus Administration baseline by cash income](#)

[2012 versus Administration baseline by cash income percentiles](#)

Additional Resources

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

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

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

Eliminate Capital Gains Taxes on Investments in Small Business Stock

Under current law, 75 percent of capital gain on qualifying small business stock issued in 2009 (after February 17, 2009) and in 2010 is excluded from tax if the stock is held for at least five years. The other 25 percent of gain is taxed at a maximum rate of 28 percent. The stimulus bill (the American Recovery and Reinvestment Act of 2009) temporarily raised the exclusion from 50 percent. After 2010, the exclusion is scheduled to return to 50 percent, and 60 percent for businesses in empowerment zones. The maximum gain eligible for the exclusion is limited to the greater of \$10 million (\$5 million for married taxpayers filing separately) less any gain reported on prior tax returns, or 10 times the taxpayer's cost basis (purchase price plus fees). Seven percent of the excluded gain is an AMT preference item (added to the AMT measure of income and subject to the alternative tax). The AMT preference is scheduled to increase after 2010 to 28 percent of the excluded gain on stock acquired in 2001 and to 42 percent on stock acquired on or before December 31, 2000.

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

The result of all these complicated rules is that new stock issued by certain small businesses is generally taxed at one-quarter of the taxpayer's marginal rate (up to a maximum of 28 percent) as long as it is held for at least five years. Thus, the maximum rate for qualifying small business stock is 7 percent. After 2010, the exclusion returns to 50 percent, and the effective capital gains tax rate on qualifying small business stock will double to 14 percent (11.2 percent in empowerment zones).

The president proposes to fully exempt capital gains on qualifying small business stock – thus reducing the effective tax rate to zero – and allow the full exclusion on the AMT. The proposal would encourage more investment in some small businesses that qualify, but based on past experience its effect would be limited. It also might divert some capital from more productive investments in firms that do not qualify for the benefit. The current 50 percent capital gains exclusion reduces revenues by only about \$500 million per year, indicating that few taxpayers take advantage of the current exclusion. The proposal would be effective for qualified small business stock issued after February 17, 2009.

Additional Resources

Tax Policy Briefing Book: Capital Gains: How are they taxed?

<http://www.taxpolicycenter.org/briefing-book/key-elements/capital-gains/how-taxed.cfm>

Dan Halperin, “The Complexity of Capital Gains Taxation,” *TaxVox*, February 24, 2009

http://taxvox.taxpolicycenter.org/blog/_archives/2009/2/24/4103366.html

Make research and experimentation tax credit permanent

Since its enactment as a temporary provision in 1981, the research and experimentation (R&E) tax credit has been extended, with modifications, thirteen times. The president would make the R&E tax credit permanent.

The R&E credit is an incremental credit. Businesses may claim a nonrefundable credit equal to 20 percent of qualified expenditures in excess of a base amount. The base is generally determined by multiplying a company's average annual gross receipts in the previous four years by its ratio of research expenses to gross receipts during the 1984 to 1988 period. (Companies that did not exist during the base period must use a fixed ratio of 3 percent.) The base cannot be less than 50 percent of qualified research expenses for the taxable year. Firms may elect to use an alternative simplified method that sets the credit at 12 percent (14 percent for 2009) of the increase of current year qualified research expenses over 50 percent of the average of the same expenses for the previous three years. If the business does not have qualified expenses in any one of the three preceding years, then the alternative credit is determined by taking 6 percent of the current year's qualified expenses.

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

Additional Resources

Congressional Research Service Report on Research and Experimentation Tax Credit (CRS Report RL31181)

<http://www.ncseonline.org/NLE/CRSreports/08Aug/RL31181.pdf>

Expand net operating loss carryback

Businesses calculate taxable income by subtracting expenses from revenues. Although net income is taxed immediately, net operating losses (NOLs) do not qualify for immediate refunds on current tax returns. Businesses, however, may “carry back” losses to offset profits from the previous two years and may carry forward losses for twenty years and deduct them against future profits. Firms do not receive interest on their loss carryovers, however, so their present value is less than if firms could claim them immediately).

The economic stimulus act (“American Recovery and Reinvestment Act of 2009”) increased the NOL carry-back period to five years for NOLs incurred in 2008. The extension applied, however, only to small businesses—those with gross receipts of \$15 million or less.

The Administration plans to work with the Congress to make a lengthened NOL carryback period available to more taxpayers. Both the Senate and House stimulus bills would have extended the increased carryback period to more firms. The Senate would have allowed all businesses to use the five-year period, except for Fannie Mae, Freddie Mac and firms that received money from the Troubled Assets Relief Program. The House bill covered the same firms as the Senate bill, but also required that businesses using the extended carryback period permanently reduce their NOLs by 10 percent. The administration’s revenue estimate suggests that the proposal would match the Senate’s stimulus provision. If measured over the ten year budget period, 2010-2019, the proposal would raise an estimated \$9.3 million over 10 years. This is because the revenue losses occur in 2009 and 2010 when losses are claimed. The resulting reduction in the stock of losses that firms could deduct from future profits yield revenue gains in later years. Measured over the years 2009 through 2019, the proposal costs \$19 billion in foregone revenues.

Increasing the carry-back period is arguably good tax policy. By not providing full refunds for losses, current law discriminates against risky investments relative to safe ones and places taxable corporations at a disadvantage compared with businesses taxed as flow through enterprises, whose owners can deduct business losses against other income. In addition, corporations with current losses, unlike profitable corporations and non-corporate businesses, cannot make full use of investment incentives, such as the recently enacted bonus depreciation proposal. Allowing full and immediate refunds of losses would level the playing field between loss corporations and profitable corporations and between taxable corporations and businesses taxed as flow through enterprises. But some business losses reflect the use of tax preferences and not real economic losses; limiting current deductibility of losses is an indirect way of paring back these tax preferences.

Additional Resources

House Stimulus Act Report Card: Five-year carryback of net operating losses
http://www.taxpolicycenter.org/taxtopics/recoveryreport/net_operating_losses.cfm

Senate Stimulus Act Report Card: Five-year carryback of net operating losses
http://www.taxpolicycenter.org/taxtopics/senate_net_operating_losses.cfm

Reinstate Superfund Taxes

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

The Superfund program receives funding from two annual appropriations: general funds from the Treasury and balances in the Superfund trust fund. In earlier years, revenues for the trust fund came from three dedicated taxes (on petroleum, chemical feedstocks, and corporate income). Those taxes expired in December 1995, however, and the amount of unobligated money in the fund gradually declined to zero by the end of fiscal year 2003. The Superfund trust fund has been funded almost entirely through general revenues ever since.

The president proposes to reinstate Superfund taxes without specifying any details. When they expired at the end of 1995, Superfund taxes included 1) an excise tax of 9.7 cents per barrel on crude oil or refined oil products; 2) excise taxes of \$0.22 to \$4.87 per ton on certain hazardous chemicals; and 3) an excise tax on imported substances that use one or more of the hazardous chemicals subject to excise tax in their production or manufacture. The three Superfund taxes would be reinstated on January 1, 2011. The proposal would also reinstate the superfund environmental income tax of 0.12 percent on the amount of a corporation's modified alternative minimum taxable income that exceeds \$2 million.

Proponents of reinstating the Superfund taxes argue that imposing these taxes is consistent with a “polluters pay” principle: industries and companies that used hazardous substances should bear the cleanup costs. But the taxes are passed forward to consumers in all likelihood. Further, the pollution in question is legacy contamination, so the incidence is unlikely to get at culpability. Proponents also argue that the Superfund taxes may discourage the use of toxins and, ultimately, hazardous waste. However, the taxes may distort economic behavior without giving businesses an incentive to handle hazardous wastes more carefully or avoid producing them. Taxes placed directly on waste (“waste end” taxes) would be more efficient. The corporate income tax component of the Superfund taxes is extremely complex. Firms had to compute a corporate AMT liability even if they did not pay the tax.

Additional Resources

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

Tax Carried Interest as Ordinary Income

The president proposes to tax the income from so called carried interest as ordinary income rather than as capital gains as under current law. Ordinary income is subject to marginal rates up to 35% (39.6% in 2011) while income from capital gains is taxed at a maximum rate of 15% (20% in 2011).

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

Opponents of the provision argue the manager as a partner is entitled to capital gain treatment under general rules for taxing partnerships in which the characteristics of a firm's income (either ordinary income or capital gains) flow through to partners. The difference, however, is that the manager has not purchased his partnership share, but has instead received this interest as a form of tax-free compensation for services. The carried interest represents therefore a form of deferred compensation instead of a share in the partnership's capital gain.

The treatment most consistent with similar transactions would tax the estimated value of the partnership interest when received as ordinary income and subsequent profits as capital gains, thereby treating the manager the same as others who are compensated with shares or other investment interests. However, the IRS has been reluctant to tax a “pure profits” interest (that is the partner has no interest in existing partnership assets at the time the interest is acquired) because of the difficulty of valuing the interest.

Under the president’s proposal, a partner’s share of income from a “services partnership interest” (SPI) would be taxed as ordinary income, regardless of the character of the income at the partnership level. Partners would be required to pay self-employment taxes on income from an SPI. If a partner sells an SPI, the gain would be taxed as ordinary income, not as a capital gain.

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

Additional Resources

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

<http://www.taxpolicycenter.org/briefing-book/key-elements/business/carried-interest.cfm>

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

<http://www.taxpolicycenter.org/briefing-book/key-elements/business/carried-interest-reform.cfm>

Discussion of alternative approaches:

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

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=892440

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

Codify “Economic Substance” Doctrine

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

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

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

Repeal LIFO

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

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

The Obama budget would repeal the election to use LIFO for income tax purposes. Taxpayers that currently use the LIFO method would be required to write up – that is, revalue – their beginning LIFO inventory to its FIFO value in the first taxable year beginning after December 31, 2011. This one time increase in gross income would be taken into account ratably over the first taxable year and the following seven taxable years.

Under LIFO, as long as sales during a year do not exceed purchases, all sales are matched against purchases in the same year and the opening inventory is never considered to have been sold. Therefore, a company that has used LIFO for many years will have a stock of inventory on its tax returns with a much lower value than its current acquisition price. Repealing LIFO and making companies pay tax on the accrued difference between the LIFO and FIFO valuations of its inventory would impose a substantial one time tax and a smaller permanent annual tax as long as prices are increasing. Ways and Means Committee Chairman Rangel has proposed in H.R. 3970 to allow firms to spread the income from the initial adjustment from LIFO to FIFO over 8 years.

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

Additional Resources

Discussions of LIFO repeal:

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

Alan D. Viard, "Why LIFO repeal is Not the Way to Go" *Tax Notes*, Vol. 113, November 6, 2006.

http://www.aei.org/publications/filter.all,pubID.25111/pub_detail.asp

Reform U.S. International Tax System

The president proposes to tighten enforcement of tax laws to limit offshore tax evasion and change the way U.S. businesses are taxed on foreign income.

During his campaign, the president promised to make it more difficult for individuals to use foreign tax havens to evade U.S. taxes. The president's budget proposal would make good on this promise by detailing a collection of measures designed to combat tax evasion by Americans and foreigners who use offshore accounts to shelter income from U.S. taxation. The provisions, which would raise \$8.7 billion from 2010 to 2019, would require more information reporting, increase tax withholding, and strengthen penalties to support U.S. taxation of income earned or held in offshore accounts or entities.

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

Not all classes of foreign source income earned by foreign subsidiaries enjoy deferral. Under current tax law, certain "passive" income such as income earned from investments in foreign assets, foreign base company sales and services income, and income from the insurance of U.S. risk is taxed upon accrual. In addition, the parent company pays U.S. tax immediately on dividends, interest, or royalties paid by one subsidiary to another. That last rule does not apply, however, to payments within a corporation—for example, from a local branch to the home office.

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

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

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

To understand how cross-crediting works, consider a company with both of the subsidiaries described above. Cross-crediting allows the parent corporation to offset the \$10 net U.S. tax liability on the first subsidiary (in the low-tax country) against the \$10 of excess credits of the second subsidiary (in the high-tax country). In this case, simultaneously repatriating income from subsidiaries in

both high- and low-tax countries results in no net U.S. tax liability on the \$200 of foreign-source income.

The president proposes a package of revenue raising reforms of the international tax system that would affect both the deferral and foreign tax credit features of current law. The bulk of the revenue raised from these provisions would come from changes related to the deduction of expenses against deferred foreign income (\$87 billion), the calculation of the foreign tax credit (\$43 billion), and the classification of foreign entities (\$60 billion). All three provisions would take effect in 2011.

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

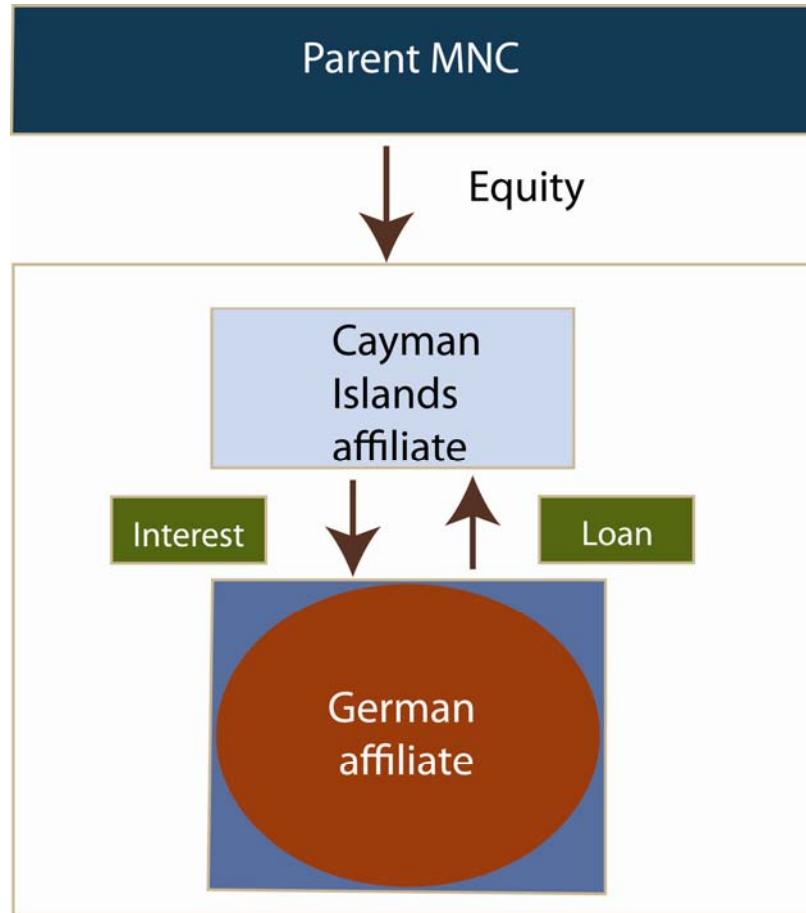
Changes related to foreign tax credits. The president proposes to limit cross-crediting by requiring firms to consider the foreign tax they pay on all of their foreign earnings and profits in determining their foreign tax credits. Under current law, the foreign tax credit is based on earnings and profits on which U.S. tax has been paid. Companies would receive no foreign tax credits for foreign taxes paid on deferred income until they repatriate that income. The provision would limit firms' ability to blend their repatriations to minimize or avoid U.S. taxes on foreign source income. This proposal would also increase the cost of deferral.

The budget also includes a provision aimed at curbing methods companies use to inappropriately separate creditable foreign taxes from the associated foreign income. Details are lacking but the proposal presumably would target arrangements in which foreign tax credits are claimed by U.S. companies on income not subject to a U.S tax.

Changes related to foreign entity classification. The president would override Treasury's "check-the-box rules" issued in 1996 to reduce the paperwork required to classify business entities for tax purposes. The rules allow corporations to identify an entity as a separate corporation or to "disregard" it as the unincorporated branch of another corporation by simply checking a box on a tax form. While the regulations were targeted at domestic business, they also allowed companies to easily create "hybrid" entities that are considered a corporation by one country but an unincorporated branch by another.

Check-the-box allows U.S. multinationals to lower their taxes in high-tax countries by shifting income from affiliates in those countries to affiliates in tax havens. Consider a parent company that plans to invest in a high-tax jurisdiction like Germany. Check-the-box lets the firm cut its tax bill by routing capital used to finance the investment through an affiliate in a tax haven like the Cayman Islands.

The diagram shows how this strategy would work.



The parent company first sends investment funds to a wholly-owned Cayman Islands affiliate, which lends the money to a second wholly-owned affiliate in Germany. The German firm uses the loan for an investment project and pays interest to the Cayman affiliate. The parent “checks the box” on the German affiliate, making it an unincorporated branch of the Cayman subsidiary for U.S. tax purposes. But the Germany government considers it to be a separate corporation. As a result, the interest payment from the German firm to the Cayman subsidiary is not taxed anywhere. The payment is deductible in Germany. The interest is not taxed in the U.S. because with check-the-box, the U.S. Treasury regards the combined German/Cayman operation as a single corporation. The interest is not taxed in the Caymans since it has a zero tax rate.

Under current law, the interest payment will not be taxed until it is paid back to the U.S. parent. The president’s proposal would impose current U.S. tax on the interest payment by making sure the hybrid entity remains visible for U.S. tax purposes. As a result, using the tax haven affiliate to finance the German investment would no longer be advantageous from a tax perspective. Interestingly, terminating check-the-box could result in more investment in low-tax foreign locations relative to high-tax locations abroad as investment in high-tax foreign locations becomes more costly from a tax perspective.

The White House press release on May 4, 2009 announcing the new international tax proposals promised that they would “replace tax advantages of creating jobs overseas with incentives to create them at home.” The proposals have the effect of limiting the benefits of deferral, but cutting back on deferral will not create more jobs in the United States. The number of jobs in the United

States has little to do with tax provisions that affect selected investments or industries. Instead, employment is influenced by fiscal and monetary policies—as well as periodic shocks to the system such as financial market meltdowns—that determine whether American and foreign consumers and investors are willing to purchase enough American-made goods, services, and assets to keep U.S. workers fully employed. Taxes can indirectly affect employment to the extent they affect overall wage levels, but the effect is likely quite small because labor supply is not very sensitive to wages. Specific tax incentives do affect where Americans work and what they produce and also affect overall living standards by influencing how efficiently we use our scarce people and capital and how much we invest for the future. Specific tax incentives have little impact on total employment.

Additional Resources

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

<http://www.taxpolicycenter.org/briefing-book/key-elements/international/international-work.cfm>

Eric Toder, “Will Paring Deferral Create Jobs?” *TaxVox*, May 5, 2009

http://taxvox.taxpolicycenter.org/blog/_archives/2009/5/5/4175662.html

Rosanne Altshuler, “The Case of the Disappearing Subsidiary,” *TaxVox*, May 7, 2009

http://taxvox.taxpolicycenter.org/blog/_archives/2009/5/7/4178158.html

Continue remaining expiring provisions through CY 2010

The revenue code includes more than 80 “temporary” tax incentives, many of which have been extended one year at a time for a decade or more. The most significant in terms of revenue provides temporary relief from the Alternative Minimum Tax ([a provision discussed elsewhere in this review](#)). Most others are highly targeted subsidies that benefit business. The most significant of these in terms of revenue is the research and experimentation credit (also known as the research and development credit). Others encourage a broad range of investment from alternative energy to low-income housing.

The Administration baseline includes permanent extension of AMT relief. The 2009 AMT parameters—exemptions, rate brackets, and phaseout thresholds—are made permanent and indexed for inflation at a ten year cost of \$575 billion. The president proposes making the research credit permanent at a cost of \$74 billion over 10 years and extending other expiring provisions for an additional year through 2010 with a one-year cost of more than \$10 billion.

Observers disagree over whether annually extending these tax benefits is good policy or whether it would be better to treat them as permanent provisions of the tax code. Proponents argue that temporary tax cuts allow for regular congressional review while critics say this review process has become a sham.

Additional Resources

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

<http://www.taxpolicycenter.org/briefing-book/background/taxes-budget/extenders.cfm>

Joint Committee on Taxation Revenue Estimate of Extenders <http://www.house.gov/jct/x-78-08.pdf>

Tax Extenders and Fiscal Responsibility (a discussion of pros and cons of extenders)

http://taxvox.taxpolicycenter.org/blog/_archives/2008/5/29/3718936.html

Climate Revenues

In his campaign, President Obama promised broad changes in fiscal policy aimed at reducing greenhouse gasses. His proposal was built on several revenue elements. A package of new tax subsidies would encourage and support production and consumption of alternative energy. A “cap and trade” program would require energy producers to buy permits granting them the right to emit a fixed level of CO₂ and other pollutants linked to global warming. While “cap and trade” is not explicitly a tax, it operates much like one. The government would auction permits and producers would have to buy permits to cover their emissions, either from the government or from permit owners. Firms could pass the costs on to consumers.

The newly-enacted stimulus bill included many of the [alternative energy tax subsidies](#) Obama proposed in the campaign. The 2010 budget would reduce incentives for domestic production of fossil fuels by eliminating about \$30 billion of tax benefits for the production of oil and gas over the next 10 years and imposing an excise tax that effectively increases royalties on oil and gas extraction from the Gulf of Mexico.

At the same time, the budget assumes “climate revenues” of about \$80 billion a year beginning in 2012. The president proposes to implement a cap-and-trade system through a 100 percent auction. Limits on the use of carbon-based fuels would raise prices of electricity generated from fossil fuels, gasoline, home heating oil, and other energy-intensive goods (including goods that use energy in transportation). The government would capture the additional revenues by auctioning permits for carbon use. The plan would devote \$15 billion annually from the program’s revenues to subsidize clean energy technologies and would allocate the remaining \$65 billion to low- and moderate-income families by using it to finance permanent extension of the Making Work Pay tax credit.

Additional Resources

Stimulus Act Report Card: Renewable Energy Incentives
http://www.taxpolicycenter.org/taxtopics/conference_renewable_energy.cfm

Tax Topics: Quick Facts on Cap-and-Trade Policies to Reduce Carbon Emissions
http://www.taxpolicycenter.org/taxtopics/quickfacts_cap-and-trade.cfm

Tax Revenue Adjustments to Baseline

Rather than assume a baseline that projects future revenues that would accrue under current tax law, the budget assumes a baseline that permanently indexes the alternative minimum tax (AMT) for inflation, extends the 2001 and 2003 income tax cuts beyond their scheduled sunset in 2011, and permanently extends the estate tax with 2009 parameters. Those assumptions reduce tax revenues by more than \$3.2 trillion over the next decade. Given that baseline, proposals that would reinstate portions of pre-2001 tax law show up as revenue raisers, even though they would occur as a matter of course if Congress did not act to prevent them.

Index 2009 parameters of the AMT to inflation

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

The stimulus bill ("American Recovery and Reinvestment Act of 2009") extended the patch through 2009, setting the exemption level at \$46,700 for single and head of household filers, \$70,950 for married people filing jointly and qualifying widows or widowers, and \$35,475 for married people filing separately. The AMT has two tax rates: 26 percent on the first \$175,000 of income above the exemption and 28 percent on incomes above that amount. The AMT exemption phases out at a 25 percent rate between \$112,500 and \$299,300 for singles and heads of household, between \$150,000 and \$433,800 for married couples filing jointly, and between \$75,000 and \$216,900 for married couples filing separately. The phaseout creates *effective* AMT tax rates of 32.5 percent—125 percent of 26 percent—and 35 percent—125 percent of 28 percent for affected taxpayers.

The president proposes to make permanent the 2009 AMT parameters—exemptions, rate brackets, and phaseout thresholds—and index them for inflation. That would remove a significant source of uncertainty about taxation and prevent inflation from pushing large numbers of taxpayers onto the AMT in future years. Most of the benefits of the change would go to taxpayers with relatively high incomes: about three-fourths of the tax cut in 2012 would go to households with income over \$100,000. Over half of taxpayers with income between \$200,000 and \$500,000 would see their tax bills drop by an average of nearly \$1,700, raising their after-tax income by more than 0.8 percent.

Distribution tables

Index 2009 parameters of the AMT to inflation

[2012 versus current law by cash income](#)

[2012 versus current law by cash income percentiles](#)

Additional Resources

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

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

Continue the 2001 and 2003 tax cuts

The 2001 and 2003 tax acts reduced tax rates on ordinary income, long-term capital gains, and qualified dividends; mitigated marriage penalties; expanded the child tax credit and the child and dependent care tax credit; and phased out limitations on itemized deductions and the phaseout of personal exemptions. All of those changes are scheduled to sunset in 2011, when the individual income tax will revert to its pre-2001 levels. The president includes permanent extension of the tax cuts beyond 2010 as part of his budget baseline. As a result, proposals that would impose pre-2001 tax rates on high-income taxpayers show up as tax increases, even though they would simply impose the same taxes on those taxpayers as would occur under current law.

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

Income Tax Provision		Current Law in 2011	2011 Assuming Extension of 2001 and 2003 Tax Cuts
Tax Rates (2011 income ranges for single filers)	\$0 - \$8,425	15%	10%
	\$8,425 - \$34,200	15%	15%
	\$34,200 - \$82,850	28%	25%
	\$82,850 - \$172,800	31%	28%
	\$172,8000 - \$375,700	36%	33%
	\$375,700 and over	39.6%	35%
Standard deduction and 15% tax bracket for joint filers		167% of single filers	200% of single filers
Child tax credit		\$500	\$1,000
Child and dependent care credit	Max. creditable amount	\$2,400/child, max \$4,800	\$3,000/child, max \$6,000
	Credit rate	20% - 30%	20% - 35%
Phaseout of Personal Exemption		Over \$122,500 range	No phaseout
Limitation of Itemized Deductions		Up to 80%	No limitation
Tax on long-term capital gains	15% bracket or lower	10%	0%
	above 15% bracket	20%	15%
Qualified Dividends	15% bracket or lower	Regular tax rate	0%
	above 15% bracket	Regular tax rate	15%

Distribution tables

Continue the 2001 and 2003 tax cuts

[2012 versus current law by cash income](#)

[2012 versus current law by cash income percentiles](#)

Additional Resources

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

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

Tax Topics: Distribution of the 2001 - 2006 Tax Cuts <http://www.taxpolicycenter.org/taxtopics/cuts0106.cfm>

Make 2009 estate tax permanent

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

The Obama budget assumes permanent extension of the estate tax under 2009 parameters as part of its baseline. Estates with a net value over \$3.5 million or more would face a 45 percent tax rate. For married couples, a modest amount of tax planning would raise the exemption to \$7 million. Making permanent the 2009 estate tax provisions would reduce federal revenues by \$171 billion over the coming decade. However, because the administration proposes to build the extension into the budget baseline, the budget itself shows no revenue cost from this proposed change.

Distribution tables

Make 2009 estate tax permanent

[2012 versus current law by cash income](#)

[2012 versus current law by cash income percentiles](#)

[2012 versus current law plus repeal of estate tax by cash income](#)

[2012 versus current law plus repeal of estate tax by cash income percentiles](#)

Additional Resources

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

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

<http://www.taxpolicycenter.org/briefing-book/key-elements/estate/index.cfm>

Indexing the Budget Tax Proposals

Much of the federal income tax is indexed for inflation to prevent nominal income growth from pushing taxpayers into higher tax brackets and the consequent higher effective tax rates, a phenomenon known as “bracket creep.” Most but not all of the tax proposals in the 2010 budget include indexing provisions and as a result, they will maintain their value over time in real terms.

Some proposals would maintain their real values because they interact with tax parameters that are indexed. Other proposals would fix important parameters in dollar terms and thus lose or gain value over time. Those proposals include:

- Making Work Pay credit: The maximum dollar value of the credit would stay at \$400 (\$800 for married couples filing jointly). By 2017, that value would drop to \$358 in real terms, a drop of 9 percent. The phaseout range would be indexed, however, so it would maintain its real value over time.
- Increase refundability of the child credit: The earnings level at which refundability of the child credit would start to phase in for low-income families would be fixed permanently at \$3,000. Over time, that value would decline in real terms, effectively extending the refundability of the credit to lower income households. By 2017, the threshold would drop to \$2,688 in 2009 dollars.

The lack of complete indexation means that the real effect of the president’s tax proposals would change over time. In 2017, 85 percent of all taxpayers would get tax cuts—relative to current law—down from 87 percent in 2012. Measured against the administration’s preferred baseline, the percentage of taxpayers who would see their taxes go down would fall from 72 percent in 2012 to 70 percent in 2017.