Unit 1A. Introduction – What is tax policy?

Joint Committee on Taxation, Overview of the Federal Tax System, JCX-36-17 selected sections and graphs

Joel Slemrod and Jon Bakija, Taxing Ourselves, Ch. 1-2, pp. 2-11, 15-24

Howard Gleckman, Don’t Confuse Trump’s Tax Cuts with Tax Reform, Tax Policy Center: TaxVox (Nov. 15, 2016)

House Ways and Means Committee, A Better Way for Tax Reform

Executive Office of the President, 2017 Tax Reform for Economic Growth and American Jobs

Questions to Consider:

1. How does our government raise revenue?
2. What is the difference between an incremental tax change (such as a tax cut) and comprehensive tax reform?
3. What do you like about our current tax system? What do you dislike? What would you change and why?
4. Many politicians, including both Republicans and Democrats, claim that they want to make the tax code fairer and simpler. What do you think it means to make the tax code fairer? What do you think it means to make it simpler? (We will revisit these questions in subsequent units.)
OVERVIEW OF THE FEDERAL TAX SYSTEM AND POLICY CONSIDERATIONS RELATED TO TAX REFORM

Scheduled for a Public Hearing
Before the
SENATE COMMITTEE ON FINANCE
on July 18, 2017

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

July 14, 2017
JCX-36-17
I. SUMMARY OF PRESENT LAW FEDERAL TAX SYSTEM

A. Individual Income Tax

In general

A United States citizen or resident alien generally is subject to the U.S. individual income tax on his or her worldwide taxable income.\(^2\) Taxable income equals the taxpayer’s total gross income (after taking into account exclusions) less deductions. Graduated tax rates are then applied to a taxpayer’s taxable income to determine his or her individual income tax liability. A taxpayer may face additional liability if the alternative minimum tax applies. A taxpayer may reduce his or her income tax liability by any applicable tax credits.

Adjusted gross income

Under the Internal Revenue Code of 1986 (the “Code”), gross income means “income from whatever source derived” except for certain items specifically exempt or excluded by statute.\(^3\) Sources of income include compensation for services, interest, dividends, capital gains, rents, royalties, alimony and separate maintenance payments, annuities, income from life insurance and endowment contracts (other than certain death benefits), pensions, gross profits from a trade or business, income in respect of a decedent, and income from S corporations, partnerships,\(^4\) estates or trusts.\(^5\) Statutory exclusions from gross income include death benefits payable under a life insurance contract, interest on certain State and local bonds, the receipt of property by gift or inheritance, as well as employer-provided health insurance, pension contributions, and certain other benefits.

An individual’s adjusted gross income (“AGI”) is determined by subtracting certain “above-the-line” deductions from gross income. These deductions include trade or business

---

\(^2\) Foreign tax credits generally are available against U.S. income tax imposed on foreign source income to the extent of foreign income taxes paid on that income. A nonresident alien generally is subject to the U.S. individual income tax only on income with a sufficient nexus to the United States. A U.S. citizen or resident who satisfies certain requirements for presence in a foreign country also is allowed a limited exclusion ($102,100 in 2017) for foreign earned income and a limited exclusion of employer-provided housing costs. Sec. 911.

\(^3\) Sec. 61.

\(^4\) In general, partnerships and S corporations (i.e., corporations subject to the provisions of subchapter S of the Code) are treated as pass-through entities for Federal income tax purposes. Thus, no Federal income tax is imposed at the entity level. Rather, income of such entities is passed through and taxed to the owners at the individual level. A business entity organized as a limited liability company (“LLC”) under applicable State law generally is treated as a partnership for Federal income tax purposes if it has two or more members; a single-member LLC generally is disregarded as an entity separate from its owner for Federal income tax purposes.

\(^5\) In general, the accumulated income of estates and trusts is taxed to the entity and the distributed income is taxed to the beneficiaries. A graduated tax rate schedule applies to the taxable income of estates and trusts and the alternative minimum tax may apply. Certain trusts are treated for income tax purposes as if the trust property is owned by grantor; in such cases, the grantor is taxed on the income of the trust.
expenses, capital losses, contributions to a qualified retirement plan by a self-employed individual, contributions to certain individual retirement accounts ("IRAs"), certain moving expenses, certain education-related expenses, and alimony payments.  

**Taxable income**

To determine taxable income, an individual reduces AGI by any personal exemption deductions and either the applicable standard deduction or his or her itemized deductions. Personal exemptions generally are allowed for the taxpayer, his or her spouse, and any dependents. For tax year 2017, the amount deductible for each personal exemption is $4,050. This amount is indexed annually for inflation. Additionally, the personal exemption phaseout reduces a taxpayer’s personal exemptions by two percent for each $2,500 ($1,250 for married filing separately), or fraction thereof, by which the taxpayer’s AGI exceeds $261,500 (single), $287,650 (head-of-household), $313,800 (married filing jointly and surviving spouses) and $156,900 (married filing separately). These threshold amounts are indexed for inflation.

A taxpayer also may reduce AGI by the amount of the applicable standard deduction. The basic standard deduction varies depending on a taxpayer’s filing status. For 2017, the amount of the standard deduction is $6,350 for single individuals and married individuals filing separately, $9,350 for heads of households, and $12,700 for married individuals filing jointly and surviving spouses. An additional standard deduction is allowed with respect to any individual who is elderly (i.e., above age 64) or blind. The amounts of the basic standard deduction and the additional standard deductions are indexed annually for inflation.

The combination of personal exemptions and the standard deduction means that taxpayers may have the first several thousand dollars of income untaxed by the income tax. For example, a single person earning under the personal exemption phaseout amount would have the first $10,400 of income would not be included in taxable income. This amount would be $20,800 for a married couple filing jointly and $28,900 if that married couple had two dependent children.

---

6 Sec. 62.

7 Sec. 63.

8 A taxpayer thus has all personal exemptions completely phased out at incomes of $384,000 (single), $410,150 (head-of-household), $436,300 (married filing jointly) and $218,150 (married filing separately).

9 For 2017, the additional amount is $1,250 for married taxpayers (for each spouse meeting the applicable criterion) and surviving spouses. The additional amount for single individuals and heads of households is $1,550. If an individual is both elderly and blind, the individual is entitled to two additional standard deductions, for a total additional amount (for 2017) of $2,500 or $3,100, as applicable.
Table 1.—2017 Standard Deduction and Personal Exemption Values

<table>
<thead>
<tr>
<th>Standard Deduction</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Married Filing Jointly</td>
<td>$12,700</td>
</tr>
<tr>
<td>Head of Household</td>
<td>$9,350</td>
</tr>
<tr>
<td>Single and Married Filing Separately</td>
<td>$6,350</td>
</tr>
<tr>
<td>Personal Exemptions</td>
<td>$4,050</td>
</tr>
</tbody>
</table>

In lieu of taking the applicable standard deductions, an individual may elect to itemize deductions. The deductions that may be itemized include State and local income taxes, real property and certain personal property taxes, home mortgage interest, charitable contributions, certain investment interest, medical expenses (in excess of 10 percent of AGI, or 7.5 percent in the case of taxpayers above age 64), casualty and theft losses (in excess of 10 percent of AGI and in excess of $100 per loss), and certain miscellaneous expenses (in excess of two percent of AGI). Additionally, the total amount of itemized deductions allowed is reduced by $0.03 for each dollar of AGI in excess of $261,500 (single), $287,650 (head-of-household), $313,800 (married filing jointly and surviving spouses) and $156,900 (married filing separately). These threshold amounts are indexed for inflation.

The Joint Committee staff estimates that for the 2017 tax year approximately 104.8 million taxpayers will claim the standard deduction while 48.7 million taxpayers will elect to itemize deductions.

**Tax liability**

**In general**

A taxpayer’s net income tax is the income tax reduced by the credits allowed against the tax. A taxpayer’s income tax is the greater of (1) the regular income tax or (2) the tentative minimum tax. The amount of income subject to tax and credits allowed are determined differently for purposes of the regular tax and the tentative minimum tax, and separate rate schedules apply. Lower rates apply for long-term capital gains and certain dividends; those rates apply for both the regular tax and the alternative minimum tax.

---

10 Sec. 67.

11 Sec. 68. This rule is sometimes referred to as the “Pease limitation.” A taxpayer may not lose more than 80 percent of his or her deductions as a result of this provision.
Regular tax liability

To determine regular tax liability, a taxpayer generally must apply the tax rate schedules (or the tax tables) to his or her regular taxable income. The rate schedules are broken into several ranges of income, known as income brackets, with the marginal tax rate increasing as a taxpayer’s income increases. Separate rate schedules apply based on an individual’s filing status. For 2017, the regular individual income tax rate schedules are as follows:

Table 2.—Federal Individual Income Tax Rates for 2017

<table>
<thead>
<tr>
<th>If taxable income is:</th>
<th>Then income tax equals:</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Single Individuals</strong></td>
<td></td>
</tr>
<tr>
<td>Not over $9,325</td>
<td>10% of the taxable income</td>
</tr>
<tr>
<td>Over $9,325 but not over $37,950</td>
<td>$932.50 plus 15% of the excess over $9,325</td>
</tr>
<tr>
<td>Over $37,950 but not over $91,900</td>
<td>$5,226.25 plus 25% of the excess over $37,950</td>
</tr>
<tr>
<td>Over $91,900 but not over $191,650</td>
<td>$18,713.75 plus 28% of the excess over $91,900</td>
</tr>
<tr>
<td>Over $191,650 but not over $416,700</td>
<td>$46,643.75 plus 33% of the excess over $191,650</td>
</tr>
<tr>
<td>Over $416,700 but not over $418,400</td>
<td>$120,910.25 plus 35% of the excess over $416,700</td>
</tr>
<tr>
<td>Over $418,400</td>
<td>$121,505.25 plus 39.6% of the excess over $418,400</td>
</tr>
<tr>
<td><strong>Heads of Households</strong></td>
<td></td>
</tr>
<tr>
<td>Not over $13,350</td>
<td>10% of the taxable income</td>
</tr>
<tr>
<td>Over $13,350 but not over $50,800</td>
<td>$1,335 plus 15% of the excess over $13,350</td>
</tr>
<tr>
<td>Over $50,800 but not over $131,200</td>
<td>$6,952.50 plus 25% of the excess over $50,800</td>
</tr>
<tr>
<td>Over $131,200 but not over $212,500</td>
<td>$27,052.50 plus 28% of the excess over $131,200</td>
</tr>
<tr>
<td>Over $212,500 but not over $416,700</td>
<td>$49,816.50 plus 33% of the excess over $212,500</td>
</tr>
<tr>
<td>Over $416,700 but not over $444,550</td>
<td>$117,202.50 plus 35% of the excess over $416,700</td>
</tr>
<tr>
<td>Over $444,550</td>
<td>$126,950 plus 39.6% of the excess over $444,550</td>
</tr>
<tr>
<td><strong>Married Individuals Filing Joint Returns and Surviving Spouses</strong></td>
<td></td>
</tr>
<tr>
<td>Not over $18,650</td>
<td>10% of the taxable income</td>
</tr>
<tr>
<td>Over $18,650 but not over $75,900</td>
<td>$1,865 plus 15% of the excess over $18,650</td>
</tr>
<tr>
<td>Over $75,900 but not over $153,100</td>
<td>$10,452.50 plus 25% of the excess over $75,900</td>
</tr>
<tr>
<td>Over $153,100 but not over $233,350</td>
<td>$29,752.50 plus 28% of the excess over $153,100</td>
</tr>
<tr>
<td>Over $233,350 but not over $416,700</td>
<td>$52,222.50 plus 33% of the excess over $233,350</td>
</tr>
<tr>
<td>Over $416,700 but not over $470,700</td>
<td>$112,728 plus 35% of the excess over $416,700</td>
</tr>
<tr>
<td>Over $470,700</td>
<td>$131,628 plus 39.6% of the excess over $470,700</td>
</tr>
</tbody>
</table>
If taxable income is: | Then income tax equals:
---|---
**Married Individuals Filing Separate Returns**
Not over $9,325 | 10% of the taxable income
Over $9,325 but not over $37,950 | $932.50 plus 15% of the excess over $9,325
Over $37,950 but not over $76,550 | $5,226.25 plus 25% of the excess over $37,950
Over $76,550 but not over $116,675 | $14,876.25 plus 28% of the excess over $76,550
Over $116,675 but not over $208,350 | $26,111.25 plus 33% of the excess over $116,675
Over $208,350 but not over $235,350 | $56,364 plus 35% of the excess over $208,350
Over $235,350 | $65,814 plus 39.6% of the excess over $235,350

**Special capital gains and dividends rates**

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of a capital asset, any gain generally is included in income. Any net capital gain of an individual is taxed at maximum rates lower than the rates applicable to ordinary income. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

Capital losses generally are deductible in full against capital gains. In addition, individual taxpayers may deduct capital losses against up to $3,000 of ordinary income in each year. Any remaining unused capital losses may be carried forward indefinitely to another taxable year.

A maximum rate applies to certain capital gains and dividends. Any adjusted net capital gain otherwise taxed at a 10- or 15-percent rate is taxed at a zero-percent rate. Adjusted net capital gain otherwise taxed at rates greater than 15 percent but less than 39.6 percent is taxed at a 15-percent rate. In addition, the maximum rate of tax on the adjusted net capital gain of an individual is 20 percent on any amount of gain that otherwise would be taxed at a 39.6-percent rate. These rates apply for purposes of both the regular tax and the alternative minimum tax. Qualified dividend income is generally taxed at the same rate as net capital gains.\(^{12}\)

**Net investment income**

An additional tax is imposed on net investment income in the case of an individual, estate, or trust.\(^{13}\) In the case of an individual, the tax is 3.8 percent of the lesser of net

---

\(^{12}\) Qualified dividend income means dividends subject to certain source and holding period requirements, and is included in adjusted net capital gain. Sec. 1(h).

\(^{13}\) Sec. 1411.
investment income or the excess of modified adjusted gross income\textsuperscript{14} over the threshold amount. The threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case.\textsuperscript{15} Thus, the maximum rate on net capital gains and qualified dividends is 23.8 percent while the maximum rate on other investment income, including interest, annuities, royalties, and rents, is 43.4 percent.

Net investment income is the excess of (1) the sum of (a) gross income from interest, dividends, annuities, royalties, and rents, other than income which is derived in the ordinary course of a trade or business that is not a passive activity with respect to the taxpayer or a trade or business of trading in financial instruments or commodities, and (b) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in the active conduct of a trade or business that is not in the trade or business of trading in financial instruments or commodities, over (2) deductions properly allocable to such gross income or net gain.

\textbf{Credits against tax}

An individual may reduce his or her tax liability by any available tax credits\textsuperscript{16}. Certain credits are “refundable;” that is, if the amount of these credits exceeds tax liability (net of other credits) an overpayment is created which may generate a refund. Two major refundable credits are the child tax credit and the earned income credit\textsuperscript{17}.

An individual may claim a tax credit for each qualifying child under age 17. The amount of the credit per child is $1,000\textsuperscript{18}. The aggregate amount of child credits that may be claimed is phased out for individuals with income over certain threshold amounts. Specifically, the otherwise allowable child tax credit is reduced by $50 for each $1,000, or fraction thereof, of modified adjusted gross income over $75,000 for single individuals or heads of households, $110,000 for married individuals filing jointly, and $55,000 for married individuals filing separately. To the extent the child credit exceeds the taxpayer’s tax liability, the taxpayer is

\textsuperscript{14} Modified adjusted gross income is adjusted gross income increased by the amount excluded from income as foreign earned income under section 911(a)(1) (net of the deductions and exclusions disallowed with respect to the foreign earned income).

\textsuperscript{15} These thresholds are not indexed for inflation.

\textsuperscript{16} These personal credits include the child tax credit, earned income tax credit, child and dependent care credit, adoption credit, premium tax credit, health coverage tax credit, saver’s credit, foreign tax credit, lifetime learning credit, American opportunity tax credit, residential energy efficient property credit (for qualifying solar energy property), and credits for the elderly or disabled.

\textsuperscript{17} Other refundable credits include the American opportunity tax credit, the premium tax credit, and the health coverage tax credit.

\textsuperscript{18} Sec. 24.
eligible for a refundable credit (the additional child tax credit) equal to 15 percent of earned income in excess of $3,000,\textsuperscript{19} not to exceed the maximum credit per child of $1,000.

A refundable earned income tax credit (“EITC”) is available to low-income workers who satisfy certain requirements.\textsuperscript{20} The amount of the EITC varies depending on the taxpayer’s earned income and whether the taxpayer has more than two, two, one, or no qualifying children. In 2017, the maximum EITC for taxpayers is $6,318 with more than two qualifying children, $5,616 with two qualifying children, $3,400 with one qualifying child, and $510 with no qualifying children. The credit amount begins to phase out at an income level of $23,930 for joint-filers with children, $18,340 for other taxpayers with children, $13,930 for joint-filers with no qualifying children, and $8,340 for other taxpayers with no qualifying children. The phase-out percentages are 21.06 for two or more qualifying children, 15.98 for taxpayers with one qualifying child, and 7.65 for no qualifying children.

Tax credits are also allowed for certain business expenditures, certain foreign income taxes paid or accrued, certain energy conservation expenditures, certain education expenditures, certain child care expenditures, and for certain elderly or disabled individuals. The personal credits allowed against the regular tax are generally allowed against the alternative minimum tax.

**Alternative minimum tax liability**

An alternative minimum tax is imposed on an individual, estate, or trust in an amount by which the tentative minimum tax exceeds the regular income tax for the taxable year.\textsuperscript{21} For 2017, the tentative minimum tax is the sum of (1) 26 percent of so much of the taxable excess as does not exceed $187,800 ($93,900 in the case of married filing separately) and (2) 28 percent of the remaining taxable excess. The taxable excess is so much of the alternative minimum taxable income (“AMTI”) as exceeds the exemption amount. The breakpoint between the 26-percent and 28-percent bracket is indexed for inflation. The maximum tax rates on net capital gain and dividends used in computing the regular tax are used in computing the tentative minimum tax. AMTI is the taxpayer’s taxable income increased by the taxpayer’s tax preferences and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items.

For tax year 2017, the exemption amount is $84,500 for married individuals filing jointly and surviving spouses, $54,300 for other unmarried individuals, $42,250 for married individuals filing separately, and $24,100 for estates or trusts. The exemption amount is phased out by an amount equal to 25 percent of the amount by which the individual’s AMTI exceeds $160,900 for married individuals filing jointly and surviving spouses, $120,700 for other unmarried

---

\textsuperscript{19} Families with three or more children may determine the additional child tax credit by taking the greater of (1) the earned income formula, or (2) the alternative formula, \textit{i.e.} the amount by which the taxpayer’s social security taxes exceed the taxpayer’s earned income tax credit.

\textsuperscript{20} Sec. 32.

\textsuperscript{21} Sec. 55.
individuals, and $80,450 for married individuals filing separately, estates, or trusts. These amounts are indexed annually for inflation.

Among the tax preferences and adjustments included in AMTI are accelerated depreciation on certain property used in a trade or business, circulation expenditures, research and experimental expenditures, certain expenses and allowances related to oil and gas, certain expenses and allowances related to mining exploration and development, certain tax-exempt interest income, and a portion of the gain excluded with respect to the sale or disposition of certain small business stock. Personal exemptions, the standard deduction, and certain itemized deductions, such as State and local taxes and miscellaneous deductions, are not allowed to reduce AMTI.
B. Corporate Income Tax

Taxable income

Corporations organized under the laws of any of the 50 States (and the District of Columbia) generally are subject to the U.S. corporate income tax on their worldwide taxable income.22 Under subchapter S of the Code, a qualified small business corporation may elect not to be subject to the corporate income tax (i.e., may make an “S corporation election”). If an S corporation election is made, the income of the corporation flows through to the shareholders and is taxable directly to the shareholders.

The taxable income of a corporation generally is its gross income less allowable deductions. Gross income generally is income derived from any source, including gross profit from the sale of goods and services to customers, rents, royalties, interest (other than interest from certain indebtedness issued by State and local governments), dividends, gains from the sale of business and investment assets, and other income.

Allowable deductions include ordinary and necessary business expenditures, such as salaries, wages, contributions to profit-sharing and pension plans and other employee benefit programs, repairs, bad debts, taxes (other than Federal income taxes), contributions to charitable organizations (subject to an income limitation), advertising, interest expense, certain losses, selling expenses, and other expenses. Expenditures that produce benefits in future taxable years to a taxpayer’s business or income-producing activities (such as the purchase of plant and equipment) generally are capitalized and recovered over time through depreciation, amortization or depletion allowances. In some instances taxpayers can recover their costs more quickly than under the general rules. An additional first-year depreciation deduction is allowed equal to 50 percent of the adjusted basis of qualified property.23 Also, a taxpayer may elect to deduct (or “expense”) up to $500,000 of the cost of certain qualifying property placed in service during the taxable year.24

A net operating loss incurred in one taxable year may be carried back two years or carried forward 20 years. Deductions are also allowed for certain amounts despite the lack of a direct expenditure by the taxpayer. For example, a deduction is allowed for all or a portion of the amount of dividends received by a corporation from another corporation (provided certain

22 A foreign corporation generally is subject to the U.S. corporate income tax only on income with a sufficient nexus to the United States.

23 Sec. 168(k). The 50-percent allowance is phased down for property placed in service in taxable years beginning after 2017 (after 2018 for certain longer-lived and transportation property).

24 This amount is reduced (but not below zero) by the amount by which the cost of qualifying property exceeds $2,000,000. Sec. 179.
ownership requirements are satisfied). Moreover, a deduction is allowed for a portion of the amount of income attributable to certain manufacturing activities.\textsuperscript{25}

Certain expenditures may not be deducted, such as dividends paid to shareholders, expenses associated with earning tax-exempt income,\textsuperscript{26} certain entertainment expenditures, certain executive compensation in excess of $1,000,000 per year, a portion of the interest on certain high-yield debt obligations that resemble equity, as well as fines, penalties, bribes, kickbacks and illegal payments.

**Tax liability**

A corporation’s regular income tax liability generally is determined by applying the following tax rate schedule to its taxable income.

<table>
<thead>
<tr>
<th>If taxable income is:</th>
<th>Then the income tax rate is:</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0-$50,000</td>
<td>15 percent of taxable income</td>
</tr>
<tr>
<td>$50,001-$75,000</td>
<td>25 percent of taxable income</td>
</tr>
<tr>
<td>$75,001-$10,000,000</td>
<td>34 percent of taxable income</td>
</tr>
<tr>
<td>Over $10,000,000</td>
<td>35 percent of taxable income</td>
</tr>
</tbody>
</table>

The first two graduated rates described above are phased out for corporations with taxable income between $100,000 and $335,000 (at a marginal rate of 39 percent). As a result, a corporation with taxable income between $335,000 and $10,000,000 is effectively subject to a flat tax rate of 34 percent. Also, the application of the 34-percent rate is gradually phased out for corporations with taxable income between $15,000,000 and $18,333,333 (at a marginal rate of 38 percent), such that a corporation with taxable income of $18,333,333 or more is effectively subject to a flat rate of 35 percent.

In contrast to the treatment of capital gains in the individual income tax, no separate rate structure exists for corporate capital gains. Thus, the maximum rate of tax on the net capital gains of a corporation is 35 percent. A corporation may not deduct the amount of capital losses in excess of capital gains for any taxable year. Disallowed capital losses may be carried back three years or carried forward five years.

\textsuperscript{25} Deductions of income amounts can be viewed as substitutes for exemption or rate reductions for the affected income.

\textsuperscript{26} For example, the carrying costs of tax-exempt State and local obligations and the premiums on certain life insurance policies are not deductible.
Corporations are taxed at lower rates on income from certain domestic production activities. This rate reduction is effected by the allowance of a deduction equal to a percentage of qualifying domestic production activities income. The deduction is generally equal to nine percent of the income from manufacturing, construction, and certain other specified activities which results in an effective marginal tax rate of 31.85 percent.  

Like an individual, a corporation may reduce its tax liability by any applicable tax credits. The largest three credits, as measured by total dollar amount claimed by all taxpayers, are the research credit, the low income housing tax credit, and the renewable electricity production credit, which target intangible investment, real property investment, and production respectively.

The research credit is generally available with respect to incremental increases in qualified research. A research tax credit is also available with respect to corporate cash expenses paid for basic research conducted by universities (and certain nonprofit scientific research organizations) above a certain floor. Finally, a research credit is available for a taxpayer’s expenditures on research undertaken by an energy research consortium.

The low-income housing tax credit may be claimed over a 10-year period by owners of certain residential rental property for the cost of rental housing occupied by tenants having incomes below specified levels. The amount of the credit for any taxable year in the credit period is the applicable percentage of the qualified basis of each qualified low-income building.

---

27 With a nine percent deduction, a corporation is taxed at a rate of 35 percent on only 91 percent of qualifying income, resulting in an effective tax rate of 0.91 * 35, or 31.85 percent. A similar reduction applies to the graduated rates applicable to individuals with qualifying domestic production activities income.

28 Business credits also apply to the business income of individuals.

29 See Joint Committee on Taxation, Estimates of Federal Tax Expenditures For Fiscal Years 2016-2020 (JCX-3-17), January 30, 2017.

30 For general research expenditures, a taxpayer may claim a research credit equal to 20 percent of the amount by which the taxpayer’s qualified research expenses for a taxable year exceed its base amount for that year. Sec. 41(a)(1). An alternative simplified research credit (with a 14 percent rate and a different base amount) may be claimed in lieu of this credit. Sec. 41(c)(5).

31 This 20-percent credit is available with respect to the excess of (1) 100 percent of corporate cash expenses (including grants or contributions) paid for basic research conducted by universities (and certain nonprofit scientific research organizations) over (2) the sum of (a) the greater of two minimum basic research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period adjusted for inflation. Sec. 41(a)(2) and (e).

32 This separate credit computation commonly is referred to as the energy research credit. Unlike the other research credits, the energy research credit applies to all qualified expenditures, not just those in excess of a base amount. Sec. 41(1)(3).

33 Sec. 42.
The qualified basis of any qualified low-income building for any taxable year equals the applicable fraction of the eligible basis of the building.

An income tax credit is allowed for the production of electricity from qualified energy resources at qualified facilities (the “renewable electricity production credit”). Qualified energy resources comprise wind, closed-loop biomass, open-loop biomass, geothermal energy, solar energy, small irrigation power, municipal solid waste, qualified hydropower production, and marine and hydrokinetic renewable energy. Qualified facilities are, generally, facilities that generate electricity using qualified energy resources. To be eligible for the credit, electricity produced from qualified energy resources at qualified facilities must be sold by the taxpayer to an unrelated person.\textsuperscript{34}

In addition there are credits applicable to businesses including credits for biofuels, investment tax credits (applicable to investment in certain renewable energy property and the rehabilitation of certain real property), the empowerment zone employment credit (applicable to wages paid to certain residents of, or employees in, empowerment zones), the work opportunity credit (applicable to wages paid to individuals from certain targeted groups), and the disabled access credit (applicable to expenditures by certain small businesses to make the businesses accessible to disabled individuals).\textsuperscript{35} Unused credits generally may be carried back one year and carried forward twenty years.

Foreign tax credits generally are available against U.S. income tax imposed on foreign source income to the extent of foreign income taxes paid on that income. The limitation on the foreign tax credit is applied separately to different categories of income. Credits for foreign tax in excess of the limitation (so-called “excess foreign tax credits” or “excess credits”) in any tax year may be carried back one year or forward ten years.

**Affiliated group**

Domestic corporations that are affiliated through 80 percent or more corporate ownership may elect to file a consolidated return in lieu of filing separate returns. Corporations filing a consolidated return generally are treated as a single corporation; thus, the losses of one corporation can offset the income (and thus reduce the otherwise applicable tax) of other affiliated corporations.

**Minimum tax**

A corporation is subject to an alternative minimum tax that is payable, in addition to all other tax liabilities, to the extent that it exceeds the corporation’s regular income tax liability. The tax is imposed at a flat rate of 20 percent on alternative minimum taxable income in excess

---

\textsuperscript{34} Sec. 45.

\textsuperscript{35} Certain of these credits are scheduled to expire in 2017 or later. For more information on expiring provisions of the Code, see Joint Committee on Taxation, *List of Expiring Federal Tax Provisions 2016-2026* (JCX-1-17), January 4, 2017.
of a $40,000 exemption amount. \( ^{36} \) Credits that are allowed to offset a corporation’s regular tax liability generally are not allowed to offset its minimum tax liability. If a corporation pays the alternative minimum tax, the amount of the tax paid is allowed as a credit against the regular tax in future years.

Alternative minimum taxable income is the corporation’s taxable income increased by the corporation’s tax preferences and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items. Among the preferences and adjustments applicable to the corporate alternative minimum tax are accelerated depreciation on certain property, certain expenses and allowances related to oil and gas, certain expenses and allowances related to mining exploration and development, certain amortization expenses related to pollution control facilities, and certain tax-exempt interest income. In addition, corporate alternative minimum taxable income is increased by 75 percent of the amount by which the corporation’s “adjusted current earnings” exceed its alternative minimum taxable income (determined without regard to this adjustment). Adjusted current earnings generally are determined with reference to the rules that apply in determining a corporation’s earnings and profits.

**Treatment of corporate distributions**

The taxation of a corporation generally is separate from the taxation of its shareholders. A distribution by a corporation to one of its shareholders generally is taxable as a dividend to the shareholder to the extent of the corporation’s current or accumulated earnings and profits. \( ^{37} \) Thus, the amount of a corporate dividend generally is taxed twice: once when the income is earned by the corporation and again when the dividend is distributed to the shareholder. \( ^{38} \) Conversely, amounts paid as interest to the debtholders of a corporation generally are subject to only one level of tax (at the recipient level) since the corporation generally is allowed a deduction for the amount of interest expense paid or accrued.

Amounts received by a shareholder in complete liquidation of a corporation generally are treated as full payment in exchange for the shareholder’s stock. A liquidating corporation recognizes gain or loss on the distributed property as if such property were sold to the distributee for its fair market value. However, if a corporation liquidates a subsidiary corporation of which

---

\( ^{36} \) The exemption amount is phased out for corporations with income above a certain threshold, and is completely phased out for corporations with alternative minimum taxable income of $310,000 or more.

\( ^{37} \) A distribution in excess of the earnings and profits of a corporation generally is a tax-free return of capital to the shareholder to the extent of the shareholder’s adjusted basis (generally, cost) in the stock of the corporation; such distribution is a capital gain if in excess of basis. A distribution of property other than cash generally is treated as a taxable sale of such property by the corporation and is taken into account by the shareholder at the property’s fair market value. A distribution of stock of the corporation generally is not a taxable event to either the corporation or the shareholder.

\( ^{38} \) This double taxation is mitigated by a reduced tax rate generally applicable to the qualified dividend income of individuals.
it has 80 percent or more control, no gain or loss generally is recognized by either the parent corporation or the subsidiary corporation.

**Accumulated earnings and personal holding company taxes**

Taxes at a rate of 20 percent (the top rate generally applicable to dividend income of individuals) may be imposed on the accumulated earnings or personal holding company income of a corporation. The accumulated earnings tax may be imposed if a corporation retains earnings in excess of reasonable business needs. The personal holding company tax may be imposed on the excessive passive income of a closely held corporation. The accumulated earnings tax and the personal holding company tax, when they apply, in effect impose the shareholder-level tax in addition to the corporate-level tax on accumulated earnings or undistributed personal holding company income.
C. Taxation of Cross-Border Transactions

The United States has adopted a Code that combines the worldwide taxation of all U.S. persons (U.S. citizens or resident aliens and domestic corporations)\(^{39}\) on all income, whether derived in the United States or abroad, with territorial-based taxation of U.S.-source income of nonresident aliens and foreign entities, and limited deferral for foreign income earned by subsidiaries of U.S. companies. Under this system (sometimes described as the U.S. hybrid system), the application of the Code differs depending on whether the income arises from outbound investment or inbound investment. Outbound investment refers to the foreign activities of U.S. persons, while inbound investment is investment by foreign persons in U.S. assets or activities.

With respect to outbound activities, income earned directly by a U.S. person, including as a result of a domestic corporation’s conduct of a foreign business itself (by means of direct sales, licensing or branch operations in the foreign jurisdiction) rather than through a separate foreign legal entity, or through a pass-through entity such as a partnership, is taxed on a current basis. However, active foreign business income earned by a domestic parent corporation indirectly through a foreign corporate subsidiary generally is not subject to U.S. tax until the income is distributed as a dividend to the domestic corporation. This taxpayer-favorable result is circumscribed by certain anti-deferral regimes of the Code.

By contrast, nonresident aliens and foreign corporations are generally subject to U.S. tax only on their U.S.-source income. Thus, the source and type of income received by a foreign person generally determines whether there is any U.S. income tax liability, and the mechanism by which it is taxed (either by gross-basis withholding or on a net basis through tax return filing).

Category-by-category rules determine whether income has a U.S. source or a foreign source. For example, compensation for personal services generally is sourced based on where the services are performed, dividends and interest are, with limited exceptions, sourced based on the residence of the taxpayer making the payments, and royalties for the use of property generally are sourced based on where the property is used. These and other source rules are described in more detail below.

To mitigate double taxation of foreign-source income, the United States allows a credit for foreign income taxes paid. As a consequence, even though resident individuals and domestic corporations are subject to U.S. tax on all their income, both U.S. and foreign source, the source of income remains a critical factor to the extent that it determines the amount of credit available for foreign taxes paid. In addition to the statutory relief afforded by the credit, the network of bilateral treaties to which the United States is a party provides a system for elimination of double taxation and ensuring reciprocal treatment of taxpayers from treaty countries.

Present law provides detailed rules for the allocation of deductible expenses between U.S.-source income and foreign-source income. These rules do not, however, affect the timing of

---

\(^{39}\) Sec. 7701(a)(30) defines U.S. person to include all U.S. citizens and residents as well as domestic entities such as partnerships, corporations, estates and certain trusts. Whether a noncitizen is a resident is determined under rules in section 7701(b).
the expense deduction. A domestic corporation generally is allowed a current deduction for its expenses (such as interest and administrative expenses) that support income that is derived through foreign subsidiaries and on which U.S. tax is deferred. The expense allocation rules apply to a domestic corporation principally for determining the corporation’s foreign tax credit limitation. This limitation is computed by reference to the corporation’s U.S. tax liability on its taxable foreign-source income in each of two principal limitation categories, commonly referred to as the “general basket” and the “passive basket.” Consequently, the expense allocation rules primarily affect taxpayers that may not be able to fully use their foreign tax credits because of the foreign tax credit limitation.

U.S. tax law includes rules intended to prevent reduction of the U.S. tax base, whether through excessive borrowing in the United States, migration of the tax residence of domestic corporations from the United States to foreign jurisdictions through corporate inversion transactions or aggressive intercompany pricing practices with respect to intangible property.
D. Tax-Favored Retirement Savings

Tax-favored employer-sponsored retirement plans

Overview

Whether to offer a tax-favored retirement plan is a voluntary choice by an employer, with various factors entering into the decision. The Code provides for multiple types of tax-favored employer-sponsored retirement plans, including qualified retirement plans and annuities (secs. 401(a) and 403(a)), tax-deferred annuities (sec. 403(b)), governmental eligible deferred compensation plans (sec. 457(b)), SIMPLE (savings incentive match plan for employees) IRAs (sec. 408(p)), and simplified employee pensions (“SEPs”) (sec. 408(k)). These plans afford employers flexibility in the design and structure of the retirement plans they adopt, subject to the requirements applicable to each type of plan under the Code and, absent an exemption, under the Employee Retirement Income Security Act of 1974 (“ERISA”).

Qualified retirement plans

Qualified retirement plans (and other tax-favored employer-sponsored retirement plans) are accorded special tax treatment under present law. Most contributions, earnings on contributions, and benefits are not included in gross income until amounts are distributed, even though the arrangement is funded and even if benefits are vested. Under some plans, a participant may choose to have contributions made to the plan, rather than receiving the amount as current compensation. Under Roth arrangements, the participant chooses to contribute on an after-tax basis and earnings generally are not subject to tax when distributed. Distributions generally can be rolled over to another qualified retirement plan for further deferral of income inclusion. In the case of a taxable employer, the employer is entitled to a current deduction (within certain limits) for contributions even though the contributions are not currently included in an employee’s income. Contributions and earnings are held in a tax-exempt trust, which enables the assets to grow on a tax-free basis.

Various requirements apply in order for qualified retirement plans to receive tax-favored treatment; specific requirements vary based on the plan type. Very generally, some of these requirements define participant rights and provide participant protections, such as minimum participation, vesting, exclusive benefit and minimum funding requirements. These requirements generally have parallels under ERISA. Other qualified plan requirements limit tax benefits, such as the limit on compensation taken into account under a plan on which contributions and benefits are based and limits on the annual amount of contributions and benefits. These limitations, along with minimum coverage and nondiscrimination requirements, are intended to ensure that qualified retirement plans achieve the goal of broad-based retirement security for lower-paid employees in addition to higher-paid employees.

Enforcement of the qualified retirement plan requirements depends on the source of the requirements. Failure to meet a tax qualification requirement may mean the loss of tax-favored status; however, in practice, the Internal Revenue Service (“IRS”) rarely disqualifies a plan and instead generally permits plan sponsors to correct errors under the Employee Plans Compliance Resolution System (“EPCRS”). Certain requirements may be enforced through an excise tax.
Types of qualified retirement plans

Qualified retirement plans are of two general types: defined benefit plans, under which benefits are determined under a plan formula and paid from general plan assets, rather than individual participant accounts; and defined contribution plans, under which benefits are based on a separate account for each participant, to which are allocated contributions, earnings and losses. Defined benefit plans generally are subject to minimum funding requirements and benefits are guaranteed, within limits, by the Pension Benefit Guaranty Corporation (“PBGC”). Some qualified retirement plans are referred to as hybrid plans because they have features of both a defined benefit plan and a defined contribution plan; for example, cash balance plans are defined benefit plans, but plan benefits are defined by reference to a hypothetical account balance.

Qualified retirement plans are also categorized by the number of employers that maintain the plan and the type of employees covered by the plan. A single-employer plan is a plan maintained by one employer (treating members of controlled groups and affiliated service groups as one employer) and may cover collectively bargained employees (employees covered by a collective bargaining agreement), noncollectively bargained employees, or both. A multiple-employer plan is a single plan in which two or more unrelated employers (not members of the same controlled group or affiliated service group) participate. Some qualification requirements apply to a multiple-employer plan on a plan-wide basis; others apply on an employer-by-employer basis. Multiemployer plans (also known as “Taft-Hartley” plans) are maintained pursuant to one or more collective bargaining agreements with two or more unrelated employers; the collective bargaining agreements require the employers to contribute to the plan.

Individual Retirement Arrangements

There are two basic types of IRAs: traditional IRAs, to which deductible or nondeductible contributions can be made, and Roth IRAs, contributions to which are not deductible. The total contributions made to all IRAs for a year cannot exceed $5,500 (for 2017), plus an additional $1,000 (not indexed) in catch-up contributions for individuals age 50 or older. Certain individuals are not permitted to make deductible contributions to a traditional IRA or to make contributions to a Roth IRA, depending on their income.

Distributions from traditional IRAs are generally includible in income, except to the extent a portion of the distribution is treated as a recovery of the individual’s basis (if any). Qualified distributions from a Roth IRA are excluded from income; other distributions from a Roth IRA are includible in income to the extent of earnings. IRA distributions generally can be rolled over to another IRA or qualified retirement plan; however, a distribution from a Roth IRA generally can be rolled over only to another Roth IRA or a designated Roth account.

SIMPLE IRAs and SEPs are special types of employer-sponsored retirement plans under which the employer makes contributions to IRAs established for each of its employees in accordance with the Code requirements for each type of plan. Deemed IRAs are permitted to be provided in conjunction with a qualified retirement plan, section 403(b) plan, or governmental section 457(b) plan. An employer may also establish a payroll deduction IRA program, under which employees can elect to have amounts withheld from their pay and contributed to an IRA.
opened by the employee. The Treasury Department has recently established the myRA program, under which individuals, particularly those without access to an employer-sponsored plan, can establish and contribute to a Roth IRA.
E. Estate, Gift, and Generation-Skipping Transfer Taxes

The United States generally imposes a gift tax on any transfer of property by gift made by a U.S. citizen or resident, whether made directly or indirectly and whether made in trust or otherwise. Nonresident aliens are subject to the gift tax with respect to transfers of tangible real or personal property where the property is located in the United States at the time of the gift. The gift tax is imposed on the donor and is based on the fair market value of the property transferred. Deductions are allowed for certain gifts to spouses and to charities. Annual gifts of $14,000 (for 2017) or less per donor and donee pair are not treated as taxable gifts and thus are not subject to tax.

An estate tax also is imposed on the taxable estate of any person who was a citizen or resident of the United States at the time of death, and on certain property belonging to a nonresident of the United States that is located in the United States at the time of death. The estate tax is imposed on the estate of the decedent and generally is based on the fair market value of the property passing at death.\textsuperscript{40} The taxable estate generally equals the worldwide gross estate less certain allowable deductions, including a marital deduction for certain bequests to the surviving spouse of the decedent and a deduction for certain bequests to charities.

The gift and estate taxes are unified such that a single graduated rate schedule and effective exemption amount apply to an individual’s cumulative taxable gifts and bequests. Under present law, this results in an effective estate and gift tax rate of 40 percent and a total amount exempted from gift and estate taxation for an individual of $5.49 million (for 2017).\textsuperscript{41} Unused exemption as of the death of a spouse generally is available for use by the surviving spouse; this feature of the law sometimes is referred to as exemption portability.

A separate transfer tax is imposed on generation-skipping transfers in addition to any estate or gift tax that is normally imposed on such transfers. This tax generally is imposed on transfers, either directly or through a trust or similar arrangement, to a beneficiary in more than one generation below that of the transferor. For 2017, the generation-skipping transfer tax is imposed at a flat rate of 40 percent on generation-skipping transfers in excess of $5.49 million.

\textsuperscript{40} In addition to interests in property owned by the decedent at the time of death, the Federal estate tax also is imposed on: (1) life insurance that was either payable to the decedent’s estate or in which the decedent had an incident of ownership at death; (2) property over which the decedent had a general power of appointment at death; (3) annuities purchased by the decedent or his employer that were payable to the decedent before death; (4) property held by the decedents as joint tenants; (5) property transferred by the decedent before death in which the decedent retained a life estate or over which the decedent had the power to designate who will possess or enjoy the property; (6) property revocably transferred by the decedent before death; and (7) certain transfers taking effect at the death of the decedent.

\textsuperscript{41} The $5.49 million value for 2017 is the result of inflation indexing required by section 2010(c)(3)(B) of the $5 million exemption amount set forth in section 2010(c)(3)(A) for years after 2011.
F. Social Insurance Taxes

**In general**

Social Security benefits and certain Medicare benefits are financed primarily by payroll taxes on covered wages. The Federal Insurance Contributions Act ("FICA") imposes tax on employers based on the amount of wages paid to an employee during the year. The tax imposed is composed of two parts: (1) the old age, survivors, and disability insurance ("OASDI") tax equal to 6.2 percent of covered wages up to the taxable wage base ($127,200 in 2017); and (2) the Medicare hospital insurance ("HI") tax amount equal to 1.45 percent of covered wages with no wage cap. In addition to the tax on employers, each employee is subject to FICA taxes equal to the amount of tax imposed on the employer. The employee level tax generally must be withheld and remitted to the Federal government by the employer.42

As a parallel to FICA taxes, the Self-Employment Contributions Act ("SECA") imposes taxes on the net income from self-employment of self-employed individuals. The rate of the OASDI portion of SECA taxes is equal to the combined employee and employer OASDI FICA tax rates and applies to self-employment income up to the FICA taxable wage base. Similarly, the rate of the HI portion is the sum of the combined employer and employee HI rates and there is no cap on the amount of self-employment income to which the rate applies.43

In addition to FICA taxes, employers are subject to a Federal unemployment insurance payroll tax equal to six percent of the total wages of each employee (up to $7,000) on covered employment. Employers are eligible for a Federal credit equal to 5.4 percent for State unemployment taxes, yielding a 0.6 percent effective tax rate. Federal unemployment insurance payroll taxes are used to fund programs maintained by the States for the benefit of unemployed workers.

**Additional hospital insurance tax on certain high-income individuals**

The employee portion of the HI tax is increased by an additional tax of 0.9 percent on wages received in excess of a specific threshold amount.44 However, unlike the general 1.45 percent HI tax on wages, this additional tax is on the combined wages of the employee and the

---

42 Instead of FICA taxes, railroad employers and employees are subject, under the Railroad Retirement Tax Act ("RRTA"), to taxes equivalent to the OASDI and HI taxes under FICA. Under RRTA, employers and employees are also subject to an additional tax, referred to as the "tier 2" tax, on compensation up to a certain amount.

43 For purposes of computing net earnings from self-employment, taxpayers are permitted a deduction equal to the product of the taxpayer’s earnings (determined without regard to this deduction) and one-half of the sum of the rates for OASDI (12.4 percent) and HI (2.9 percent), i.e., 7.65 percent of net earnings. This deduction reflects the fact that the FICA rates apply to an employee’s wages, which do not include FICA taxes paid by the employer, whereas a self-employed individual’s net earnings are economically equivalent to an employee’s wages plus the employer share of FICA taxes.

44 Sec. 3101(b), as amended by the Patient Protection and Affordable Care Act ("PPACA"), Pub. L. No. 111-148.
employee’s spouse, in the case of a joint return. The threshold amount is $250,000 in the case of married filing jointly, $125,000 in the case of married filing separately, and $200,000 in any other case (unmarried individual, head of household or surviving spouse).45

The same additional HI tax applies to the HI portion of SECA tax on self-employment income in excess of the threshold amount. Thus, an additional tax of 0.9 percent is imposed on every self-employed individual on self-employment income in excess of the threshold amount.46

45 These threshold amounts are not indexed for inflation.

46 Sec. 1402(b).
G. Excise Taxes

The Federal tax system imposes excise taxes on selected goods and services. Generally, excise taxes are taxes imposed on a per unit or ad valorem (i.e., percentage of price) basis on the production, importation, or sale of a specific good or service. Among the goods and services subject to U.S. excise taxes are motor fuels, alcoholic beverages, tobacco products, firearms, air and ship transportation, certain environmentally hazardous products (e.g., the tax on ozone depleting chemicals, and a tax on crude oil and certain petroleum products to fund the Oil Spill Liability Trust Fund), coal, certain telephone communications (e.g., local service), certain wagers, indoor tanning services, and vehicles lacking in fuel efficiency. Additionally, an annual fee is imposed on health insurers and on certain manufacturers and importers of branded prescription drugs. The largest excise taxes in terms of revenue are those for gasoline motor fuel ($26.1 billion collected in fiscal year 2016), diesel motor fuel ($10.3 billion), and domestic air tickets ($9.9 billion). In fiscal year 2015, the latest fiscal year for which data is publicly available, $13.6 billion was collected on the excise tax on domestic cigarettes.

Revenues from certain Federal excise taxes are dedicated to trust funds (e.g., the Highway Trust Fund) for designated expenditure programs, and revenues from other excise taxes (e.g., alcoholic beverages) go to the General Fund for general purpose expenditures.

---

47 For a description of the various Federal excise taxes, see Joint Committee on Taxation, Present Law and Background Information on Federal Excise Taxes (JCX-99-15), July 13, 2015.


49 Ibid.


Table 4.–2017 Federal Excise Tax Rates for Selected Taxed Products or Services

<table>
<thead>
<tr>
<th>Product</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gasoline Motor Fuel</td>
<td>18.3 cents per gallon&lt;sup&gt;52&lt;/sup&gt;</td>
</tr>
<tr>
<td>Diesel Motor Fuel</td>
<td>24.3 cents per gallon&lt;sup&gt;53&lt;/sup&gt;</td>
</tr>
<tr>
<td>Cigarettes</td>
<td>$50.33 per thousand small cigarettes ($1.01 per standard pack); $105.69 per thousand large cigarettes.</td>
</tr>
<tr>
<td>Domestic Air Tickets</td>
<td>7.5 percent of fare, plus $4.10 (2017) per domestic flight segment generally.</td>
</tr>
</tbody>
</table>

<sup>52</sup> This rate does not include the additional 0.1 cent per gallon to fund the Leaking Underground Storage Tank Trust Fund.

<sup>53</sup> This rate does not include the additional 0.1 cent per gallon to fund the Leaking Underground Storage Tank Trust Fund.
APPENDIX: FIGURES AND TABLES

Table A-1.—Federal Receipts by Source, 1967-2016.................................................................49
Table A-2.—Federal Receipts by Source, as a Percentage of GDP, 1967-2016............................50
Table A-3.—Federal Receipts by Source, as a Percentage of Total Revenues, 1967-2016.............51
Figure A-1.—Federal Receipts by Source as Share of Total Receipts, 1950-2016 .......................52
Figure A-2.—Federal Receipts as a Percentage of GDP, 1950-2016...........................................53
Figure A-3.—Federal Receipts by Source, 2017 (Projected)......................................................54
Figure A-4.—Sources of Income for Individual Taxpayers, 1984-2014........................................55
Table A-4.—Number of Business Returns by Type, 1978-2014 ..............................................56
Figure A-5.—Number of C Corporation Returns Compared to the Sum of S Corporation and Partnership Returns, 1980-2014.........................................................................................57
Figure A-6.—Share of Net Income (Less Deficit) by Form of Business, 1980-2013 ..................59
Table A-5.—Social Security Taxable Wage Base and Rates of Tax, 1975-2017 .........................60
Table A-6.—Distribution of Income and Taxes, and Average Tax Rates in 2017 (Projected)......61
Table A-7.—Tax Returns with Income or Employment Taxes in 2017 (Projected).....................62
Table A-8.—Marginal Tax Rates on Labor and Long-Term Capital Gains, by Income Category in 2017 (Projected)...............................................................................................62
Table A-9.—Distribution of Selected Sources of Income in 2017 (Projected).............................63
Figure A-1.-Federal Receipts by Source as Share of Total Receipts, 1950-2016

Sources: Office of Management and Budget, Historical Tables, Fiscal Year 2017; Final Monthly Treasury Statement Fiscal Year 2016; Joint Committee on Taxation calculations.
Figure A-2.-Federal Receipts as a Percentage of GDP, 1950-2016

Sources: Office of Management and Budget, Historical Tables, Fiscal Year 2017; Final Monthly Treasury Statement Fiscal Year 2016; Bureau of Economic Analysis; Joint Committee on Taxation calculations.
Figure A-3.-Federal Receipts by Source, 2017 (Projected)

- Individual Income Tax: 48.5%
- Social Insurance Taxes: 33.8%
- Corporate Income Tax: 9.4%
- Excise Taxes: 2.5%
- Estate & Gift Tax: 0.7%
- Other Taxes: 5.1%

Source: Congressional Budget Office, January 2017 Baseline
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than $10,000...</td>
<td>19,174</td>
<td>11.0%</td>
<td>70,570</td>
<td>0.5%</td>
<td>6.9</td>
<td>0.2%</td>
<td>9.8%</td>
</tr>
<tr>
<td>$10,000 to $20,000</td>
<td>20,306</td>
<td>11.7%</td>
<td>312,768</td>
<td>2.2%</td>
<td>-2.5</td>
<td>-0.1%</td>
<td>-0.8%</td>
</tr>
<tr>
<td>$20,000 to $30,000</td>
<td>21,107</td>
<td>12.1%</td>
<td>524,442</td>
<td>3.6%</td>
<td>19.4</td>
<td>0.7%</td>
<td>3.7%</td>
</tr>
<tr>
<td>$30,000 to $40,000</td>
<td>15,985</td>
<td>9.2%</td>
<td>553,747</td>
<td>3.9%</td>
<td>43.8</td>
<td>1.5%</td>
<td>7.9%</td>
</tr>
<tr>
<td>$40,000 to $50,000</td>
<td>12,680</td>
<td>7.3%</td>
<td>569,576</td>
<td>4.0%</td>
<td>62.6</td>
<td>2.1%</td>
<td>11.0%</td>
</tr>
<tr>
<td>$50,000 to $75,000</td>
<td>26,945</td>
<td>15.5%</td>
<td>1,658,978</td>
<td>11.5%</td>
<td>244.1</td>
<td>8.2%</td>
<td>14.7%</td>
</tr>
<tr>
<td>$75,000 to $100,000</td>
<td>17,417</td>
<td>10.0%</td>
<td>1,509,610</td>
<td>10.5%</td>
<td>255.8</td>
<td>8.6%</td>
<td>16.9%</td>
</tr>
<tr>
<td>$100,000 to $200,000</td>
<td>29,971</td>
<td>17.2%</td>
<td>4,112,030</td>
<td>28.6%</td>
<td>858.8</td>
<td>29.0%</td>
<td>20.9%</td>
</tr>
<tr>
<td>$200,000 to $500,000</td>
<td>8,975</td>
<td>5.2%</td>
<td>2,518,200</td>
<td>17.5%</td>
<td>663.1</td>
<td>22.4%</td>
<td>26.3%</td>
</tr>
<tr>
<td>$500,000 to $1,000,000</td>
<td>1,121</td>
<td>0.6%</td>
<td>754,750</td>
<td>5.3%</td>
<td>233.2</td>
<td>7.9%</td>
<td>30.9%</td>
</tr>
<tr>
<td>$1,000,000 and over.</td>
<td>560</td>
<td>0.3%</td>
<td>1,790,486</td>
<td>12.5%</td>
<td>577.4</td>
<td>19.5%</td>
<td>32.2%</td>
</tr>
<tr>
<td>Total, All Taxpayers</td>
<td>174,220</td>
<td>100.0%</td>
<td>14,375,157</td>
<td>100.0%</td>
<td>2,962.5</td>
<td>100.0%</td>
<td>20.8%</td>
</tr>
</tbody>
</table>

[1] The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: (1) tax-exempt interest, (2) employer contributions for health plans and life insurance, (3) employer share of FICA tax, (4) worker’s compensation, (5) nontaxable Social Security benefits, (6) insurance value of Medicare benefits, (7) alternative minimum tax preference items, (8) individual share of business taxes, and (9) excluded income of U.S. citizens living abroad. Categories are measured at 2017 levels.

[2] Includes nonfilers, excludes dependent filers and returns with negative income.

[3] Federal taxes are equal to individual income tax (including the outlay portion of refundable credits), employment tax (attributed to employees), excise taxes (attributed to consumers), and corporate income taxes. The estimates of Federal taxes are preliminary and subject to change. Individuals who are dependents of other taxpayers and taxpayers with negative income are excluded from the analysis. Does not include indirect effects.


Source: Joint Committee on Taxation staff estimates.
### Table A-7. Tax Returns with Income or Employment Taxes in 2017 (Projected)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than $10,000</td>
<td>19.2</td>
<td>-6.2</td>
<td>7.6</td>
<td>11.3</td>
<td>0.2</td>
<td>59.1%</td>
</tr>
<tr>
<td>$10,000 to $20,000</td>
<td>20.3</td>
<td>-41.0</td>
<td>31.0</td>
<td>15.3</td>
<td>0.2</td>
<td>75.5%</td>
</tr>
<tr>
<td>$20,000 to $30,000</td>
<td>21.1</td>
<td>-31.9</td>
<td>41.3</td>
<td>13.5</td>
<td>0.2</td>
<td>64.1%</td>
</tr>
<tr>
<td>$30,000 to $40,000</td>
<td>16.0</td>
<td>-12.5</td>
<td>45.5</td>
<td>11.7</td>
<td>0.6</td>
<td>73.1%</td>
</tr>
<tr>
<td>$40,000 to $50,000</td>
<td>12.7</td>
<td>2.3</td>
<td>45.8</td>
<td>3.7</td>
<td>1.3</td>
<td>75.2%</td>
</tr>
<tr>
<td>$50,000 to $75,000</td>
<td>25.9</td>
<td>60.6</td>
<td>149.3</td>
<td>21.2</td>
<td>4.0</td>
<td>78.6%</td>
</tr>
<tr>
<td>$75,000 to $100,000</td>
<td>17.4</td>
<td>91.9</td>
<td>130.1</td>
<td>11.8</td>
<td>5.2</td>
<td>67.5%</td>
</tr>
<tr>
<td>$100,000 to $200,000</td>
<td>30.0</td>
<td>358.9</td>
<td>387.9</td>
<td>17.8</td>
<td>12.0</td>
<td>59.4%</td>
</tr>
<tr>
<td>$200,000 to $500,000</td>
<td>9.0</td>
<td>396.3</td>
<td>201.4</td>
<td>1.4</td>
<td>7.6</td>
<td>15.1%</td>
</tr>
<tr>
<td>$500,000 to $1,000,000</td>
<td>1.1</td>
<td>172.9</td>
<td>35.7</td>
<td>[3]</td>
<td>1.1</td>
<td>1.3%</td>
</tr>
<tr>
<td>$1,000,000 and over</td>
<td>0.6</td>
<td>404.8</td>
<td>49.9</td>
<td>[3]</td>
<td>0.6</td>
<td>0.7%</td>
</tr>
<tr>
<td><strong>Total, All Taxpayers</strong></td>
<td><strong>174.2</strong></td>
<td><strong>1476.5</strong></td>
<td><strong>1114.6</strong></td>
<td><strong>111.7</strong></td>
<td><strong>32.0</strong></td>
<td><strong>65.3%</strong></td>
</tr>
</tbody>
</table>

[1] The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: (1) tax-exempt interest, (2) employer contributions for health plans and life insurance, (3) employer share of FICA tax, (4) worker’s compensation, (5) non-taxable Social Security benefits, (6) insurance value of Medicare benefits, (7) alternative minimum tax preference items, (8) individual share of business taxes, and (9) excluded income of U.S. citizens living abroad. Categories are measured at 2017 levels.

[2] Includes nonfilers, excludes married joint filers and returns with negative income.

[3] Less than $0,000.

Source: Joint Committee on Taxation staff estimates.

### Table A-8. Marginal Tax Rates on Labor and Long-Term Capital Gains, by Income Category in 2017 (Projected)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than $10,000</td>
<td>7.2%</td>
<td>14.2%</td>
<td>7.0%</td>
<td>8.0%</td>
</tr>
<tr>
<td>$10,000 to $29,999</td>
<td>9.5%</td>
<td>14.2%</td>
<td>14.7%</td>
<td>2.5%</td>
</tr>
<tr>
<td>$30,000 to $39,999</td>
<td>11.4%</td>
<td>14.2%</td>
<td>25.7%</td>
<td>2.1%</td>
</tr>
<tr>
<td>$40,000 to $49,999</td>
<td>14.0%</td>
<td>14.2%</td>
<td>29.2%</td>
<td>2.2%</td>
</tr>
<tr>
<td>$50,000 to $59,999</td>
<td>15.4%</td>
<td>14.2%</td>
<td>29.6%</td>
<td>1.7%</td>
</tr>
<tr>
<td>$60,000 to $75,000</td>
<td>18.3%</td>
<td>14.2%</td>
<td>32.5%</td>
<td>6.9%</td>
</tr>
<tr>
<td>$75,000 to $100,000</td>
<td>19.2%</td>
<td>14.2%</td>
<td>32.4%</td>
<td>9.2%</td>
</tr>
<tr>
<td>$100,000 to $200,000</td>
<td>21.0%</td>
<td>13.4%</td>
<td>34.4%</td>
<td>13.1%</td>
</tr>
<tr>
<td>$200,000 to $500,000</td>
<td>29.5%</td>
<td>9.7%</td>
<td>39.2%</td>
<td>21.0%</td>
</tr>
<tr>
<td>$500,000 to $1,000,000</td>
<td>34.0%</td>
<td>7.2%</td>
<td>41.8%</td>
<td>23.8%</td>
</tr>
<tr>
<td>$1,000,000 and over</td>
<td>37.7%</td>
<td>6.8%</td>
<td>44.5%</td>
<td>24.1%</td>
</tr>
<tr>
<td><strong>Total, All Taxpayers</strong></td>
<td><strong>15.6%</strong></td>
<td><strong>13.6%</strong></td>
<td><strong>29.2%</strong></td>
<td><strong>22.0%</strong></td>
</tr>
</tbody>
</table>

[1] The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: (1) tax-exempt interest, (2) employer contributions for health plans and life insurance, (3) employer share of FICA tax, (4) worker’s compensation, (5) non-taxable Social Security benefits, (6) insurance value of Medicare benefits, (7) alternative minimum tax preference items, (8) individual share of business taxes, and (9) excluded income of U.S. citizens living abroad. Categories are measured at 2017 levels.

[2] For individual income and employment taxes, the average marginal tax rate is equal to the change in taxes from an additional $100 of wages to each spouse with positive wages. For long-term capital gain, the average marginal tax rate equals the change in taxes from an additional 1% increase in long-term capital gains to each taxpayer with positive long-term capital gains.

Source: Joint Committee on Taxation staff estimates.
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than $10,000</td>
<td>13.2</td>
<td>419</td>
<td>0.2</td>
<td>0.6</td>
<td>0.6</td>
<td>7.0</td>
<td>-0.7</td>
</tr>
<tr>
<td>$10,000 to $20,000</td>
<td>20.5</td>
<td>168.1</td>
<td>0.5</td>
<td>0.9</td>
<td>0.5</td>
<td>32.2</td>
<td>0.9</td>
</tr>
<tr>
<td>$20,000 to $30,000</td>
<td>21.1</td>
<td>241.3</td>
<td>0.6</td>
<td>1.5</td>
<td>1.2</td>
<td>17.2</td>
<td>1.2</td>
</tr>
<tr>
<td>$30,000 to $40,000</td>
<td>16.0</td>
<td>269.4</td>
<td>0.9</td>
<td>2.0</td>
<td>1.8</td>
<td>13.3</td>
<td>1.1</td>
</tr>
<tr>
<td>$40,000 to $50,000</td>
<td>12.7</td>
<td>292.9</td>
<td>1.5</td>
<td>3.2</td>
<td>1.9</td>
<td>10.2</td>
<td>1.4</td>
</tr>
<tr>
<td>$50,000 to $75,000</td>
<td>26.9</td>
<td>925.2</td>
<td>7.1</td>
<td>11.1</td>
<td>5.2</td>
<td>20.9</td>
<td>5.5</td>
</tr>
<tr>
<td>$75,000 to $100,000</td>
<td>17.4</td>
<td>815.2</td>
<td>11.0</td>
<td>13.4</td>
<td>5.9</td>
<td>21.6</td>
<td>9.6</td>
</tr>
<tr>
<td>$100,000 to $200,000</td>
<td>30.0</td>
<td>2,475.2</td>
<td>51.3</td>
<td>47.3</td>
<td>15.6</td>
<td>69.4</td>
<td>53.5</td>
</tr>
<tr>
<td>$200,000 to $500,000</td>
<td>5.0</td>
<td>1,542.5</td>
<td>91.4</td>
<td>54.4</td>
<td>15.0</td>
<td>83.8</td>
<td>140.8</td>
</tr>
<tr>
<td>$500,000 to $1,000,000</td>
<td>1.1</td>
<td>393.5</td>
<td>69.5</td>
<td>30.5</td>
<td>8.0</td>
<td>36.6</td>
<td>118.1</td>
</tr>
<tr>
<td>$1,000,000 and over</td>
<td>0.6</td>
<td>546.2</td>
<td>442.0</td>
<td>103.5</td>
<td>39.1</td>
<td>47.0</td>
<td>464.1</td>
</tr>
<tr>
<td>Total, All Taxpayers</td>
<td>174.2</td>
<td>7,709.5</td>
<td>676.9</td>
<td>288.5</td>
<td>94.8</td>
<td>358.2</td>
<td>794.7</td>
</tr>
</tbody>
</table>

[1] The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: (1) tax-exempt interest, (2) employer contributions for health plans and life insurance, (3) employer share of FICA tax, (4) worker's compensation, (5) nontaxable Social Security benefits, (6) insurance value of Medicare benefits, (7) alternative minimum tax preference items, (8) individual share of business taxes, and (9) excluded income of U.S. citizens living abroad. Categories are measured at 2017 levels.

[2] Includes nonfilers, excludes dependents and returns with negative income.

Source: Joint Committee on Taxation staff estimates.
alternative minimum tax (AMT), which requires taxpayers to recalculate their tax bills using a completely different set of rules from the ordinary personal income tax and then to pay whichever of the two tax bills is larger, will apply to tens of millions of taxpayers by the end of this decade unless changes are made. Further in the future, an aging population and rising medical costs imply that promised spending on Social Security and Medicare will greatly exceed currently scheduled taxes for those programs, meaning that some combination of massive tax increases and substantial cutbacks in promised benefits will be required eventually.

Opinions differ on what the recent changes augur for the prospects of sweeping reform. Conservative commentator Bruce Bartlett conjectured that the tax changes of 2001 and 2003 were part of a long-term strategy to move the tax system toward something like the “flat tax” in gradual steps. Len Burman of the Urban Institute offered the less sanguine opinion that the tax changes were part of a strategy to make the income tax such a mess that it would “collapse under its own weight.” Others argued that a truly fundamental tax reform would involve such difficult and politically unpopular trade-offs (and inevitably create winners and losers) that it might need to be accompanied by a significant tax cut as a sweetener. By giving away the tax cut before the reform and by adding ever more special preferences to the tax code, which develop their own constituencies, the prospects for anything deserving of the label “fundamental reform” might have grown dimmer.

In 2005, President Bush appointed an advisory panel to make recommendations about the federal tax system. Its report, issued in November of 2005, laid out two alternative tax systems—one a modified income tax and the other a hybrid of an income tax and a consumption tax. The report attracted little interest, and its recommendations have not prompted tax reform legislation.

Why the tax system attracts all this attention is no mystery. It is the aspect of government that directly affects more people than any other. Taxes at all levels of government take slightly less than one-third of people’s income. Although tax cuts and tax reform are appealing to many people, Americans also have a right to be apprehensive about big changes in the tax system. Some are concerned that tax cuts just create big budget deficits and trade better times now for much higher taxes, or even a financial crisis, later. Others are concerned that fundamental tax reform would trade the deductions and credits they rely on for lower tax rates and that rates would soon afterward climb back up
to where they were, leaving them worse off. In both cases, some people worry that big changes in the distribution of the tax burden will eventually shift more of it their way. Despite these concerns, there’s plenty of frustration with the existing tax system and little doubt that we ought to be able to do better.

Complaints about the Current Tax System

The most common complaint about taxes is straightforward enough: they are too high. To some degree, this complaint just reflects self-interest; no one likes to pay taxes, just as no one enjoys paying utility bills. We all benefit in some way, however, from the government activities that those taxes finance. As U.S. Supreme Court Chief Justice Oliver Wendell Holmes, Jr., once noted, “Taxes are what we pay for civilized society.”

Dissatisfaction with the overall level of taxes sometimes arises from a deep-seated opposition to allowing government to play an active role in society or from a belief that the government is wasting money. Many voters want to see a smaller government, with a correspondingly smaller tax bill. Such questions are naturally controversial and difficult to resolve. But even agreement on how big government should be—and therefore on how much tax money needs to be collected—would not resolve how those taxes should be raised. Similarly, people who disagree vehemently about the proper size of government might well find agreement on how our tax system ought to be designed. The design of the tax system sometimes gets short shrift in a political debate dominated by differences over the level of taxes, but it is a crucially important issue.

It Is Too Complicated

Another common grievance with the U.S. tax system is that it is too complicated. For many, complying with our labyrinthine tax regulations is frustrating, costly, and intrusive. Literally billions of hours are spent every year in the United States on fundamentally unproductive tax-related activities such as recordkeeping, wading through instructions, hunting for deductions and credits, and arranging personal and business financial affairs to avoid unnecessary tax payments and to take advantage of tax preferences.

The cost of this complexity is staggering. In total, individual taxpayers spend as much as 3 billion hours of their own time on tax matters,
or about 27 hours per taxpayer on average. That is the equivalent of over 1.5 million full-time (but hidden and unpaid) IRS employees! Many buy books or computer software programs such as TurboTax to help them through tax season. On top of that, well over half of all individual taxpayers purchase professional assistance from an accountant, a lawyer, or another adviser to help prepare their tax returns. Businesses also face a heavy compliance burden, with a typical Fortune 500 firm spending $4.6 million per year on tax matters. The total cost of collecting income taxes, including the value of those billions of hours that taxpayers could have put to better use, is probably $135 billion per year or more, which amounts to more than 10 cents for every dollar of revenue raised.

Of course, the taxpaying process is not difficult for everyone. Millions of low-income households need not submit a return at all. Of the 132 million taxpayers who do file individual returns, 16 percent are able to use the very simple Form 1040EZ, and 22 percent use the fairly straightforward Form 1040A. All in all, survey evidence indicates that 45 percent of all taxpayers spend fewer than ten hours per year on their taxes. But for businesses and individuals with more complicated finances, the burden of compliance can be onerous indeed.

It Is Difficult and Sometimes Intrusive to Enforce
The IRS budget for 2005 was $10.2 billion. In a single year, the IRS processes over 174 million returns, including 134 million individual returns. It audits or “examines” about 1.3 million tax returns and additionally sends 3.5 million computer-generated notices to taxpayers who are suspected of having reported incorrect tax liabilities. The IRS compares data from 1.5 billion documents—such as information reports from banks, stockbrokers, and mortgage lenders—to the numbers that taxpayers report on their returns.

Despite the significant expenditures on IRS enforcement, the massive compliance costs borne by the public, and the miseries suffered by those who are investigated by the IRS, a great deal of cheating on taxes apparently still occurs. Such things are hard to measure accurately, but the most recent estimate by the IRS suggests that about 16 percent of what should be paid in personal and corporate income tax, amounting to $345 billion, is not paid and that $290 billion of this will never be collected. Other things being equal, this means higher tax rates and a heavier burden for the many people who are honest or who have few opportunities to cheat.
The flip side of tax evasion is that the IRS has sometimes been accused of using heavy-handed tactics to enforce the tax law. Televised congressional hearings in the late 1990s highlighted cases where the IRS appeared to overstep its bounds and led to new legislation that set up an oversight board for the IRS and shifted the burden of proof in a tax court case to the IRS, among other changes. Since then, the IRS has made progress in modernizing its operations, improving taxpayer service, and burnishing its public image. However, abundant evidence shows that this progress has been accompanied by a dramatic decline in the amount of auditing and enforcement activity undertaken by the IRS, raising concerns of a major adverse impact on tax compliance. Recently, the pendulum of tax enforcement appears to have begun swinging in the other direction. Spurred by highly publicized tax-shelter abuses by companies such as Enron and by prominent executives, in 2003 the Bush administration proposed to give the IRS a budget increase, including some funding for initiatives to improve enforcement of tax compliance for high-income taxpayers and businesses. Nevertheless, many indicators of enforcement are still quite a bit below their levels of a decade ago.

It is Bad for the Economy

Political debates often revolve around how taxes affect the economy. Proponents of tax reforms or tax cuts almost always trumpet the economic benefits that they expect to result from their changes, and opponents argue that these claims are greatly exaggerated. During recessions, the focus turns to whether tax cuts will jumpstart the sluggish economy. Other times, the focus is on how the design of the tax system affects long-term economic prosperity.

The sheer size of taxes—in 2005, federal taxes were $2.2 trillion, or 18 percent of the gross domestic product, while state and local taxes took up another 9.5 percent—suggests that they can have an important effect on the way the U.S. economy operates. But beyond the magnitude of tax collections, taxes affect the terms of almost every economic decision that an individual or a company makes. Taxes affect, and for the most part reduce, the rewards obtained from saving, working hard, taking a second job, and investing in education or training. The income tax reduces how much it costs to contribute to charity, buy a home, or put children in day care. Business decisions such as whether and how much to invest in a new technology or whether to locate a factory in the United States or India can hinge on the tax consequences of the
action. Because it alters the incentives associated with all these and scores of other decisions, the tax system can affect the actions people and businesses take. And the aggregate of all these actions comprises the economy.

Some critics of the current income tax charge that high tax rates on the wealthy discourage the hard work, innovation, and entrepreneurship necessary for a vibrant economy. Others stress that the tax system inordinately penalizes saving and investment, which are essential for maintaining and improving the country's long-run standard of living, and that it is at least partly responsible for a U.S. national saving rate that is low by both international and historical standards. Another criticism is that the preferences and penalties that are littered throughout the individual and corporate income tax codes can significantly distort economic choices. By capriciously changing the relative costs and benefits of various activities and investments from what they would be in the free market, goes this argument, the tax system causes us to channel our resources to the wrong places, hampering the efficiency of the economy and shackling long-term growth prospects.

It Is Unfair
Americans are understandably divided in their opinions on the fairness of the tax system. A 2003 poll found Americans almost equally split. Only 4 percent of people said the federal tax system was “very fair,” but 47 percent thought it “moderately fair,” so that just over half consider it to be fair to some extent. In contrast, 32 percent said it was “not too fair,” and 16 percent felt that it was “not fair at all.” Putting aside rounding error, this is very close to a 50-50 split.

What is it about taxes that people think is either fair or unfair? For one thing, people disagree about how the burden should be shared across families of different levels of affluence. The current personal income tax is “progressive,” meaning that higher-income people typically pay a larger percentage of their incomes in taxes than do those with lower incomes. For some, a “fair” tax system means maintaining this progressivity and perhaps increasing the burden on those with high incomes. But others dismiss this as “soaking the rich” or “class warfare” and would prefer a less progressive system. Not surprisingly, people’s views about whether the tax system is fair are strongly influenced by how hard the tax system hits their own families.
Even among families with the same income, the tax burden can differ widely depending on whether family members are married, how many dependent children they have, how much they give to charity, whether they own or rent housing, and whether their income is mostly from wages or salaries or from capital gains. Whether these and other characteristics and choices should affect one’s tax burden is a contentious and often divisive issue and raises fundamental questions about the role of government in favoring or penalizing particular types of people and choices.

Finally, many believe that those individuals and corporations with good lobbyists, lawyers, and accountants are able to manipulate the tax code and take advantage of numerous loopholes and preferences to avoid paying their “fair share” of the tax burden. Such beliefs may lead to support for a streamlined tax system that eliminates opportunities for tax avoidance or for a more effective system of enforcement that prevents the tax burden from being shifted onto those taxpayers who do not have the influence, opportunity, or inclination to escape them.

A Different Way to Tax

One way to deal with these problems is to start over. Indeed, several congressional leaders, some Republican presidential candidates, a talk-show host or two, as well as some prominent economists have advocated abolishing the existing personal and corporate income tax systems and replacing them with something quite different. Consider, for example, this statement from recently retired House Ways and Means Committee chair Bill Archer (R-TX): “We’ve got to tear the income-tax system out by its roots. We have to remove the Internal Revenue Service from the lives of Americans totally.” Or this from one-time Republican presidential hopeful Steve Forbes: “With a beast like this, the only thing to do is kill it.”

Archer, Forbes, and others would like to replace the personal and corporate income taxes entirely with some form of tax on consumption—that is, on the portion of income that people spend rather than save. Most attention has focused on two forms of consumption tax—a national retail sales tax and a so-called flat tax.

The more familiar of the two is the retail sales tax, since it is already used by all but five states. Proposals for such a tax have been presented
in Congress in recent years by Representatives John Linder (R-GA) and Collin Peterson (D-MN). Another adherent of this approach is a former Republican presidential candidate, Senator Richard Lugar, who supported a plan to replace the corporate and personal income taxes with a 17 percent national retail sales tax.¹⁶ Lugar argued that “the national sales tax would allow for the dismantling of the current IRS and the intrusive, inefficient, and costly enforcement of the current tax code” and that under it “Americans [would] enjoy a capital formation boom [with] . . . increased productivity, higher paying jobs, and new investment from around the world attracted by a policy of no income taxes.”²⁰

Another alternative to the income tax is the “flat tax” developed by Robert Hall of Stanford University and Alvin Rabushka of the Hoover Institution. Steve Forbes championed a 17 percent flat tax in his runs at the Republican presidential sweepstakes in early 1996 and 2000, and similar proposals have been put forward in Congress by Senator Richard Shelby (R-AL) and former House majority leader Richard Armey (R-TX). Under the flat tax, most individuals would still have to file a tax return, but it would differ from the current system on three key dimensions. First, the tax base would include wages, salaries, and pension benefits, but all other kinds of income (such as interest, dividends, and capital gains) would be completely excluded from taxation at the personal level. Second, all taxable income above an exempt level, based on family size, would be subject to a single, “flat” rate of tax. Finally, tax returns would allow no itemized deductions or other special preferences of any kind—no deductions for mortgage interest, charitable contributions, or child care and no Hope Scholarship Credit. Proponents emphasize that, as a result of this clean tax base, the flat-tax return for individuals could fit on a postcard! As we explain in chapter 7, although it looks like a simpler version of our current tax system, the flat tax is actually not an income tax at all. Instead, it is a kind of consumption tax and a close relative of a retail sales tax or a European-style value-added tax (VAT).

Advocates of the flat tax express great confidence in its potential benefits. Hall and Rabushka promise their flat tax “would give an enormous boost to the U.S. economy by dramatically improving incentives to work, save, invest, and take entrepreneurial risks” and assert that it is “fair to ordinary Americans because it would provide a tax-free allowance.” Finally, they pledge that the flat tax “would save taxpayers hundreds of billions in direct and indirect compliance
costs." In short, they and the other supporters of the flat tax argue that it would address the major complaints made about today's tax system.

Objections to Radical Reform

Although almost everyone criticizes some aspects of the U.S. tax system, not everyone favors a complete overhaul. Over 80 percent of the members of the National Tax Association (the leading professional group of tax experts from academia, government, and business) favor retaining a personal income tax with rates that rise with income. The most commonly expressed objection to radical reform proposals is that the average taxpayer would end up with the short end of the stick. Robert McIntyre of Citizens for Tax Justice says, "There is little or no disagreement among serious analysts that replacing the current, progressive income tax with a flat-rate tax would dramatically shift the tax burden away from the wealthy—and onto the middle class and the poor." Unless a national sales tax is accompanied by some difficult-to-implement form of rebate scheme, it could shift even more of the tax burden toward low-income families.

Are we willing to accept a big change in who bears the tax burden in exchange for the promised benefits of the reforms? The public appears to be ambivalent. Surveys consistently find that solid majorities of the public want taxes on upper-income people to go up instead of down. On the other hand, polls generally find that support for a flat tax is close to that for a progressive income tax and that the poll results can depend on precisely how the question is asked. A crucial factor is that many Americans apparently believe (incorrectly) that the current distribution of income tax burdens is not progressive (i.e., the rich do not pay a higher fraction of their income in taxes than others), perhaps because they think loopholes for the rich are pervasive. Survey evidence also makes clear that most people know relatively little about the current tax system or proposals for reform, so in the event of a serious reform effort, public opinion may change as people learn more about the details.

A second common critique of the radical reform proposals is that their promised economic and simplification benefits are overstated. Although proponents have touted their potential for improving long-run economic growth and simplifying the taxpaying process, the degree to which they would accomplish these goals is subject to
much debate among economists. There is much more uncertainty about the positive economic consequences of tax reform than advocates let on.

Even most skeptics admit that a flat tax could be significantly simpler than the current system. But much of the simplification that the flat tax promises comes at the cost of forgoing progressivity and the kind of personalized tax system that many Americans appear to favor. And while a national retail sales tax may appear simple on its surface, many experts are concerned that it would be impossible to administer equitably at the rates necessary to replace the revenues now generated by the income tax—rates probably in excess of 30 percent.

Finally, some skeptics are afraid that we’re opening quite a can of worms. A free-for-all over tax policy, with special interests thrown into the mix, could conceivably end up producing legislation that is even more of a mess than what we have now. Similarly, some critics and advocates of reform are united by the concern that once we overhaul the system it will inevitably and gradually get messed up again. They argue that any one-time tax change ought to be accompanied by reforms in the policy process itself to prevent a gradual drift back to complexity, inefficiency, and unfairness.

Changes in the Context of the Current System

Don’t hold your breath waiting for the Congress to dump the income tax and start over from scratch. In the meantime, big—if not radical—changes in the tax system are being debated and enacted all the time. Politicians are constantly fighting over and changing things like income tax rates, saving incentives, the tax treatment of capital gains, and special deductions and credits for all manner of politically favored items. These debates may not capture the imagination in the same way that throwing the whole system out and starting over might, but the resulting changes in the tax code can have important implications for the economy and for the fairness and complexity of the tax system. Indeed, it should be possible to reform the income tax in a way that makes it significantly simpler, better for the economy, and arguably fairer without running afoul of the objections to more radical reforms raised above and without necessarily throwing the existing system out altogether.
The Need for Objective Analysis

Sorting out the claims and counterclaims made for tax cut, tax increase, or tax reform proposals is a difficult task even for the most informed and interested citizens who must wade through a sea of self-serving arguments. Those groups that have the most to gain or lose from tax reform produce arguments that buttress their point of view. They don’t trumpet the money that they (or their constituencies) stand to make but emphasize growth, productivity, and achieving the American dream. The potential losers seldom say they are opposing a policy simply because it skims their own hides but couch their argument in terms of how the national interest is hurt, how many jobs will be lost, and how unfair it is.

Making an intelligent judgment about tax policy requires seeing through the self-serving arguments to a clear understanding of the issues involved. Unfortunately, judgments and policy decisions must be made without the luxury of having definitive answers to many of the critical questions. For example, whether cutting taxes by 10 percent will cause the gross domestic product to rise by 2 percent, fall by 2 percent, or have no effect at all will never be definitely known, although economists can shed light on such questions and rule out certain outlandish claims. Some issues, such as what is “fair,” ultimately rely on individual value judgments.

What’s in This Citizen’s Guide

This book offers a guide to the always contentious debate over tax policy and is designed to help the concerned citizen come to informed judgments. Our goal is to cut through the academic jargon, the “Washingtonspeak,” and the self-serving arguments to explore the fundamental choices and questions inherent in tax policymaking. We have no tax plan of our own to push.

Chapter 2 offers some historical and international perspectives on taxation in the United States and a concise description of the current federal tax system. Chapters 3 through 5 examine the basic criteria by which tax policy should be judged—how fairly it assigns tax burdens, whether it promotes or inhibits growth and prosperity, and whether it is simple and enforceable. As we lay out the basic principles underlying these criteria, we also explore the controversies and difficulties that
In 2005, retail sales taxes accounted for 33 percent of state and local tax revenues, while property taxes provided another 30 percent. Income taxation plays a smaller role for states and localities; 21 percent of their tax revenues came from personal income taxes, while just 5 percent came from corporate income taxes.

International Comparisons

Table 2.2 shows how our nation’s tax system stacks up against those of other economically advanced countries. Relative to the size of our economy, the United States has lower taxes than most comparable countries. In 2004, shortly after two major tax cuts had been enacted, the United States had the third-lowest tax-to-GDP ratio of the thirty

<table>
<thead>
<tr>
<th>Table 2.2</th>
<th>International comparison of taxes as a percentage of GDP, 2004</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>United States</td>
</tr>
<tr>
<td>Total taxes</td>
<td>25.5</td>
</tr>
<tr>
<td>Income taxes</td>
<td>11.1</td>
</tr>
<tr>
<td>Personal income taxes</td>
<td>8.9</td>
</tr>
<tr>
<td>Corporate income taxes</td>
<td>2.2</td>
</tr>
<tr>
<td>Consumption taxes</td>
<td>4.0</td>
</tr>
<tr>
<td>Value-added taxes</td>
<td>—</td>
</tr>
<tr>
<td>Social insurance taxes</td>
<td>2.2</td>
</tr>
<tr>
<td>Other taxes</td>
<td>3.7</td>
</tr>
</tbody>
</table>

Source: OECD (2006)

Notes: Dash (—) indicates tax not used by country in question. Includes taxes at all levels of government.

a. Unweighted average of all thirty nations in the Organisation for Economic Co-operation and Development.

b. Includes value-added taxes, sales taxes, excise taxes, import and customs duties, and other consumption taxes.
countries in the Organisation for Economic Co-operation and Development (OECD), a group of industrialized nations from North America, Europe, Asia, and the Pacific. On average, OECD countries raised taxes equal to 35.9 percent of their GDPs in 2004, compared to 25.5 percent for the United States. Among rich countries, only Japan is close to the the low U.S. level, with taxes equal to 26.4 percent of GDP. At the high end, Sweden had taxes amounting to a whopping 50.4 percent of GDP.

It is not our reliance on income taxes or social insurance taxes that sets the United States apart from most other advanced nations; for these two types of tax, our tax-to-GDP ratio is close to the OECD mean. The big difference is how little we collect from consumption taxes—just 4 percent of GDP in consumption taxes compared to the 10.8 percent OECD average. This is due mostly to the fact that the United States is the only OECD country not to have a value-added tax (VAT), a close cousin of both the flat tax and retail sales tax discussed at length in chapter 7. The VAT is the most common variety of consumption tax in the rest of the world and is now used in over 120 countries. On average, the OECD countries raise 6.5 percent of GDP with their VATs. Retail sales taxes, the kind of general consumption tax used by the states, are rare outside the United States.

Completely replacing the U.S. personal and corporate income taxation with a consumption tax, as some advocate, would be an unprecedented move among major industrialized nations. All of the OECD countries have significant income taxes in addition to their value-added taxes. However, the amount of revenue relative to GDP that would be required to replace income taxation in the United States would not be that much larger than what is raised by value-added taxes already used in some other countries. Retail sales taxes of that size, though, have never been attempted in any of these nations; we discuss why in chapter 7.

Historical Perspectives on the U.S. Tax System

The Overall Level of Taxes
Figure 2.1 illustrates how government revenues have changed relative to the size of the economy in the United States since 1900. Perhaps the most striking feature is the tremendous growth in the role of the federal government in the first half of the twentieth century. Federal taxes rose from 2.8 percent of GDP in 1900 to 19.5 percent by 1943. World War II
was clearly the critical juncture, although the New Deal years of the 1930s were also important. Not only did federal revenues grow significantly relative to GDP during the 1930s, but many programs that would require high taxes in later years, such as the Social Security system, were born in this period.

Equally striking is how little the ratio of federal taxes to GDP has changed since the mid-twentieth century. Since 1950, federal taxes have averaged 18.1 percent of GDP and seldom strayed far from that level. For all the contentious debate about the expanding federal government and attempts to downsize it, taxes as a share of the economy have not changed much for nearly sixty years. There have been some recent blips, though. Beginning in the late 1990s, there was a largely unexpected, and apparently temporary, surge in federal income tax revenues, which had more to do with economic conditions than any changes in tax law. By 2005, due to tax cuts and a recession, federal taxes were back down to 18.0 percent of GDP.

State and local taxes have followed a somewhat more complicated pattern. In the early part of the twentieth century, state and local
governments raised more money than the federal government. At their peak in 1932, they were collecting four times as much tax revenue as the federal government—10.8 percent of GDP versus only 2.7 percent. As the federal role in the economy expanded, due in part to New Deal programs, state and local revenues shrank dramatically relative to GDP, hitting a low of just 4.1 percent by 1944. They then rebounded throughout the 1950s and 1960s and reached 9.0 percent of GDP by 1970. Since then, they have consistently remained in the 8 to 10 percent range.

Putting federal, state, and local government taxes together, the story is as follows. Taxes grew enormously from 6.2 percent of GDP at the beginning of the twentieth century to 24 percent by the middle of World War II and then continued growing at a slower pace to 28.2 percent of GDP by 1969. They experienced relatively little net change throughout the 1970s and 1980s, increased a bit during the 1990s, and then came back down in the early 2000s. This left taxes at 27.5 percent of GDP by 2005. The bottom line is that despite a massive increase in taxes over the last century as a whole, there’s been relatively little net change in the share of national income that goes to taxes at all levels of government for about the last thirty-five years. Of course, even a fixed share of GDP can buy a great deal more in real terms today than it could three or five decades ago, due to the growth of the economy. For instance, total tax revenues including all levels of government were 3.25 times as high in inflation-adjusted dollars in 2005 as they were in 1969. Nevertheless, the total tax burden has been fairly stable relative to our incomes for a long time.

History of the U.S. Personal Income Tax
Our nation’s first income tax was a temporary emergency measure used during the Civil War; it was enacted in 1861 and expired in 1871. Beginning in the late 1800s, popular opposition mounted against what were then the major sources of federal revenues—tariffs, excise taxes, and property taxes—on the grounds that they were unfairly burdensome to working-class Americans. Many critics of the existing tax structure viewed a personal income tax—and especially a graduated income tax that exempted some amount of income—as an appealing alternative because it could be made progressive, imposing a heavier proportional burden on the rich than on the poor. Congress enacted an income tax in 1894, but one year later the U.S. Supreme Court declared it in violation of the clause in article I, section 9, of the Constitution,
which states: "No capitation, or other direct, tax shall be laid, unless in proportion to the census or enumeration herein before directed to be taken." This obstacle to an income tax was eliminated by the Sixteenth Amendment to the U.S. Constitution, which was ratified in February 1913. President Woodrow Wilson signed the modern personal income tax into law shortly thereafter, in October 1913.4

The 1913 personal income tax had graduated rates, like the current system, but they ranged from only 1 to 7 percent. Even at those rates, tiny in comparison to today’s, opponents were outraged. Senator Henry Cabot Lodge of Massachusetts remarked that graduated tax rates levied on income above an exemption level would "set a class apart and say they are to be pillaged, their property is to be confiscated."5 Many of today’s most important deductions and exclusions were already there in 1913, including the deductions for home mortgage interest, the deduction for tax payments to state and local governments, and the exclusion of interest on state and local bonds. A deduction for charitable contributions was added in 1917.6 Perhaps the biggest difference between the 1913 income tax and today’s was that personal exemptions were so large relative to typical incomes of the day that only those with extremely high incomes had to pay any income tax at all. In 1914, the first year of its operation, the total number of personal tax returns filed amounted to less than 0.5 percent of the total U.S. population; these days the figure is about 45 percent.7

Figure 2.2 illustrates how two aspects of the U.S. personal income tax—revenues as a percentage of GDP and the tax rate in the top bracket—have changed since 1913. The historical revenue pattern for the personal income tax is similar to that for the overall federal government. Until World War II, receipts were quite small, staying well below 2 percent of GDP. This was true even when top rates were very high, sometimes exceeding 70 percent, because these rates continued to apply to only a very small number of high-income people. The number of returns filed never exceeded 7 percent of the total population between 1913 and 1939.

Because of the need for a lot of revenue fast, personal income taxation was expanded dramatically during World War II. The exempt level of income was reduced greatly, transforming what had been a "class tax" into a "mass tax." In the five years between 1939 and 1944 alone, personal income tax revenues surged from 1 percent to 8 percent of GDP, and the number of returns filed rose sharply from 6 percent of the population to 34 percent. To facilitate the collection of taxes from
Figure 2.2
The U.S. personal income tax: (a) Revenues as a percentage of GDP, and (b) marginal tax rate in top bracket, 1913–2005

Sources: Carter et al. (2006); U.S. Bureau of Economic Analysis (2007); and IRS, Statistics of Income Bulletin (Fall 2006, appendix table A).
this many people, employer withholding and remitting of income taxes on wages and salaries were introduced in 1943.

Ever since rising to 8 percent of GDP during World War II, the personal income tax has rarely strayed far from that level. There was something of a surge in income tax revenues during the 1990s, and they peaked at 10.2 percent of GDP in 2000 before beginning to fall again. Although legislated hikes in federal income tax rates on high-income taxpayers in 1991 and 1993 played some role in this increase, the surge was driven largely by the booming economy and stock market and especially by a tremendous jump in the taxable incomes of the most affluent families. When the share of the nation’s income that goes to people who are already in high-income tax brackets experiences a big increase, tax revenues relative to GDP rise automatically. Largely because of the tax cuts enacted in 2001 and 2003, personal income taxes had fallen to 7.4 percent of GDP by 2005.

One striking feature of figure 2.2 is that while personal income tax revenues as a fraction of GDP have been fairly stable since World War II, the top tax rate has fallen dramatically. The top rate hit a peak of 94 percent in 1944 and 1945, stayed at 91 percent or higher from 1950 until the Kennedy-Johnson tax cut of 1964, and remained as high as 70 percent until 1980. Due to tax cuts enacted in 1981 and 1986, though, by 1988 the top rate had fallen all the way to 28 percent and in 2007 was still at 35 percent, a rate that is low by historical standards.

This top tax rate has played a central role in the public debate over taxes, especially in recent years. But note that the top rate by itself can give a misleading impression of the personal income tax as a whole. During the years when the top rate was very high, it typically affected only a small fraction of 1 percent of the population; almost everyone else was in a significantly lower tax bracket. And even among those who did face the top rate, it applied only to the portion of their incomes that exceeded the top bracket amount; all income below that fell into lower tax brackets and hence was taxed at lower rates. Moreover, historically dramatic changes have been made not only in tax rates but also in the tax base. Despite these caveats, the decline in the top rate has been a truly important part of the story of income taxes over the past few decades.

History of the U.S. Corporate Income Tax
As with the personal income tax, the first special tax on corporations in the United States was a temporary emergency levy enacted during
the Civil War. Corporate income taxation was first adopted on a permanent basis in 1909. As with the personal income tax, its support arose from opposition to the prevailing taxes of the day and a belief that its burden would fall disproportionately on the wealthy. In addition, many thought it would facilitate the regulation of corporations in an era of loose financial reporting. Unlike the personal tax, however, the corporate tax was able to escape constitutional problems because Congress packaged it as an “excise” tax.

Federal corporate income tax revenues followed a pattern similar to that of the personal income tax up through World War II (see figure 2.3). Revenues increased sharply from 1.4 percent of GDP in 1939 to a peak of 6.9 percent in 1942. From 1950 to the early 1980s, however, corporate tax revenues experienced a major decline relative to GDP, falling to just 1.5 percent of GDP by 1982. Since then, corporate tax revenues have followed the business cycle, reaching 2.4 percent in 1997 as the economy boomed, dipping back to 1.4 percent during the recession of 2002, and then rising back up to 2.6 percent by 2005, due largely to a surge in corporate profits and possibly due to less use of aggressive corporate tax shelters.

Precisely identifying the driving factors behind the large decline compared to 1950 in corporate tax revenues is difficult. The decline certainly is not due primarily to cuts in the basic tax rate imposed on the vast majority of corporate income (shown in the bottom panel of figure 2.3), which hardly changed at all between 1950 and 1986 while revenues dropped sharply. Rather, much of the decline mirrors a drop in taxable corporate profits, which averaged 9.0 percent of GDP in the 1960s, 9.1 percent of GDP in the 1970s, 6.9 percent of GDP in the 1980s, and 7.1 percent of GDP in the 1990s. After dipping to just 5.7 percent of GDP in 2002, taxable corporate profits rebounded to 7.2 percent of GDP by 2004. Some of the long-term decline reflects statutory changes in the tax base, as features such as allowances for depreciation and investment tax credits have been altered over time. In recent years, an acrimonious debate raged about whether the proliferation of tax shelters had also contributed to the erosion of corporate tax revenues; in part because tax shelters are difficult to detect (or indeed to define precisely), this debate has not been resolved. By 2007, though, there was a growing consensus that the combination of crackdowns by the IRS and new rules about corporate accounting in the Sarbanes-Oxley Act had curtailed the most egregious of corporate tax shelters. This is
Figure 2.3
The U.S. corporate income tax: (a) Revenues as a percentage of GDP, and (b) marginal tax rate on the largest corporations, 1900–2005

Sources: Carter et al. (2006), U.S. Bureau of Economic Analysis (2007), and IRS Statistics of Income Bulletin (Fall 2006, Appendix Table B).
consistent with, but probably not the only reason for, the recent uptick in corporate tax revenues.

**Recent Changes**

Dissatisfaction with the income tax is by no means a new phenomenon. Throughout its existence, both its level and its structure have generated great controversies, and the income tax has often been "reformed" in an attempt to reassign the tax burden or to achieve a desired impact on the economy.

Two of the most dramatic changes in the U.S. income tax system occurred in the 1980s. Although both happened during the Reagan administration, their underlying philosophies were vastly different and in some ways contradictory. The effects of these changes and their implications for current and future efforts to alter tax policy remain controversial and vital questions to this day.

In 1981, President Reagan and Congress collaborated to produce the Economic Recovery Tax Act (ERTA). Reagan had just won the presidency with a campaign that emphasized the negative economic effects of high tax rates and promises of a substantial across-the-board cut in personal rates. In 1980, the top personal income tax rate was 70 percent, but even people who did not have large incomes had recently begun to face unusually high rates because inflation was gradually pushing people into higher and higher tax brackets—*bracket creep*. Unchecked bracket creep from 1976 through 1981 had caused an upward blip in revenues that is clear from figure 2.2. By 1981, the ratio of federal personal income tax to GDP had risen to what was then an all-time high of 9.3 percent.

The defining feature of ERTA was tax rate cuts. At the personal level, ERTA reduced the top rate from 70 percent to 50 percent by 1982, and it cut rates in all other brackets by approximately 23 percent of their former levels over a three-year period.\(^{12}\) It also provided for automatic adjustments of tax brackets for inflation beginning in 1984 to prevent further bracket creep. In addition, several deductions in the personal and corporate income taxes were expanded or newly introduced.

No sooner had the ink dried on ERTA than projections of large federal deficits grabbed public attention. As a result of these concerns, in 1982 and 1984 Congress enacted some measures to offset a small portion of the revenue losses from ERTA. Nonetheless, revenues did decline relative to GDP following the tax cuts adopted in 1981, falling...
Don’t confuse Trump’s tax cuts with tax reform

Have you noticed the subtle reframing of Donald Trump’s tax plan? During the campaign, it was a huge tax cut. Now, Trump and his congressional allies are transforming it into the far less controversial “tax reform.” After all, while a tax cut may be dubious when the economy is growing moderately and the budget deficit tops $587 billion, who could be against tax reform?

But don’t be fooled by those who call the Trump plan reform. While it may include some random elements of reform, it would firmly retain the basic structure of today’s code. At heart it is merely a giant tax cut designed to benefit mostly businesses and high-income households.

What’s the difference? Well, a tax cut is pretty obvious. But what is tax reform, a phrase that broadly defines many different ideas?

There is the 1986 model, which cuts tax rates while reducing or eliminating tax preferences—often described as the lower-the-rates, broaden-the-base prototype. Then, there are the many ways to shift to, or at least towards, a consumption tax. They come in many varieties and with many names, such as value-added taxes, cash-flow taxes, national sales taxes, and business transfer taxes. But all share the common characteristic of reducing or eliminating taxes on savings while taxing spending.

What has Trump proposed? Because his tax ideas are both vague and constantly evolving, it is hard to really know. But while his latest version <http://www.taxpolicycenter.org/publications/analysis-donald-trumps-revised-tax-plan> seems to include bits of both versions of reform, it really looks much more like a plain old tax cut—only bigger than what we are used to seeing. The Tax Policy Center estimates that Trump would cut taxes by $6.2 trillion over the next decade. But don’t make the mistake of confusing ambitious with reform.
He is not proposing a consumption tax. True, by allowing firms the option of immediately expensing the cost of capital investment (and giving up the ability to deduct interest costs), Trump would dabble with a key element of business cash flow tax. But Trump is just dipping his toe in these waters, in stark contrast to the more comprehensive versions many of his GOP primary challengers offered. On the individual income tax side, Trump does nothing to shift to a consumption-type tax.

What about reform by broadening the base and lowering the rates? Well, there is little doubt that Trump has fully embraced the easy half of that formulation. He certainly wants to lower tax rates for businesses and most individuals. But when it comes to the hard part—cutting tax deductions and credits to offset the cost of those rate cuts—Trump doesn’t come close.

On the business side, Trump does not identify a single tax preference that he would eliminate (other than the voluntary swap of the interest deduction for expensing). His late-campaign plan promised to eliminate “most corporate tax expenditures” but he never said what they were. And in some ways, Trump may be headed in just the opposite direction. For instance, a few weeks ago two of his economic advisers suggested new tax credits to encourage businesses to invest in infrastructure.

Similarly, Trump did not identify a single individual income tax preference that he’d eliminate or scale back. He did say he’d limit the ability of hedge fund operators and others to treat compensation as capital gains instead of ordinary income. And he vowed to cap itemized deductions. But he also proposed creating both a new deduction and a new tax-favored savings account for child and dependent care costs and expanding the credit for employer-provided child care. This seems more like shuffling the base than narrowing it.

And what of the House Republican tax plan—House Speaker Paul Ryan’s “Better Way?” It too is something of a mixed bag though it is closer to something called reform. By cutting tax rates and promising to eliminate most tax deductions, it includes elements of a 1986-like rewrite. By eliminating expensing and the related deduction for interest costs and cutting taxes on investment income, it includes
hints of a consumption tax. But mostly it too is a very big tax cut—though not quite as grand as Trump’s. TPC’s estimates
<http://www.taxpolicycenter.org/publications/analysis-house-gop-tax-plan/full> the House GOP plan would cut taxes by $3.2 trillion over the next decade. If it walks like a duck....

Beware the next time you hear politicians throw around a phrase like “tax reform.” Pay more attention to what they propose than what they call it.
A Better Way for Tax Reform

Our Principle
In a Confident America, the tax code and the IRS work for us, not against us.

Our Challenge
Our tax code is a mess, and that’s putting it lightly. Multiple brackets. High rates. Special interest breaks everywhere. Rules and regulations that are too complicated to understand. It costs more and more each year just to do your taxes, let alone pay them. All of this drags people down and leaves businesses buried in paperwork and compliance problems. So instead of promoting growth, our tax code is pushing jobs overseas. And the agency charged with overseeing all of this—the IRS—has repeatedly violated the trust of the American taxpayer.

Our Vision
We need a new tax code. It needs to be fair and simple for everyone. It should be so simple that most Americans can do their taxes on a form as simple as a postcard. Our tax code should be built for growth. It should help make the United States the best place in the world to hire and invest. And if we’re going to have a better tax code, we need a better IRS, one that puts the taxpayers first.

This blueprint offers a better way to dramatic reform—without increasing the deficit. It does so by promoting growth—of American jobs, wages, and ultimately the entire economy.

Our Ideas
- Simplicity and fairness. Our plan makes the tax code simpler, fairer, and flatter, so that it’s not only easier to do your taxes, but it’s also easier to have peace of mind at critical moments in life.
- Jobs and growth. Our plan makes it easier to create jobs, raise wages, and expand opportunity for all Americans.
- A service first IRS. Our plan matches a simpler, fairer tax code with a simpler, fairer IRS that puts taxpayers first.

Simplicity and Fairness
Our plan makes the tax code simpler, fairer, and flatter, so that it’s not only easier to do your taxes, but it’s also easier to have peace of mind at critical moments, whether it’s going to school, getting a job, raising a family, or planning for retirement.

- Save time and money by making it so that most Americans can do their taxes on a form as simple as a postcard.
- Consolidate the system down to three tax brackets, and lower the top individual income tax rate to 33 percent.
- Simplify tax filing for families by creating a larger standard deduction and a larger child and dependent tax credit.
- Make it easier to pay for college by streamlining the maze of education tax benefits.
- Eliminate the alternative minimum tax so you don’t have to do your taxes twice a year.
- Reward work by improving the EITC.
- Encourage charitable giving by providing a real tax incentive.
- Help families plan for retirement by reforming savings provisions.
- Stop overtaxing “Made in America” products so that our manufacturers can compete.
- Repeal the death tax so that the loss of a family member will no longer be taxable.
JOBS AND GROWTH
Our plan will make it easier to create jobs, raise wages, and expand opportunity for all Americans.

- Cut taxes on small businesses by creating a separate, low tax rate of 25 percent for many on Main Street.
- Cut taxes on savings and investment by allowing families and individuals to deduct 50 percent of the dividends, capital gains, and interest received from stocks and mutual funds.
- Provide a tax-free return on new investment by allowing, for the first time ever, full and immediate write-offs.
- Restore American competitiveness by lowering our corporate tax rate from the highest in the industrialized world to 20 percent and shifting to a “territorial” system with more competitive rates.
- Create more certainty by eliminating the death tax, which can take up to 40 percent of a family business’s assets if the owner passes away.

A SERVICE FIRST IRS
A simpler, fairer tax code will require a simpler, fairer IRS with one mission: Put the taxpayers first.

- Restructure the IRS around three major units: one for individuals and families, one for businesses of all sizes, and one that provides an independent “small claims court” approach to resolving routine disputes quickly.
- Install a new commissioner, subject to term limits, who will be required to administer the new tax code with fairness and keep the politics out of the IRS.
- Cut down on IRS intimidation by creating an Office of Dispute Resolution to serve as an independent arbiter to protect your rights and resolve disputes in a timely manner.
- Clear out the bureaucracy by doing away with all the rules, regulations, forms, and instructions that won’t be needed with a simpler, fairer tax code.
- Modernize information systems so that taxpayers have access to the resources they need when they need them—all while protecting privacy.
2017 Tax Reform for Economic Growth and American Jobs

The Biggest Individual And Business Tax Cut In American History

Goals For Tax Reform

- Grow the economy and create millions of jobs
- Simplify our burdensome tax code
- Provide tax relief to American families—especially middle-income families
- Lower the business tax rate from one of the highest in the world to one of the lowest

Individual Reform

- Tax relief for American families, especially middle-income families:
  - Reducing the 7 tax brackets to 3 tax brackets of 10%, 25% and 35%
  - Doubling the standard deduction
  - Providing tax relief for families with child and dependent care expenses
- Simplification:
  - Eliminate targeted tax breaks that mainly benefit the wealthiest taxpayers
  - Protect the home ownership and charitable gift tax deductions
  - Repeal the Alternative Minimum Tax
  - Repeal the death tax

- Repeal the 3.8% Obamacare tax that hits small businesses and investment income

Business Reform

- 15% business tax rate
- Territorial tax system to level the playing field for American companies
- One-time tax on trillions of dollars held overseas
- Eliminate tax breaks for special interests

Process

- Throughout the month of May, the Trump Administration will hold listening sessions with stakeholders to receive their input and will continue working with the House and Senate to develop the details of a plan that provides massive tax relief, creates jobs, and makes America more competitive—and can pass both chambers.