

REIGNITING AMERICAN GROWTH AND
PROSPERITY SERIES: INCENTIVIZING
ECONOMIC EXCELLENCE THROUGH TAX POLICY

HEARING
BEFORE THE
COMMITTEE ON THE BUDGET
HOUSE OF REPRESENTATIVES
ONE HUNDRED EIGHTEENTH CONGRESS
FIRST SESSION

HEARING HELD IN WASHINGTON, D.C., JUNE 22, 2023

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CONTENTS

	Page
Hearing held in Washington, D.C., June 22, 2023	1
Hon. Jodey C. Arrington, Chairman, Committee on the Budget	1
Prepared Statement of	4
Hon. Brendan F. Boyle, Ranking Member, Committee on the Budget	7
Prepared Statement of	9
Hon. Sheila Jackson Lee, Member, Committee on the Budget, statement submitted for the record	13
National Association of Manufacturers, statement submitted for the record	17
Dr. William McBride, Vice President of Federal Tax Policy and Stephen J. Entin Fellow in Economics, Tax Foundation	22
Prepared Statement of	24
Mr. Kyle Pomerleau, Senior Fellow on Tax Policy, American Enterprise Institute	36
Prepared Statement of	38
Mr. Kevin Kuhlman, Vice President of Federal Government Relations, National Federation of Independent Business	51
Prepared Statement of	53
Hon. Mark Mazur, Former Assistant Secretary for Tax Policy, U.S. Department of the Treasury	59
Prepared Statement of	61
Hon. Rudy Yakym, Member, Committee on the Budget, submission for the record	88
Hon. Lloyd Smucker, Member, Committee on the Budget, submission for the record	119
Hon. Lloyd Smucker, Member, Committee on the Budget, submission for the record	214
Hon. Michael Burgess, Member, Committee on the Budget, submission for the record	256
Hon. Michael Burgess, Member, Committee on the Budget, submission for the record	263
Hon. Michael Burgess, Member, Committee on the Budget, submission for the record	269
Questions and Answers submitted for the record	276

REIGNITING AMERICAN GROWTH AND PROSPERITY SERIES: INCENTIVIZING ECONOMIC EXCELLENCE THROUGH TAX POLICY

THURSDAY, JUNE 22, 2023

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
Washington, DC.

The Committee met, pursuant to call, at 12:04 p.m., in Room 210, Cannon Building, Hon. Jodey Arrington [Chairman of the Committee] presiding.

Present: Representatives Arrington, Norman, McClintonck, Grothman, Smucker, Burgess, Carter, Cline, Good, Bergman, Ferguson, Moore, Estes, Yakym, Brecheen, Edwards, Boyle, Higgins, Schakowsky, Blumenauer, Kildee, Panetta, Omar, Balint, and Scott.

Chairman ARRINGTON. I want the record to reflect we are waiting on my Democrat Ranking Member.

And I also want to take this opportunity to wish one of our Committee Members, Mr. Blake Moore, a happy birthday. So, please join me in wishing him a happy 55 years.

Mr. MOORE. It has been a lovely 30 years.

Chairman ARRINGTON. 55 years. He is—

Mr. MOORE. Thirtieth, my 43.

Chairman ARRINGTON. It was the fifth anniversary of an announcement of our budget resolution when I was a freshman on the Budget Committee, and sad to say and report that I was unrecognizably younger and more vibrant than I am today. So, we are going to do—

VOICE. Did you say vibrant or violent?

Chairman ARRINGTON. Yeah, and violent. Yeah, and violent.

Thank you all for appearing today. We will get started momentarily.

The hearing will come to order. Today's hearing will focus on tax policies that will strengthen our economy, our balance sheet, and our Nation's financial health now and into the future.

And I would like to now yield myself such time as I may consume for an opening statement.

I want to thank our members and the witnesses for being here today. This hearing is the second in a series on growth, entitled Incentivizing Economic Excellence Through Tax Policy.

Economic growth and prosperity, I believe, is the tide that lifts all boats with more and better jobs, higher wages and income,

lower unemployment, lower poverty rates, and an overall improved standard of living for all Americans.

As we have discussed, and I think most of us believe, a vibrant and flourishing economy would also strengthen our balance sheet and improve our Nation's fiscal health by generating revenue to the Treasury, as we have witnessed since the Tax Cuts and Jobs Act of 2017. Also, that revenue will help us pay our bills and fund our priorities, it will also reduce our financial risk, lower our interest payments by bringing down our debt-to-GDP ratio, and then ultimately helping us stave off a debt crisis.

Last hearing, we examined the effects of excessive and over-reaching regulations and how they compromise our freedom, quench the entrepreneurial spirit, and suppress economic growth. We noted that President Biden, his regulatory track record at this point is two times the previous President Obama and the overall cost is at \$360 billion. That is a major drag on the economy.

We are going to focus today on the relationship between tax policy and economic growth, and again its fiscal impact on our country and our country's future.

Unfortunately, we are far from a rigorous and thriving economy today, as our Nation continues and our working families continue to suffer from sustained 40-year high inflation, and inflation is coming down, I want it to come down, but core inflation is sticking, and it is about the same as it was over the first year of this Administration. We have seen the fastest pace of interest rate hikes in history. We have experienced three consecutive quarters of economic decline with the most recent quarterly output at just around one percent.

This is a direct result, in my opinion, of too much spending and wrong-headed policies, and I will spare you all the litany of failed economic policies and the \$11 trillion in spending that I believe it put us in this tough spot, and then, for me, and I think most of our members, it has added \$6 trillion to the national debt, which is already on an unsustainable course.

We have to examine the relationship between good tax policy and our budget process. Congress has the power to tax. In 1913, the 16th Amendment gave us the power to tax directly, through income, but what we pay for, scope, mission of our Republic, who we tax, and how we tax, is of the utmost importance as we seek to responsibly pay our bills and encourage growth and ensure the financial health of the United States.

History is replete with the evidence that when you reduce the tax burden on job creators and consumers, the economy grows. Kennedy did it. Clinton did it. Bush did it. Reagan did it, and whether it was significant or modest, the result was, the economy grew.

In fact, President Kennedy said that economic growth in the post era was, post-war era rather, was the most urgent task facing our Nation, which is why he proposed a tax reform package that, by the way, included a significant reduction in the corporate rates. He said it was to step up the growth and vigor of our Nation's economy, increase job and investment opportunities, and improve our productivity. As President Kennedy said, completing this task was about protecting the security of our people.

Let me jump to the most recent example, the Tax Cuts and Jobs Act. Very proud of what we did. Would it have paid for itself? It is a good question. I think that will probably be raised by some of my colleagues. I don't know. I know that the economic feedback is positive. I know that we brought in more revenue than was projected and had to be upwardly revised several times by CBO.

I think Republicans made a mistake not to include spending cuts. I will say it and I will continue to say it. For a party that is so obsessed with out-of-control spending, for us to have the House and Senate and the Presidency, and to pass tax cuts and tax reforms and not reduce spending, which I think is the preponderance of the problem, certainly one of the two pieces of the equation here, growth and reduction in spending, I think is more than disappointing. I think it is shameful, actually, and we can't repeat that if we are given the opportunity.

But what tax cuts and tax reform did was to generate more capital investment than we have ever seen, more R&D investment than we have ever experienced. We had the lowest unemployment rate. We had the lowest poverty rate in recorded history. Six million people lifted out of poverty. A lot of benefits accrued to this country, namely, people were having better opportunities, higher paying jobs, and they kept more of their money, and that we experienced an economic renaissance.

Rather than to go through all of my notes here because I know I have filibustered before, I would just say we have to have the most simple and efficient tax code. We have to find a way to make it more simple and, simpler and more efficient. We have to have a fair and equitable tax code.

And there is going to be debate about what that means. For me, to have 40 percent of the American people not having any stake in their country is a problem. To have the top ten percent paying 75 percent of the taxes, I think that is inequitable, but we can debate that and we should.

And then, finally, we need a productive, the most productive, and most competitive tax rate. We can't have China, Communist China, have a lower tax rate on their businesses, their job creators, than we do in the United States, and even today, after lowering the corporate rates, you combine the state taxes on businesses and Federal taxes, we are paying more than businesses in Communist China, our competitor, and our adversary. That is a problem.

So, let's work together, try to figure out how to get this right. We know the formula for success after World War II. Cut spending, right size the government, the bureaucracy, take on entitlement reform. That will be a fun discussion. We haven't gotten there yet, but let's figure out how to grow this economy and leave our children a better country and a better spot with a brighter future.

And with that, I yield to my Ranking Member for such time as he may consume for his opening remarks.

[The prepared statement of Chairman Arrington follows:]



CHAIR JODEY ARRINGTON

HOUSE BUDGET COMMITTEE

Arrington Opening Statement on Incentivizing Economic Excellence Through Tax Policy

June 22, 2023

Chairman Arrington's Remarks as prepared for delivery:

This hearing is the second in a series on growth entitled, 'Incentivizing Economic Excellence Through Tax Policy.'

Economic growth and prosperity, I believe, is the tide that lifts all boats with more and better jobs, higher wages and income, lower unemployment, lower poverty rates, and an overall improved standard of living for all Americans. But as we've discussed, and I think most of us believe, a vibrant and flourishing economy would also strengthen our balance sheet and improve our Nation's fiscal health by generating revenue to the Treasury, as we've witnessed since the Tax Cuts and Jobs Act of 2017. Also, that revenue will help us pay our bills and fund our priorities. It will also reduce our financial risk, lower interest payments by bringing down our debt to GDP ratio, and then ultimately, helping us stave off a debt crisis.

Last hearing, we examined the effects of excessive and overreaching regulations and how they compromise our freedom, quench the entrepreneurial spirit, and suppress economic growth. We noted that President Biden's regulatory track record at this point is two times previous President Obama, and the overall cost is at \$360 billion. That is a major drag on the economy.

We're going to focus today on the relationship between tax policy and economic growth, and again, its fiscal impact on our country and our country's future.

Unfortunately, we are far from a rigorous and thriving economy today, as our Nation and our working families continue to suffer from sustained 40-year high inflation. And inflation is coming down, I want it to come down. But core inflation is sticking. And it's about the same as it was over the first year of this Administration.

We've seen the fastest pace of interest rate hikes in history, we've experienced three consecutive quarters of economic decline with the most recent quarterly output at just around 1%. This is a direct result, in my opinion, of too much spending and wrongheaded policies. And I'll spare you all the litany of failed economic policies, and the \$11 trillion in spending that I believe put us in this tough spot. And then for me, and I think most of our Members, it's added \$6 trillion to the national debt, which is already on an unsustainable course. We have to examine the relationship between good tax policy and our budget process.

Congress has the power to tax. In 1913, the 16th Amendment gave us the power to tax directly to income. But what we pay for, the scope and mission of our republic, who we tax and how we tax is of the utmost importance, as we seek to responsibly pay our bills, and encourage growth and ensure the financial health of the United States. History is replete with the evidence that when you reduce the tax burden on job creators and consumers, the economy grows. Kennedy did it. Clinton did it. Bush did it. Reagan did it. And whether it was significant or modest, the result was the economy grew.

In fact, President Kennedy said that economic growth in the post war era was 'the most urgent task facing our nation,' which is why he proposed a tax reform package that, by the way, included a significant reduction in the corporate rates. He said it was to 'step up the growth and vigor of our nation's economy,' 'increase job and investment opportunities' and 'improve our productivity.' As President Kennedy said, completing this task was about protecting the security of our people. Let me jump to the most recent example, the Tax Cuts and Jobs Act, very proud of what we did, would it have paid for itself? It's a good question, I think that will probably be raised by some of my colleagues. I don't know.

I know that the economic feedback is positive. I know that we brought in more revenue than was projected and had to be upwardly revised several times by CBO. I think Republicans made a mistake not to include spending cuts. I'll say it, and I'll continue to say it. For a party that so obsessed with out-of-control spending, for us to have the House and Senate and the presidency and to pass tax cuts and tax reforms and not reduce spending, which I think is the preponderance of the problem. Certainly, one of the two pieces of the equation here, growth and reduction and spending, I think is more than disappointing. I think it's shameful actually. And we can't repeat that if we are given the opportunity. But what tax cuts and tax reform did was to generate more capital investment than we've ever seen, more R&D investment than we've ever experienced. We had the lowest unemployment rate, we had the lowest poverty rate in recorded history, 6 million people lifted out of poverty.

A lot of benefits accrue to this country, namely, people were having better opportunities, higher paying jobs, and they kept more of their money. And we experienced an economic renaissance. Rather than go through all of my notes here, because I know I've filibustered

before, I would just say, we have to have the most simple and efficient tax code. We have to find a way to make it more simple and more efficient. We have to have a fair and equitable tax code. And there's going to be debate about what that means to have 40% of the American people not having any stake in their country, it's a problem to have the top 10% paying 75% of the taxes. I think that's a problem. I think that's inequitable. But we can debate that, and we should.

And then finally, we need a productive, the most productive and most competitive tax rate. We can't have China, Communist China have a lower tax rate on their businesses, their job creators than we do in the United States. And even today, after lowering the corporate rates, you combine the state taxes on businesses and Federal taxes, we're paying more than in businesses in communist China, our competitor, and our adversary; that's a problem. So, let's work together and try to figure out how to get this right. We know that we know the formula for success after World War II, cut spending right size the government and the bureaucracy. Take on entitlement reform. That'll be a fun discussion. We haven't gotten there yet. But let's figure out how to grow this economy and leave our children a better country and a better spot with a brighter future.

Mr. BOYLE. Well, thank you, Mr. Chairman, and glad to have this hearing today.

A number of things I wanted to respond to, maybe some other occasion or some other format we will have a chance in a respectful, of course, way to go back and forth on some of these points that you raise.

First, I would say, before I even get to my opening statement, we know definitively the answer to the question whether or not the Tax Cuts and Jobs Act paid for itself. The answer is no, and don't take my word for it. Sitting right at that chair, our guest at a previous hearing, Douglas Holtz-Eakin, clearly a well-respected right-of-center economist, his exact quote, so I don't misquote him here, when asked the question whether or not—actually I believe I was the one who asked him the question—whether or not tax cuts entirely pay for themselves, he said, "No serious economists would make such a claim."

Now, tax cuts do have some stimulative effect, more of an effect when they are targeted in the right way versus others, but no, of course, they never entirely pay for themselves. Heck, if they did, then why not have a tax rate of 0.00001 percent if we thought that they were—oh, wait, some of my friends might take me up on that. Oh, geez. I think I just won the 2024 Republican nomination, but of course, they don't pay entirely for themselves. Money does not grow on trees.

And the reality is when we—another witness testified to this, if people recall. I like to do callbacks for those longtime viewers of our hearings. When you add up the two Bush tax cuts, 2001 and 2003, and then of course they were extended jointly under split rule—President Obama and the Republican-led Congress—and then you add in the TCJA, we are missing \$10 trillion. So, when you look at that national debt figure, recognize that's where some of that debt comes from.

I would also point out, since a favorite president of mine, JFK, was invoked, it is true he did push for a tax cut. I am not sure my Republican friends would like us to go back to what the marginal rates were after those tax cuts. They were significantly higher than the taxes we have today. Indeed, we have some of the lowest tax rates right now that we have ever had since having this modern system of taxation.

Now, part of the title for this hearing is "Reigniting American Growth." I have good news. It is already happening: more than 13 million jobs created over the last two and a half years, the lowest unemployment rate since the 1960s, more jobs have been created in this presidential term than any other single term in American history.

On inflation, with the latest data that came out last week, inflation has now dropped for 11 consecutive months. It is still higher than what we would like it to be, but my goodness, are we in a different world than our friends in Europe. Their situation is much worse on inflation, without the signs that it is necessarily going to get better soon.

On this point, I had a German parliamentarian, a member of the Bundestag, in my office last week, a good ally of the United States. He was talking about the situation they are facing in terms of in-

flation and expressing the wish that inflation was in Germany what it is in the United States right now, with it dropping so heavily.

So, once again, as I have said here many times, the United States continues to lead the worldwide recovery coming out of COVID, and we need to make sure we don't do anything that would jeopardize that.

Now, finally, let me say on the other half of what I think this hearing will be, the trade picture, I am glad that we are having a hearing talking about trade. We are four percent of the world's population. Sometimes, you know, being Americans, it is very easy to forget that 96 percent of the world lives outside our shores. Mark Twain once said, "America's two best friends in the world are the Atlantic and the Pacific." So, sometimes, you know, we can have a more parochial view.

The reality is being only four percent of the world's population, we do need trade. However, I think it is clear, and in some ways there might be Democrats and Republicans who agree on this, I think there have been trade deals over the last quarter-century that have not paid close enough attention to the needs and concerns of American workers, especially America's blue collar workers.

There was a victory on that front, a bipartisan one, that is, you know, not really talked about that often, and that was the revision of NAFTA, the USMCA, a deal in which, for the first time, you saw a majority of organized labor in support. It got over 400 votes in the House of Representatives. The same number of House Democrats and House Republicans voted for USMCA.

So, it shows that this isn't just rhetoric. I am a believer that we can have trade agreements that are in our national security interest, but also balance the need for growth and the balance to drive good prices for American consumers, with also protecting the interests of American workers.

So, with that, I will yield back and look forward to hearing from our witnesses.

[The prepared statement of Ranking Member Boyle follows:]

Ranking Member Brendan F. Boyle
Hearing on Reigniting American Growth and Prosperity Series:
Incentivizing Economic Excellence Through Tax Policy
Opening Remarks
Thursday, June 22, 2023

Thank you, Mr. Chairman. And thank you to our panel of witnesses for being here today.

Today's hearing is supposed to be about "reigniting American growth" but I have to wonder if my Republican colleagues and I have been reading the same economic reports. We don't need to "reignite" American growth, because our economy is already thriving.

On the jobs front: over 13 million jobs have been created since President Biden took office. The economy is at full employment levels and wages are rising.

On inflation: Inflation has now declined for 11 months in a row, falling to the lowest level in over two years. While this does not make higher prices any less painful, last month's meaningful decline in inflation led the Fed to pause its interest rate hikes – a win for families and small businesses.

On growing our economy: Following the passage of the Infrastructure Investment and Jobs Act, the CHIPS and Science Act, and the Inflation Reduction Act, manufacturing construction is booming and America is innovating again.

Despite all the doom and gloom from my Republican colleagues, no nation on earth has emerged from the pandemic stronger than the United States of America.

While Republicans have used their power to try and stoke a catastrophic default and gut critical investments, Democrats delivered for families by enacting historic legislation that is helping to generate millions of good-paying jobs, repair our roads and bridges, shrink the deficit, and create more opportunities for Americans to succeed.

Now Republicans are actually pushing to reverse this progress and undo our historic recovery. Mere weeks after holding our economy hostage over their supposed concerns over the deficit, House Republicans are already reneging on their Bipartisan Budget Agreement. They've renewed their attacks on Social Security and Medicare and are plotting steeper cuts – all while pushing for more deficit-funded tax breaks for the wealthy and well-connected.

If House Republicans were serious about tackling the deficit, they'd enforce the laws that are already on the books. We know that for every dollar we invest in making sure the wealthy pay their fair share, we can return \$12 to American taxpayers. But Republicans would rather help the rich cheat on their taxes by crippling the IRS.

If House Republicans wanted to help grow the middle class, they'd join Democrats to lower everyday costs and expand the Child Tax Credit. Instead, Republicans are pushing corporate tax changes that would send 75% of the benefits to owners and shareholders. They're even trying to give big corporations retroactive tax breaks for previous investments. How does that help workers?

If House Republicans wanted to grow our economy, they'd build on the success of the Inflation Reduction Act and its investments in American-made clean energy and manufacturing. But Republicans would rather sacrifice American jobs, the livability of our planet, and the health of future generations just to pad the pockets of Big Oil.

It would be shocking if it wasn't so predictable. Over the last 25 years, Republicans have repeatedly showered the richest Americans with wasteful tax giveaways, adding \$10 trillion to the debt without producing any of their promised benefits for working families.

It's the same trickle-down scam that has stifled our growth and punished American families for decades.

We're seeing Republicans' same-old three-step plan play out in real time: First, Republicans cut taxes for the rich.

Then, they suddenly rediscover a fear of deficits.

And finally, they'll demand cuts to Social Security, Medicare, and other vital programs to help subsidize their extreme agenda.

If you don't believe me, just look at the FY24 Budget released by the Republican Study Committee last week. The budget – backed by almost 80% of House Republicans – calls for cuts to Social Security benefits and an end to Medicare as we know it. It will raise the age for Social Security benefits, forcing at least 77% of Americans to work longer for less, all while extending Trump's tax scam to help the rich get richer.

The RSC budget stands in stark contrast to the positive, hopeful vision for shared growth and prosperity put forward by President Biden and supported by House Democrats: a government that works for working families, an economy where the wealthy pay their fair share, and a country where every worker can live and retire with the dignity they deserve.

I am glad today's hearing will provide an opportunity to compare these two very different visions.

Chairman ARRINGTON. I associate myself with the remarks of my colleague on trade, and I look forward to opening up new markets, new customers for American producers and manufacturers.

With that, I want to thank my colleague and want to make mention that if any member has an opening statement, you can submit it for the record. I will hold the record open until the end of the day to accommodate those members who may not yet have prepared written statements.

[The information follows:]

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Washington, DC 20515

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**BUDGET COMMITTEE HEARING
“REIGNITING AMERICAN GROWTH AND PROSPERITY
SERIES: INCENTIVIZING ECONOMIC EXCELLENCE
THROUGH TAX POLICY”**

STATEMENT

**THURSDAY, JUNE 22, 2023
210 CANNON**



- Thank you, Chairman Arrington, and Ranking Member Boyle, for convening this hearing on Incentivizing Economic Excellence Through Tax Policy.
- Let me first welcome our witnesses:
 - **Dr. Mark Mazur (Democratic witness)**
 - Dr. William McBride
 - Mr. Kyle Pomerleau
 - Mr. Kevin Kuhlman

- For years Republicans have misled the American public into thinking that their policies support the middle class - in reality, their policies make the rich richer and hurt everyday Americans.
- My Republican colleagues continue to call for spending cuts despite the true cause of the rising debt: tax cuts initially enacted during Republican trifectas in the past 25 years which have slashed taxes disproportionately for the wealthy and profitable corporations, severely reducing federal revenues.
- In fact, the massive Republican tax cuts over the last 25 years have cost \$10 trillion to date and are responsible for 57 percent of the increase to the debt ratio since 2001.
- As evidence of their deceptive policies and practices, look no further than the tax bills that were marked up in the Ways and Means Committee last week.
- These bills, H.R. 3936, the *Tax Cuts for Working Families Act*, H.R. 3937, the *Small Business Jobs Act*, and H.R. 3938, and the *Build It in America Act*, extend provisions in the Tax Cuts and Jobs Act (TCJA) by increasing the standard deduction and repealing major climate subsidies in the IRA.
- None of these bills or policies will solve our fiscal problems or help working families, but they do support

the wealthy, with most benefits going to high earners and big corporations.

- Republicans continue to focus on pushing through massive tax cuts for the rich, then say that the debt is exploding to unsustainable levels, and further demand cuts to programs that families and workers' pay into and benefit from, in order to get the deficit under control and pay for their agenda.
- In 2017 Republicans passed the massive Tax Cuts and Jobs Act, which cost \$1.9 trillion, gave the majority of benefits to the rich, and did not meaningfully stimulate economic growth or pay for itself as promised.
- Now they are eager to point out that the national debt is too large, and we have a crisis on our hands.
- Republicans publicly claimed that their manufactured debt-limit crisis this spring was driven by the need to get the federal debt under control at any cost, even if that meant blowing up the global economy.
- Instead of discussing years of tax cuts for the rich, which have exploded the deficit, they are now turning to spending cuts as the solution to reduce the national debt.
- This means putting the burden on the backs of families, workers, and retirees, instead of asking the rich to pay their fair share.

- It means refusing to make investments in programs like affordable childcare and infrastructure, which would support economic growth, but instead calling for another round of tax cuts to the wealthy when they try to extend the TCJA in 2025.
- It means reducing Social Security and Medicare benefits instead of supporting funding for the IRS to enforce laws already on the books and make the wealthy pay the taxes they owe.
- It means gutting education funding, which will lead to a less-trained workforce for generations to come, instead of closing tax loopholes for corporations.
- It is time to get serious about real tax reform and policies that will truly help our economy and support the needs of our government and the American people.
- Thank you, I yield back the remainder of my time.



Statement for the Record

National Association of Manufacturers
733 10th Street NW, Suite 700
Washington, DC 20001

HOUSE BUDGET FULL COMMITTEE HEARING

"REIGNITING AMERICAN GROWTH AND PROSPERITY SERIES:
INCENTIVIZING ECONOMIC EXCELLENCE THROUGH TAX POLICY"

JUNE 22, 2023



Statement for the Record

House Budget Committee
Full Committee Hearing
“Reigniting American Growth and Prosperity Series:
Incentivizing Economic Excellence Through Tax Policy”

June 22, 2023

The National Association of Manufacturers appreciates the opportunity to submit written comments for the record as part of the House Budget Committee's hearing on “Reigniting American Growth and Prosperity Series: Incentivizing Economic Excellence Through Tax Policy.”

The NAM is the largest manufacturing association in the United States, representing large and small manufacturers in every industrial sector and in all 50 states. Manufacturing employs nearly 13 million men and women, contributes \$2.90 trillion to the U.S. economy annually, pays workers over 18% more than the average for all businesses and has one of the largest sectoral multipliers in the economy. Taken alone, manufacturing in the United States would be the eighth-largest economy in the world.

Tax policy plays a critical role in the ability of manufacturers to thrive in the United States and effectively compete in a global economy. The Tax Cuts and Jobs Act included many key reforms necessary to boost manufacturing in America: a lower, more competitive corporate tax rate, a reduced tax burden on pass-through income, incentives for investment in capital equipment and estate tax relief. Following the passage of the TCJA in 2017, manufacturers responded by hiring more workers, increasing wages and benefits and investing in their businesses and communities.

Consider the following:

- Manufacturers created 263,000 jobs in 2018, the best year for manufacturing job creation in the previous 21 years.
- Wages rose for production workers 3.4% year-over-year in March and April of 2018 (at the time, the highest since February 2003).
- Manufacturing capital expenditures increased by 4.5% and 5.7% in 2018 and 2019, respectively.

Increasing the tax burden on manufacturers would reverse these gains and result in significant job losses and harm to the economy. According to an NAM-commissioned analysis by economists from Rice University, adopting tax policy changes including but not limited to increasing the corporate tax rate to 28%, increasing the top individual tax rate to 39.6% and repealing the 20% deduction for certain pass-through business income would cost the United States 1 million jobs in just the first two years after enactment and result in an average loss of 600,000 jobs each year over the next decade.¹ In addition to these job losses, wages, investment and U.S. GDP would all decline under a less competitive tax code.² Moreover, in the NAM's latest quarterly survey of manufacturers, 88% of respondents said higher tax burdens on manufacturing income would make it difficult for their companies to expand their workforce, invest in new equipment or expand their facilities.³

¹ Diamond, John W. and George R. Zodrow. “Dynamic Estimates of the Macroeconomic Effects of Tax Rate Increases and Other Tax Policy Changes” (April 2021). Available at <https://www.nam.org/wp-content/uploads/2021/04/NAM-Tax-Study-2021.pdf>.

² *Ibid.*

³ Manufacturers' Outlook Survey: Second Quarter 2023, National Association of Manufacturers (June 7, 2023). Available at https://www.nam.org/wp-content/uploads/2023/03/Manufacturers_Outlook_Survey_Q2_June_2023.pdf.

Unfortunately, several harmful tax changes have recently gone into effect that make it more costly to buy machinery, perform research and finance capital investments. If not reversed, these policies will hurt manufacturers' ability to create jobs in the United States, invest in their communities and effectively compete in the global economy. Moreover, starting in 2026, several scheduled tax increases affecting pass-throughs and family-owned businesses are set to go into effect that would make it even harder for manufacturers to compete and succeed.

The NAM respectfully urges members of this committee to strengthen manufacturing competitiveness by supporting the tax policies described below.

1. Make permanent a key incentive for capital equipment purchases.

For the past several decades, the tax code has provided businesses with varying degrees of first-year expensing (i.e., accelerated depreciation). A 100% deduction for the purchase of equipment and machinery in the tax year purchased was in place from 2017 through 2022. This critical incentive decreases a company's tax bill in the year of purchase and frees up cash for that purchase. For capital-intensive industries like manufacturing, where the latest technology is key to production, this kind of support can be vital, especially among smaller manufacturers with tighter margins.

According to recent analysis by the nonpartisan Joint Committee on Taxation, manufacturers led all sectors in the use of expensing by a wide margin.⁴ Unfortunately, the 100% level of full expensing began to phase out this year and will be eliminated completely by 2027. If this occurs, it will become costlier for manufacturers to undertake job-creating investments, make it more difficult to strengthen domestic supply chains and harm the ability of manufacturers to compete effectively on a global scale.

The NAM thanks Chairman Arrington for introducing H.R. 2406, the Accelerate Long-Term Investment Growth Now (ALIGN) Act, which would make permanent the ability to fully expense new investments. Manufacturers urge committee members to support its passage.

2. Ensure the tax code continues to support innovation.

Manufacturers in the United States drive more innovation than any other sector, performing 55% of private-sector research and development in the U.S. In 2021 alone, manufacturers spent nearly \$350 billion on R&D. Research is the lifeblood of manufacturing: new products, new materials and new processes help propel manufacturing in America forward. Unless Congress acts, manufacturers' ability to innovate and create new products, technologies and lifesaving medicines will be harmed.

Since 1954, the tax code has recognized the important role of R&D in creating jobs and spurring innovation by providing a critical incentive for investments in R&D. Specifically, the tax code has allowed businesses to immediately deduct 100% of their R&D expenses in the same year in which they are incurred. However, as of Jan. 1, 2022, businesses have been required to amortize these expenses (deducting them over a period of years), making R&D more costly to conduct in the U.S. This change has been particularly harmful for small businesses, which account for about 15% of all private-sector R&D investments.⁵

Coming at a time of increasingly fierce global competition for research dollars, this policy—if not reversed—will hurt jobs, innovation and competitiveness. According to a recent economic analysis, the U.S. economy would lose 263,382 jobs and experience a GDP reduction of \$82.39 billion in 2023, with the manufacturing industry projected to lose nearly 60,000 jobs, if the harmful R&D amortization policy is

⁴ "Tax Incentives for Domestic Manufacturing," Joint Committee on Taxation (March 12, 2021). Available at <https://www.jct.gov/publications/2021/jcx-15-21/>.

⁵ National Center for Science and Engineering Statistics, National Science Foundation, *InfoBrief*, NSF 22-343, Oct. 4, 2022, <https://ncses.nsf.gov/pubs/nsf22343>.

not reversed quickly.⁶ For small manufacturers, the impact is especially onerous because the tax change took effect in 2022, creating unexpectedly higher tax bills during the 2023 filing season and significantly reducing the amount of capital available to reinvest into these businesses.

Unless Congress acts, the U.S. will remain just one of two developed countries with an amortization requirement for R&D expensing (the other being Belgium). Meanwhile, China, which has made no secret of its ambition to become the world leader in advanced manufacturing, provides a 200% deduction for R&D expenses for manufacturers. In fact, 17 countries, including 10 OECD countries, provide for recovery of more than 100% of eligible R&D expenses.⁷

For these reasons, the NAM strongly encourages members of the committee to support expeditious passage of H.R. 2673, the American Innovation and R&D Competitiveness Act, bipartisan legislation introduced by Reps. Ron Estes (R-KS) and John Larson (D-CT) that would repeal the R&D amortization provision, so that manufacturers in the U.S. can continue leading the world in innovation, growing the economy and creating well-paying jobs.

3. Enable manufacturers to continue to finance growth.

Debt financing plays an important role in supporting manufacturing growth. Many manufacturers borrow funds to finance long-term investments in equipment and facilities, which in turn help create jobs and enable manufacturers to compete effectively in today's global economy. At the beginning of 2022, a stricter limitation on the deductibility of interest payments on business loans went into effect, increasing the cost of financing critical investments in machinery and equipment.

The maximum interest deduction under section 163(j) of the tax code is now limited to 30% of a company's earnings before interest and tax, a substantial change from the standard in place prior to 2022, which was based on earnings before interest, tax, depreciation and amortization. By excluding depreciation and amortization, the EBIT-based limitation makes it more expensive for capital-intensive companies to finance critical purchases, grow their businesses and hire new workers. This stricter limitation effectively acts as a tax on investment and has a disproportionate impact on manufacturers given that long-lived manufacturing investment can generate significant depreciation and amortization.

The EBIT standard also makes the U.S. a global outlier and directly harms the competitiveness of manufacturers in the U.S. Of the more than 30 OECD countries with an earnings-based interest limitation, the U.S. is the only one that employs an EBIT standard.

According to a recent study, failing to reverse this harmful change could cost the U.S. economy 467,000 jobs and reduce U.S. GDP by \$43.8 billion.⁸ These job losses will be felt across the country, as the breadth and depth of manufacturing supply chains and the spillover effects of this tax increase will ensure that small and medium-sized businesses are directly affected.

The NAM encourages members of the committee to support job-creating manufacturing investments here in the U.S. by supporting expeditious passage of H.R. 2788, the American Investment in Manufacturing (AIM) Act, bipartisan legislation introduced by Reps. Adrian Smith (R-NE) and Joe Morelle (D-NY) that would permanently preserve the EBITDA standard for interest deductibility.

⁶ "New Data: Taxing R&D Will Cost U.S. More Than 260,000 Jobs Next Year If Congress Doesn't Act," National Association of Manufacturers (Dec. 16, 2022). Available at <https://www.nam.org/new-data-taxing-r&d-will-cost-u-s-more-than-260000-jobs-next-year-if-congress-doesnt-act-19949/>.

⁷ "Tax Incentives for R&D and Innovation," OECD. Available at <https://stip.oecd.org/innotax/>.

⁸ "Economic Impact of a Stricter 163(j) Interest Expense Limitation," EY (September 2022). Available at https://documents.nam.org/tax/nam_interest_deductibility_study.pdf.

4. Protect pass-through manufacturers from damaging tax increases.

Beginning in 2018, pass-through entities (including partnerships, S corporations and sole proprietorships) have been eligible for a qualified business income deduction under the new Section 199A of the Internal Revenue Code, which allows eligible taxpayers to deduct up to 20% of the income earned by their business from their taxable ordinary income. This deduction was put in place to provide targeted tax relief for small business owners that pay tax at individual rates and was coupled with a reduction in individual rates. However, both the individual rates and the Section 199A deduction are set to expire at the end of 2025, increasing the tax burden on small and medium-sized businesses that are organized as pass-through entities.

The NAM urges members of the committee to prevent the expiration of Section 199A and make permanent the individual tax rates. These looming tax increases make it difficult for small businesses to plan for long-term investments.

5. Preserve family-owned manufacturers' ability to pass their business on to the next generation.

Family-owned businesses are central to the manufacturing industry. These companies have often been pillars of their communities for generations, creating jobs, bolstering economic development, supporting charitable endeavors and investing for the future.

The estate tax can have a significant impact on family-owned manufacturers' ability to continue to operate following the death of an owner. The estate tax has a disproportionate impact on family-owned manufacturers because their companies consist largely of illiquid assets that would need to be sold or leveraged to pay the tax burden. Limiting the impact of the estate tax allows family-owned manufacturers to continue operating following the death of a loved one. Conversely, increasing the estate tax burden could force these businesses to close their doors.

In 2017, the TCJA increased the exemption threshold for the estate tax, allowing more of a family-owned business's assets to be passed on to the next generation without the company incurring a tax burden. The increased exemption is set to expire in 2026, which will expose more of family-owned businesses' assets to taxation, making it more difficult for them to continue operating and supporting local jobs following the death of a loved one.

The NAM strongly encourages members of the committee to prevent a reduction to the estate tax exemption threshold. Manufacturers also support efforts to permanently repeal the estate tax.

Additionally, the NAM encourages members of the committee to fully preserve stepped-up basis, which prevents a business owner's heirs from being forced to pay capital gains tax on the appreciation in value of the business's assets that occurred during the owner's lifetime. A recent study found that taxing these unrealized gains would cost the U.S. economy 80,000 jobs per year over the course of a decade and 100,000 jobs per year thereafter.⁹

After decades of advocating for a pro-growth, competitive tax code, manufacturers in America kept their promises following the enactment of the TCJA by raising wages and benefits, hiring more workers and investing in their communities. The NAM urges members of the committee to support competitive tax policies that will help manufacturers continue to thrive in the United States and effectively compete in a global economy.

⁹ "Repealing step-up of basis on inherited assets: Macroeconomic impacts and effects on illustrative family businesses," EY (April 2021). Available at <https://documents.nam.org/tax/ey-fbetc-stepupreport.pdf>.

Once again, I would like to welcome our witnesses. Today, we are going to hear testimony from Dr. William McBride, Vice President of Federal Tax Policy at the Tax Policy Foundation; Mr. Kyle Pomerleau, Senior Fellow on Tax Policy at the American Enterprise Institute; Mr. Kevin Kuhlman, Vice President of Federal Government Relations at the National Federation of Independent Businesses; and the Honorable Mark Mazur, Former Assistant Secretary for Tax Policy at the United States Treasury Department, and we all extend our appreciation for your time and your insights.

The Committee has received y'all's written statements, and they will be made part of the formal hearing record. You will each have five minutes to deliver your oral remarks.

I now yield five minutes to Dr. McBride.

STATEMENT OF WILLIAM MCBRIDE, VICE PRESIDENT OF FEDERAL TAX POLICY AND STEPHEN J. ENTIN FELLOW IN ECONOMICS, TAX FOUNDATION

Dr. MCBRIDE. Thank you, Chairman Arrington, Ranking Member Boyle, and Members of the Committee. I appreciate the opportunity to speak with you.

My testimony will focus on the economic effects of recent changes to the Federal tax code, including the Tax Cuts and Jobs Act, and recommend ways to boost economic growth going forward.

TCJA reduced income tax rates broadly, both for individuals and corporations, lowering taxes for every income group and improving incentives to work, save, and invest, through lower marginal income tax rates on labor and capital income.

Lowering the corporate tax rate, in particular, improved the long-run health of the economy by reducing the tax burden on corporate investment. As a result, the Joint Committee on Tax and the Congressional Budget Office both predicted more investment, more labor supply, and faster economic growth.

However, several temporary features complicate the law and reduce its impact. On the individual side, all of the individual income tax cuts expire in 2025. On the business side, the ability to immediately deduct R&D expenses ended last year. So, businesses are now required to delay those deductions for five years. Likewise, bonus depreciation initially allowed businesses to immediately write off the full cost of equipment, but now, depreciation rules are returning and require businesses to delay those deductions for up to 20 years.

We found TCJA's positive impacts on the economy would build in the first few years, resulting in a three percent increase in GDP and a 1.7 percent increase in wages by 2025, with smaller impacts in the long run. Comparison to actual outcomes is difficult due to confounding events, such as the pandemic. However, at a high level, several measures point to a strengthened economy post-TCJA. GDP investment and labor compensation all improved in the two years after enactment of TCJA and before the pandemic, relative to historic averages.

Regarding tax revenue, while TCJA was estimated to reduce revenue initially, both our analysis and that of the JCT indicated it would raise revenue by the end of the budget window. Actual tax collections have exceeded expectations, hitting an all-time high in

nominal terms last year of 4.9 trillion and 19.6 percent of GDP, which is a 22-year high. Average Federal tax collections in the five years since TCJA's enactment are higher than forecasted by the CBO, higher than most years leading up to TCJA, and higher than the long-run average.

In contrast to TCJA, President Biden's tax proposals would raise marginal income tax rates. While the proposals are ostensibly aimed at high-income earners and businesses, they would depress economic activity generally and reduce opportunities for workers at every level. Revenue raised with these tax hikes would in part be spent on tax credits and other subsidies for specific industries and taxpayers, further adding to the complexity of the tax code and expanding the scope of the IRS.

Going forward, lawmakers should focus on simplifying the Federal tax code, creating stability, and broadly improving economic incentives. As a first step, lawmakers should permanently extend R&D expensing and bonus depreciation. The policy, which would boost GDP by 0.5 percent over the long run, would add about 87,000 jobs.

As 2025 approaches, when much of the TCJA expires, lawmakers should consider fundamental tax reform to systematically address the tax code shortcomings. While there are many options, we have recently detailed and analyzed a proposal that would substantially boost economic growth and opportunity. It follows along the lines of the Estonian income tax system, which tops our annual ranking of most competitive tax systems.

The reform would fully integrate the corporate and individual income taxes to avoid double taxing corporate income. Instead of a complicated corporate income tax and separate rules that apply to passthrough businesses, all businesses would be subject to a simple 20 percent tax on distributed profits. At the individual level, a simple flat tax of 20 percent applies to all individual income, except dividends, since they are already taxed by the distributed profits tax. Capital gains are taxed as ordinary income, also at 20 percent. Rather than a complicated estate tax like ours, the taxes accumulated savings at death, bequeathed assets are simply taxed as capital gains when sold by the heir, with deductible basis determined only by cost incurred by the heir.

We find if such a system were implemented in the U.S., it would greatly simplify the tax code, saving taxpayers more than \$100 billion annually and reduce compliance cost. In addition, our modeling indicates it would increase GDP by 2.3 percent in the long run, raise wages by 1.3 percent, and add 1.3 million jobs.

My written testimony goes into other ideas along these lines. I am happy to answer any questions you may have about that. Thank you for your time and attention.

[The information follows:]

Written Testimony before the U.S. House Committee on Budget**Reigniting American Growth and Prosperity Series: Incentivizing Economic Excellence Through Tax Policy**

June 22, 2023

William McBride

Vice President of Federal Tax Policy and Stephen J. Entin Fellow in Economics, Tax Foundation

TCJA, Biden's Tax Policies, and Potential Pro-Growth Reforms

Chairman Arrington, Ranking Member Boyle, and distinguished members of the House Budget Committee, thank you for the opportunity to provide testimony on "incentivizing economic excellence through tax policy." I am William McBride, Vice President of Federal Tax Policy and Stephen J. Entin Fellow in Economics at the Tax Foundation, where I focus on how we can improve our federal tax code.

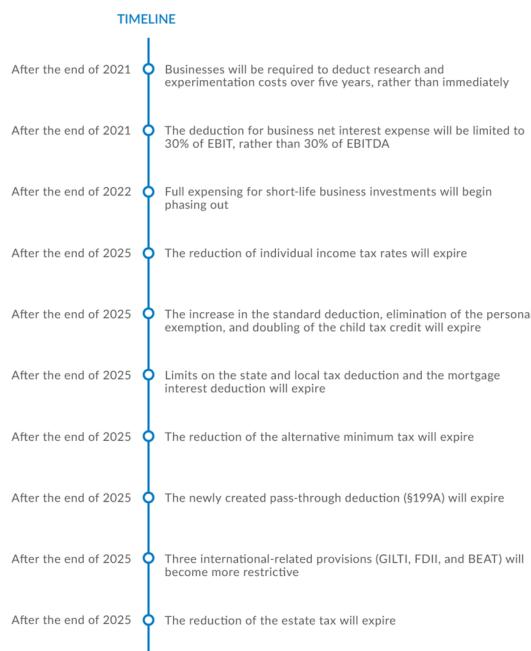
Today, my testimony will focus on three points. First, I will describe how the Tax Cuts and Jobs Act (TCJA) improved incentives and economic growth, contributing to record low unemployment and record high federal tax collections. Second, I will contrast TCJA with President Biden's tax policies. Third, I will recommend ways to reform the federal tax code to reduce complexity, improve economic incentives, grow the economy, increase opportunity, and raise sufficient tax revenues at or above current levels.

TCJA Lowered Marginal Tax Rates and Raised Economic Growth

TCJA reduced income tax rates broadly for individuals and corporations: for individuals through a set of tax cuts that apply from 2018 to 2025, including lower statutory income tax rates on individual income, a larger standard deduction, and a larger child tax credit; for corporations mainly through a permanent reduction in the statutory corporate income tax rate from 35 percent to 21 percent as well as temporary 100 percent bonus depreciation (allowing companies to immediately deduct the full cost of investment in equipment) that applies from 2018 to 2022 and is phased out thereafter. These tax cuts were partially offset by curtailing deductions, among other things, including capping individual deductions for state and local taxes and mortgage interest and limiting business deductions for interest expense and R&D. Beginning in 2022, the limit on business interest expense became more stringent and businesses were required to amortize R&D expenses over five years (15 years for foreign R&D).¹

¹ Tax Foundation, "Preliminary Details and Analysis of the Tax Cuts and Jobs Act," Dec. 18, 2017, <https://taxfoundation.org/final-tax-cuts-and-jobs-act-details-analysis/>; Huaiqin Li and Kyle Pomerleau, "The Distributional Impact of the Tax Cuts and Jobs Act over the Next Decade," Tax Foundation, Jun. 28, 2018, <https://taxfoundation.org/the-distributional-impact-of-the-tax-cuts-and-jobs-act-over-the-next-decade/>.

FIGURE 1.
Timeline of Scheduled TCJA Changes over the Next Decade



Similar to analysis by the Congressional Budget Office (CBO), in 2018, the Tax Foundation analyzed the distributional impact of TCJA and found it would reduce taxes, and raise after-tax incomes, for all income groups throughout the period 2018 to 2025 in which the law's individual income tax cuts apply.² For example, we found TCJA would raise real (inflation-adjusted) after-tax incomes for all quintiles of earners in 2022, by 0.9 percent for the bottom quintile, 1.6 percent for the middle quintile, and 2.4 percent for the top quintile, based on conventional (static) analysis that does not account for economic growth.

Also, similar to analysis by the CBO as well as several other researchers, we found that TCJA would improve incentives to work, save, and invest by lowering marginal income tax rates that apply to labor and capital income, resulting in more investment, more labor supply, and faster economic growth.³

2 Huaqun Li and Kyle Pomerleau, "The Distributional Impact of the Tax Cuts and Jobs Act over the Next Decade," Tax Foundation, Jun. 28, 2018, <https://taxfoundation.org/the-distributional-impact-of-the-tax-cuts-and-jobs-act-over-the-next-decade/>; Congressional Budget Office, "Distributional Analysis of the Tax Cuts and Jobs Act," Nov. 27, 2017, <https://www.cbo.gov/publication/53349>; Garrett Watson, "Congressional Budget Office Shows 2017 Tax Law Reduced Tax Rates Across the Board in 2018," Tax Foundation, Aug. 5, 2021, <https://taxfoundation.org/congressional-budget-office-shows-2017-tax-law-reduced-tax-rates-across-board-2018/>.

3 John McClelland and Jeffrey Werling, "How the 2017 Tax Act Affects CBO's Projections," Congressional Budget Office, Apr. 20, 2018, <https://www.cbo.gov/publication/53787>; Congressional Budget Office, "The Effects of the 2017 Tax Act on CBO's Economic and Budget Projections," Appendix B of *The Budget and Economic Outlook: 2018 to 2028*, Apr. 9, 2018, <https://www.cbo.gov/publication/53651>; Tax Foundation, "Preliminary Details and Analysis of the Tax Cuts and Jobs Act," Dec. 18, 2017, <https://taxfoundation.org/final-tax-cuts-and-jobs-act-details-analysis/>; Huaqun Li and Kyle Pomerleau, "The Distributional Impact of the Tax Cuts and Jobs Act over the Next Decade," Tax Foundation, Jun. 28, 2018, <https://taxfoundation.org/the-distributional-impact-of-the-tax-cuts-and-jobs-act-over-the-next-decade/>.

Lowering the corporate tax rate in particular improved the long-run health of the economy, reducing the tax burden on corporate investment, while bonus depreciation reduced the economic harm of both the corporate tax and individual income taxes on pass-through business income, boosting business investment incentives broadly albeit on a temporary basis.

We found TCJA's positive impacts on the economy would build over time and by 2025 would result in a 3.0 percent increase in GDP, a 6.4 percent increase in the capital stock, and a 1.7 percent increase in real wages. The improved economic growth would translate into larger incomes for all income groups. For example, accounting for the growth effects, we found TCJA would substantially raise real after-tax incomes for all quintiles of earners in 2025, by 3.9 percent for the bottom quintile, 4.1 percent for the middle quintile, and 4.9 percent for the top quintile. After 2025, as the individual tax cuts expire and business taxes increase, the economic benefits of TCJA diminish, but the law's permanent features lead to a 1.7 percent increase in GDP in the long run.⁴

At least nine other research groups, including the CBO, the Joint Committee on Taxation (JCT), and the International Monetary Fund, came to similar conclusions, although they predicted somewhat different patterns and magnitudes of growth resulting from the law, reflecting differing assumptions used and considerable uncertainty in the law's effects.⁵

Comparison of the predicted effects to actual outcomes is extraordinarily difficult due to a series of confounding and unrelated events including higher tariffs and other policy developments, a pandemic, and the return of high inflation. However, at a high level, several measures point to a strengthening economy post-TCJA relative to expectations and to historic averages. For instance, actual business investment surged in 2018 by 6.5 percent, exceeding CBO's forecast that factored in the effects of the law.⁶ In 2019, unemployment hit a 50-year low of 3.5 percent.⁷ Figure 2 and Table 1 show that economic performance, as measured by real GDP, investment, and labor compensation, improved in the two years after enactment of TCJA and before the pandemic relative to historic averages. Real GDP grew at an annual rate of 2.6 percent from 2017 to 2019, compared to 2.3 percent over the 20 years prior to TCJA. Real gross private domestic investment grew 4.2 percent and nonresidential business investment grew 5.0 percent from 2017 to 2019, compared to 2.8 percent and 3.8 percent growth respectively over the period 1997 to 2017. Real compensation of employees grew 2.6 percent from 2017 to 2019, compared to 2.1 percent over the 20 years prior to TCJA.

⁴ Tax Foundation, "Preliminary Details and Analysis of the Tax Cuts and Jobs Act," Dec. 18, 2017, <https://taxfoundation.org/final-tax-cuts-and-jobs-act-details-analysis/>; Huaqun Li and Kyle Pomerleau, "The Distributional Impact of the Tax Cuts and Jobs Act over the Next Decade," Tax Foundation, Jun. 28, 2018, <https://taxfoundation.org/the-distributional-impact-of-the-tax-cuts-and-jobs-act-over-the-next-decade/>.

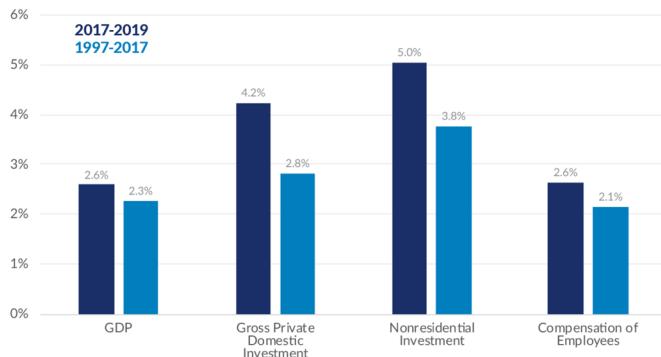
⁵ For a comparison of estimated effects, see: Congressional Budget Office, "The Effects of the 2017 Tax Act on CBO's Economic and Budget Projections," Appendix B of *The Budget and Economic Outlook: 2018 to 2028*, Apr. 9, 2018, <https://www.cbo.gov/publication/53651>.

⁶ Congressional Budget Office, "The Effects of the 2017 Tax Act on CBO's Economic and Budget Projections," Appendix B of *The Budget and Economic Outlook: 2018 to 2028*, Apr. 9, 2018, <https://www.cbo.gov/publication/53651>; Bureau of Economic Analysis, "Table 5.3.6. Real Private Fixed Investment by Type, Chained Dollars," last revised on May 25, 2023, <https://www.bea.gov/itable/national-gdp-and-personal-income>.

⁷ Bureau of Labor Statistics, <https://data.bls.gov/timeseries/LNS14000000>.

FIGURE 2.
U.S. Economy Improved after TCJA Compared to Historical Averages

Economic Performance before and after TCJA (Real Annualized Percent Change)



Source: BEA, "Table 1.1.3. Real Gross Domestic Product, Quantity Indexes"; BEA, "Table 1.10. Gross Domestic Income by Type of Income"; BEA, "Table 1.1.4. Price Indexes for Gross Domestic Product."

TABLE 1.
Economic Performance before and after TCJA (Real Annualized Percent Change)

	Post-TCJA		Pre-TCJA	
	2019-22	2017-19	2015-17	1997-2017
GDP	1.7%	2.6%	2.0%	2.3%
Gross Private Domestic Investment	2.4%	4.2%	1.5%	2.8%
Nonresidential Investment	1.6%	5.0%	2.5%	3.8%
Compensation of Employees	1.5%	2.6%	2.2%	2.1%

Source: BEA, "Table 1.1.3. Real Gross Domestic Product, Quantity Indexes"; BEA, "Table 1.10. Gross Domestic Income by Type of Income"; BEA, "Table 1.1.4. Price Indexes for Gross Domestic Product."

Tax Revenues under TCJA Have Met or Exceeded Historic Levels

Regarding revenue estimates for TCJA, the law's major changes, including a reduction in the corporate tax rate from 35 percent to 21 percent as well as the introduction of GILTI and other international provisions, resulted in considerable uncertainty about how the law might affect tax revenue, particularly due to effects on profit shifting and economic growth. While the JCT estimated in December 2017 that TCJA would reduce tax revenue by \$1.5 trillion over the period 2018 to 2027, the JCT also provided a macroeconomic analysis of the bill estimating that TCJA would increase the average level of GDP over the budget window by 0.7 percent, resulting in an offsetting increase in revenue of \$451 billion over the budget window.⁸

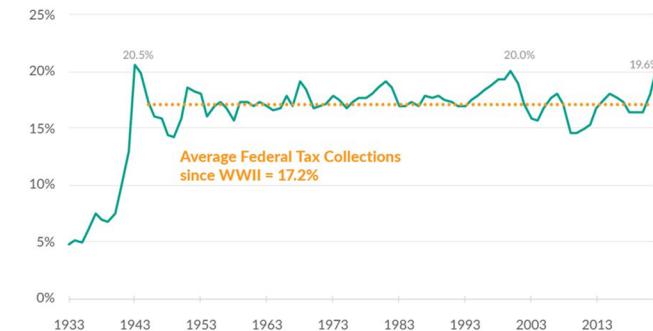
⁸ Joint Committee on Taxation, "Macroeconomic Analysis of the Conference Agreement for H.R. 1, The Tax Cuts and Jobs Act," Dec. 22, 2017, [JCT-69-17 | Joint Committee on Taxation \(jct.gov\)](http://www.jct.gov).

Our modeling and analysis of TCJA largely agreed with JCT's, though our estimates were somewhat different. We estimated TCJA would increase GDP by 2.9 percent over the budget window, reducing a static revenue loss of about \$1.8 trillion to about an \$800 billion loss after accounting for economic growth, with initial revenue losses switching to revenue gains by 2023.⁹

Actual revenue collections have generally matched or exceeded these forecasts, though noting again the influence of several non-tax factors. Federal tax collections dropped initially in fiscal years 2018 and 2019 to 16.4 percent of GDP, below the long-run average of 17.2 percent since World War II, and stayed at about that level in the pandemic year of 2020. Reflecting the rebounding economy and booming stock and housing markets, tax collections soared to 17.9 percent in 2021 and 19.6 percent in 2022, the highest level since the dot-com bubble in 2000 and nearly the highest level on record. Average federal tax collections in the five years since TCJA's enactment are about 17.3 percent of GDP, higher than the 16.7 percent forecasted by the CBO following its passage, higher than most years leading up to TCJA, and higher than the long-run average of 17.2 percent.¹⁰

FIGURE 3.
Federal Tax Collections Approaching a Record High

Total Federal Tax Revenue as a Share of GDP (1933-2022)



Source: OMB, CBO.

It remains to be seen where federal tax collections go from here. Through the first eight months of FY 2023, collections are down 11 percent relative to the same period last year, apparently due in part to reduced capital gains revenue as the stock and housing markets deflated in 2022.¹¹ However, this is relative to a record-breaking FY 2022. As such, depending on the path of GDP, federal tax collections as a share of GDP could come in near the historic average in FY 2023.

9 Tax Foundation, "Preliminary Details and Analysis of the Tax Cuts and Jobs Act," Dec. 18, 2017, <https://taxfoundation.org/final-tax-cuts-and-jobs-act-details-analysis/>.

10 William McBride, "Inflation Is Surging, So Are Federal Tax Collections," Tax Foundation, Oct. 13, 2022, <https://taxfoundation.org/federal-tax-collections-inflation-surging/>.

11 Congressional Budget Office, "Monthly Budget Review: May 2023," Jun. 8, 2023, <https://www.cbo.gov/publication/59134>.

Note that tax collections as a share of GDP reflects both changes in nominal collections and changes in nominal GDP. TCJA boosted real and nominal GDP (according to our analysis and the JCT's, for instance), so reaching and exceeding the historic average of tax collections as a share of GDP as TCJA has done understates the revenue performance of the law. Indeed, the available evidence over the last five years indicates the federal tax system under TCJA substantially boosted both the economy and federal tax collections, roughly in proportion.

President Biden's Tax Proposals Would Stifle Economic Growth

In contrast to TCJA, President Biden's tax proposals would raise marginal income tax rates, reducing incentives to work, save, and invest. While the proposals are ostensibly aimed at high-income earners and businesses, they would depress economic activity generally and reduce opportunities for workers at every level. Revenue raised with these tax hikes would in part be spent on tax credits and other subsidies for specific industries and taxpayers, further adding to the complexity of the tax code and expanding scope of the IRS.

The president's most recent budget proposes nearly \$4.8 trillion in new taxes through 2033 targeting businesses and high-income individuals, offset by about \$833 billion in tax credits leading to a net tax increase of about \$4 trillion.¹² The proposals include:

- Raising the top individual income tax rate to 39.6 percent, adding another 1.2 percent to the Medicare tax on wages, and expanding the base of the Net Investment Income Tax (NIIT) to include all pass-through business income while raising the rate to 5 percent, effectively resulting in a federal top income rate of about 44 percent (when combined with state income taxes, many taxpayers would face top rates over 50 percent).¹³
- Doubling the top capital gains tax rate to 39.6 percent, which combined with the NIIT yields a top rate of 44.6 percent—the highest rate in several decades and the highest in the Organisation for Economic Co-operation and Development (OECD).¹⁴
- Taxing unrealized capital gains with a 25 percent minimum tax, an untried and impractical policy that taxes phantom income and has many potential downsides.¹⁵
- Raising the corporate income tax rate to 28 percent, resulting in a higher corporate tax rate than any of our major trading partners.¹⁶

¹² Garrett Watson et al., "Details and Analysis of President Biden's Fiscal Year 2024 Budget Proposal," Tax Foundation, Mar. 23, 2023, <https://taxfoundation.org/biden-budget-tax-proposals-analysis/>.

¹³ Erica York, Garrett Watson, and Alex Durante, "Biden's FY 2024 Budget Would Result in More Than \$4.5 Trillion in Gross Tax Increases," Tax Foundation, Mar. 9, 2023, <https://taxfoundation.org/biden-budget-taxes/>.

¹⁴ Alex Muresianu, Erica York, and Garrett Watson, "Biden's Proposed Capital Gains Tax Rate Would be Highest for Many in a Century," Tax Foundation, Apr. 26, 2021, <https://taxfoundation.org/biden-capital-gains-tax-rate-historical/>; Clifton Painter, "Biden's Top Marginal Capital Gains Tax Rate Would Be Highest in OECD," Tax Foundation, Jul. 6, 2021, <https://taxfoundation.org/biden-capital-gains-tax-rate-oecd/>.

¹⁵ Garrett Watson and Erica York, "Proposed Minimum Tax on Billionaire Capital Gains Takes Tax Code in Wrong Direction," Tax Foundation, Mar. 30, 2022, <https://taxfoundation.org/biden-billionaire-tax-unrealized-capital-gains/>.

¹⁶ Christina Enache, "Corporate Tax Rates around the World, 2022," Tax Foundation, Dec. 13, 2022, <https://taxfoundation.org/publications/corporate-tax-rates-around-the-world/>.

- Hiking the GILTI tax and adding an Undertaxed Profits Rule (UTPR), further exposing U.S. companies to double taxation on their foreign income.¹⁷
- Quadrupling the stock buyback tax to 4 percent, which can also subject multi-national companies to double taxation.¹⁸
- Raising taxes further on targeted industries, hitting pharmaceutical innovation and oil and gas production.¹⁹

Estimating the economic effects of many of these major tax hikes, we find they would reduce the size of the economy as measured by GDP by 1.3 percent over the long run, reduce wages by 1.0 percent and eliminate 335,000 jobs. This estimate likely understates the full economic harm from the president's budget because it excludes the effects of the 25 percent minimum tax on unrealized capital gains and the UTPR, which together represent about a \$1 trillion tax hike according to the administration's estimates.²⁰

The president's budget is proposed in addition to the recently enacted Inflation Reduction Act (IRA), which includes several new, complicated, and burdensome tax hikes and tax credits that go into effect this year, including a book minimum tax, stock buyback tax, an excise tax to control drug prices, and about two dozen green energy tax credits.²¹ The IRA was originally estimated to reduce deficits, according to analysis by the CBO and JCT, and was thus sold as a way to reduce inflation. However, JCT currently estimates the cost of the green energy credits has more than doubled to \$663 billion while outside estimates put the cost at about \$1 trillion over 10 years, indicating the IRA likely increases deficits.²²

We find the IRA is a net drag on the economy, as it adds new penalties on business investment through the book minimum tax and stock buyback tax, ultimately shrinking the economy by 0.2 percent in the long run, lowering wages by 0.1 percent and eliminating 29,000 jobs.²³ However, these estimates do not capture what may be the most costly aspects of the law, which is the extraordinary complexity of many of its provisions and the associated distortionary effects of simultaneously penalizing and subsidizing specific activities and types of taxpayers, i.e., picking winners and losers on a grand scale.

¹⁷ Daniel Bunn, "U.S. Cross-border Tax Reform and the Cautionary Tale of GILTI," Tax Foundation, Feb. 17, 2021, <https://taxfoundation.org/gilti-us-cross-border-tax-reform/>.

¹⁸ Alex Durante, "Stock Buyback Tax Would Hurt Investment and Innovation," Tax Foundation, Aug. 12, 2022, <https://taxfoundation.org/inflation-reduction-act-stock-buybacks/>.

¹⁹ Erica York, "Lawmakers Revive Prescription Drug Pricing Policies and 1,900% Excise Tax," Tax Foundation, Jul. 11, 2022, <https://taxfoundation.org/prescription-drug-pricing-reform/>; Alex Muresanu and William McBride, "A Guide to the Fossil Fuel Provisions of the Biden Budget," Tax Foundation, Sep. 2, 2021, <https://taxfoundation.org/biden-fossil-fuel-tax/>.

²⁰ Garrett Watson et al., "Details and Analysis of President Biden's Fiscal Year 2024 Budget Proposal," Tax Foundation, Mar. 23, 2023, <https://taxfoundation.org/biden-budget-tax-proposals-analysis/>.

²¹ Alex Durante et al., "Details and Analysis of the Inflation Reduction Act Tax Provisions," Tax Foundation, Aug. 12, 2022, <https://taxfoundation.org/inflation-reduction-act/>.

²² William McBride and Daniel Bunn, "Repealing Inflation Reduction Act's Energy Credits Would Raise \$663 Billion, JCT Projects," Tax Foundation, Jun. 7, 2023, <https://taxfoundation.org/inflation-reduction-act-green-energy-tax-credits-analysis/>.

²³ Alex Durante et al., "Details and Analysis of the Inflation Reduction Act Tax Provisions," Tax Foundation, Aug. 12, 2022, <https://taxfoundation.org/inflation-reduction-act/>.

The book minimum tax suffers from many flaws, including the fact that book income is not a well-defined tax base, and so it requires voluminous regulatory guidance and taxpayer comments to try and sort out how it could possibly work.²⁴ Meanwhile, the guidance continues to roll out even as the new tax liabilities are due, and many outstanding issues, such as how small partnerships are affected, will probably need to be settled in the courts.²⁵ Practitioners have noted that the book minimum tax contains so many unresolved, and possibly unresolvable, problems relating to fundamental differences in book and tax accounting rules, that the ensuing complexity and uncertainty for corporate taxpayers may exceed that created by all of the corporate tax changes in TCJA.²⁶

The stock buyback tax is another new idea in taxation, but not a good one.²⁷ Ostensibly aimed at perceived problems in corporate finance, in practice it is also proving to be a way the administration can selectively punish certain types of firms and create additional compliance costs.²⁸

While some might see the exploding budgetary cost of the green energy credits as a sign that they are working, because they target so specifically certain activities and technologies, they will primarily benefit a small minority of taxpayers, such as the 1 percent of relatively wealthy car owners who drive an electric vehicle;²⁹ automakers; solar panel and battery manufacturers; lithium miners; and financial, accounting, and consulting firms specializing in the complex rules relating to eligibility, credit transferability and monetization. Such a large subsidy targeting a limited number of suppliers will face substantial capacity constraints, especially in an overheated economy racked by labor shortages and inflation, potentially worsening price pressures for consumers.

Overall, the president's tax policies signal a preference for expansive government intervention, control, and direction of the private economy, combined with a disregard for taxpayer concerns about complexity, compliance costs, and the economic cost of high marginal income tax rates.³⁰ At four million words and counting, the complexity of the federal tax code has reached absurd levels, far exceeding the ability of taxpayers to comprehend it and costing taxpayers more than \$300 billion a year in compliance costs.³¹ The economic cost of high marginal income tax rates have been well understood by economists for decades and have been documented and reaffirmed by dozens of

²⁴ Cody Kallen, William McBride, and Garrett Watson, "Minimum Book Tax: Flawed Revenue Source, Penalizes Pro-Growth Cost Recovery," Tax Foundation, Aug. 5, 2022, <https://taxfoundation.org/inflation-reduction-act-accelerated-depreciation/>; IRS, "Inflation Reduction Act of 2022: Latest Updates," <https://www.irs.gov/inflation-reduction-act-of-2022>; Chandra Wallace, "Corporate AMT Comment Letters Rich in Detail - And Disagreement," Tax Notes, Mar. 22, 2023, <https://www.taxnotes.com/tax-notes-today-federal/corporate-alternative-minimum-tax/corporate-amt-comment-letters-rich-detail-and-disagreement/2023/03/22/77804>.

²⁵ Erin Slovay, "Partnerships Struggle With Impact of US Corporate Minimum Tax," Oct. 4, 2022, <https://news.bloombergtax.com/daily-tax-report/partnerships-struggle-with-impact-of-us-corporate-minimum-tax>.

²⁶ Tax Policy Center, "Raising Revenue for Corporations," May 16, 2023, <https://www.taxpolicycenter.org/event/raising-revenue-corporations>.

²⁷ Alex Durante, "Stock Buyback Tax Would Hurt Investment and Innovation," Tax Foundation, Aug. 12, 2023, <https://taxfoundation.org/inflation-reduction-act-stock-buybacks/>.

²⁸ Alex Muresianu, "A Better Way to Tax Buybacks," Tax Foundation, Apr. 25, 2023, <https://taxfoundation.org/biden-stock-buybacks-tax/>; Jennifer Williams-Alvarez, "U.S. Buyback Tax Could Hit More Foreign Firms Than First Expected," The Wall Street Journal, Apr. 14, 2023, <https://www.wsj.com/articles/u-s-buyback-tax-could-hit-more-foreign-firms-than-first-expected-e9dedec3>.

²⁹ David Roberts, "Clean Energy Tax Credits Mostly Go to the Affluent. Is There a Better Way?," Vox, Nov. 24 2015, <https://www.vox.com/2015/11/24/9792474/energy-tax-credits-inequitable>; U.S. Department of Energy, "Vehicle Registration Counts by State," <https://afdc.energy.gov/vehicle-registration>.

³⁰ William McBride, "Testimony: The Costs and Complexity of the Federal Tax Code Demand Reform," Tax Foundation, Apr. 18, 2023, <https://taxfoundation.org/federal-tax-complexity-costs-reform/>.

³¹ Scott Hodge, "The Tax Compliance Costs of IRS Regulations," Tax Foundation, Aug. 23, 2022, <https://taxfoundation.org/tax-compliance-costs-irs-regulations/>.

studies.³² The president and his advisors should weigh these costs when considering the potential benefits of new tax proposals.

Recommendations for Reform

Adam Smith's advice on tax policy still applies, perhaps now more than ever:

Little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism, but peace, easy taxes, and a tolerable administration of justice; all the rest being brought about by the natural course of things. All governments which thwart this natural course, which force things into another channel, or which endeavour to arrest the progress of society at a particular point, are unnatural, and to support themselves are obliged to be oppressive and tyrannical.³³

Rather than easy taxes, we have a behemoth of a tax code that creates confusion and controversy while punishing success. Lawmakers should focus on simplifying the federal tax code, creating stability, and broadly improving economic incentives. There are incremental steps that can be made on the path to fundamental tax reform.

In the immediate term, lawmakers should seek solutions with bipartisan appeal. At the top of the list is returning to full expensing for R&D on a permanent basis, a policy that had existed from the beginning of the tax code, until last year, when a TCJA provision began requiring amortization of R&D expenses over five years (15 years for foreign-located R&D).³⁴ This policy switch delays legitimate business deductions for R&D, triggering liquidity problems for small businesses and penalizing R&D investment, particularly in manufacturing, information technology, and other R&D-intensive sectors, due to inflation and the time value of money.

A related policy, 100 percent bonus depreciation, allows full expensing for equipment, but is phasing down to 80 percent this year and to zero over the next four years, meaning companies will have to wait up to 20 years to deduct the original cost of equipment purchases, according to complicated depreciation schedules.³⁵ If bonus depreciation were made permanent along with R&D expensing, we estimate it would boost GDP by 0.5 percent over the long run and add about 87,000 jobs. While these policies would have a dynamic budgetary cost of about \$460 billion over the next decade, in

³² N. Gregory Mankiw, Matthew Weinzierl, and Danny Yagan, "Optimal Taxation in Theory and Practice," *Journal of Economic Perspectives* 23:4 (2009), <https://eml.berkeley.edu/~yagan/OptimalTaxation.pdf>; William McBride, "What Is the Evidence on Taxes and Growth," Tax Foundation, Dec. 18, 2012, <https://www.taxfoundation.org/what-evidence-taxes-and-growth/>; Alex Durante, "Reviewing Recent Evidence of the Effect of Taxes on Economic Growth," Tax Foundation, May 21, 2021, <https://taxfoundation.org/reviewing-recent-evidence-effect-taxes-economic-growth/>; Timothy Vermeer, "The Impact of Individual Income Tax Changes on Economic Growth," Tax Foundation, June 14, 2022, <https://taxfoundation.org/income-taxes-affect-economy/>; Robert Carroll, "The Excess Burden of Taxes and the Economic Cost of High Tax Rates," Tax Foundation, August 2009, <https://files.taxfoundation.org/legacy/docs/s170.pdf>; Martin Feldstein, "Tax Avoidance and the Deadweight Loss of the Income Tax," *The Review of Economics and Statistics* 81:4 (November 1999): 674-680, <https://www.jstor.org/stable/2646716>; Åsa Johansson, Christopher Heady, Jens Arnold, Bert Brys, Cyrille Schwellnus, & Laura Vartia, "Taxation and Economic Growth," Congressional Budget Office, "The Economics of Financing a Large and Permanent Increase in Government Spending: Working Paper 2021-03," Mar. 22, 2021, <https://www.cbo.gov/publication/57021>; see also Garrett Watson, "Congressional Budget Office and Tax Foundation Modeling Show That Some Tax Hikes Are More Damaging Than Others," Tax Foundation, Mar. 26, 2021, <https://www.taxfoundation.org/tax-hikes-are-more-damaging-than-others-analysis/>.

³³ Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (Cannan ed.), vol. 1, Methuen, 1776, <https://oll.libertyfund.org/title/smith-an-inquiry-into-the-nature-and-causes-of-the-wealth-of-nations-cannan-ed-vol-1>

³⁴ Alex Muresianu, "R&D Amortization Hurts Economic Growth, Growth Industries, and Small Businesses," Tax Foundation, June 1, 2023, <https://taxfoundation.org/rd-amortization-impact/>

³⁵ Stephen J Entin, "Expensing of Machinery and Equipment Should Be Made Permanent," Tax Foundation, May 30, 2023, <https://taxfoundation.org/permanent-expensing-machinery-equipment/>

the long run, revenues would be above baseline levels due to economic growth.³⁶ Temporary deficits could be covered by curtailing tax credits and other tax expenditures, such as by repealing or capping some of the green energy credits recently implemented as part of the IRA.

Going one step further and providing full expensing for all assets, including structures, on a permanent basis would greatly simplify business taxation while substantially growing the economy. We estimate full expensing would increase GDP by 2.3 percent in the long run, raise wages by 1.9 percent, and add 442,000 jobs.³⁷ While the revenue cost within the budget window would exceed \$1 trillion, this too could be offset by a more thorough scrubbing of the tax code's roughly 200 tax preferences that cost about \$2 trillion annually.³⁸

As 2025 approaches, when much of TCJA expires, lawmakers should consider fundamental tax reform to systematically address the tax code's shortcomings. While there are many approaches to fundamental, pro-growth tax reform, we have recently detailed and analyzed a proposal that would substantially boost economic growth and opportunity.³⁹ It follows along the lines of the Estonian income tax system, which tops our annual ranking of most competitive tax systems.⁴⁰

Simplicity and neutrality are the hallmarks of the Estonian income tax system.⁴¹ Taxes are so simple in Estonia that they can typically be filed in five minutes, and the cost of compliance for businesses is among the lowest of any country.⁴² Estonia's tax system is also very pro-growth, increasing small business entrepreneurship, investment, labor productivity and, thereby, wages.⁴³ Estonia's income tax system does all of this while generating substantial revenue comparable to other developed countries.⁴⁴

The Estonian income tax is fully integrated, so it avoids double-taxing corporate income through taxes at both the entity and shareholder levels. Instead of a complicated corporate income tax and separate rules that apply to passthrough businesses, all businesses are subject to a simple 20 percent tax on distributed profits (including dividends and stock buybacks). At the individual level, a simple flat tax of 20 percent applies to all individual income except dividends, since they are already taxed

³⁶ Garrett Watson, Erica York, Cody Kallen, and Alex Durante, "Details and Analysis of Canceling the Scheduled Business Tax Increases in Tax Cuts and Jobs Act," Tax Foundation, Nov. 1, 2022, <https://taxfoundation.org/tax-cuts-jobs-act-business-tax-increases/>

³⁷ Tax Foundation, "Options for Reforming America's Tax Code 2.0: Option 65," Apr. 19, 2021, <https://taxfoundation.org/tax-reform-options/?option=65>

³⁸ The Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2022-2026," Dec. 22, 2022, <https://www.jct.gov/publications/2022/jct-22-22/>; Treasury Department, "Tax Expenditures," <https://home.treasury.gov/policy-issues/tax-policy/tax-expenditures>.

³⁹ William McBride, Huaiquin Li, Garrett Watson, Alex Durante, Erica York, and Alex Muresianu, "Details and Analysis of a Tax Reform Plan for Growth and Opportunity," Tax Foundation, Feb. 14, 2023, <https://taxfoundation.org/growth-opportunity-us-tax-reform-plan/>

⁴⁰ Daniel Bunn and Lisa Hogreve, "International Tax Competitiveness Index, 2022," Tax Foundation, Oct. 17, 2022, <https://taxfoundation.org/2022-international-tax-competitiveness-index/>.

⁴¹ Estonia's simple approach to taxing business and individual income has also been implemented in Latvia and Georgia. Daniel Bunn, "Better than the Rest," Tax Foundation, Oct. 9, 2019, <https://taxfoundation.org/estonia-tax-system-latvia-tax-system/>; Gia Jandieri, "Tax Reform in Georgia 2004-2012," Tax Foundation, Jul. 17, 2019, <https://taxfoundation.org/tax-reforms-in-georgia-2004-2012/>.

⁴² Kyle Pomerleau, "The Best Part of the Estonian Tax Code Is Not 5 Minute Tax Filing," Tax Foundation, Jul. 21, 2015, <https://taxfoundation.org/best-part-estonian-tax-code-not-5-minute-tax-filing/>; William McBride, Garrett Watson, Erica York, "Taxing Distributed Profits Makes Business Taxation Simple and Efficient," Tax Foundation, Mar. 1, 2023, <https://taxfoundation.org/distributed-profits-tax-us-businesses/>.

⁴³ Jaan Maaso, Jaanika Merikull, and Priti Vahter, "Gross Profit Taxation Versus Distributed Profit Taxation and Firm Performance: Effects of Estonia's Corporate Income Tax Reform," The University of Tartu Faculty of Economics and Business Administration Working Paper No. 81-2011, Mar. 23, 2011, <https://ssrn.com/abstract=1793143> or <http://dx.doi.org/10.2139/ssrn.1793143>; Jaan Maaso and Jaanika Merikull, "Macroeconomic Effects of Zero Corporate Income Tax on Retained Earnings," Baltic Journal of Economics, 11:2 (2011): 81-99, <https://www.tandfonline.com/doi/pdf/10.1080/1406099X.2011.110840502>; Aaro Hazak, "Companies' Financial Decisions Under the Distributed Profit Taxation Regime of Estonia," Emerging Markets Finance & Trade 45:4 (2009): 4-12, <https://www.jstor.org/stable/27750676>; Eduardo Davila and Benjamin Hebert, "Optimal Corporate Taxation under Financial Frictions," NBER Working Paper No. 25520, Oct. 2021, <https://www.nber.org/papers/w25520>.

⁴⁴ Over the last 10 years, Estonia's central government tax collections from income and profit amount to about 7.4 percent of GDP, compared to 7.3 percent for the median OECD country and 8.4 percent averaged across OECD countries. See OECD Tax Revenue Statistics, <https://stats.oecd.org/Index.aspx>

by the distributed profits tax. Capital gains are taxed as ordinary income at 20 percent. Rather than a complicated estate tax like ours that taxes accumulated savings at death, bequeathed assets are simply taxed as capital gains when sold by the heir with deductible basis determined only by costs incurred by the heir.⁴⁵

Our proposal consists of a revenue-neutral reform of the U.S. tax code along the lines of the Estonian income tax system, keeping only certain features of the current code that benefit low-income households (such as the Earned Income Tax Credit and Child Tax Credit) and support saving (such as 401ks).⁴⁶ By greatly simplifying the federal tax code, these reforms would substantially reduce compliance costs, potentially saving U.S. taxpayers more than \$100 billion annually, comprised of more than \$70 billion in reduced compliance costs for businesses and more than \$30 billion in reduced compliance costs for individuals related to individual income and estate tax returns.

In addition to compliance cost savings, our modeling of the reform's impacts on the U.S. economy indicates it would increase GDP by 2.3 percent in the long run, amounting to about \$400 billion in additional annual output by 2032 and \$1 trillion in the long run (both in 2023 dollars). These changes would increase the long-run capital stock by 3 percent, amounting to \$2.1 trillion in 2023 dollars. Additionally, we estimate it would add 1.3 million full-time equivalent jobs and raise wages by 1.3 percent. By increasing GDP, the debt burden as measured by the debt-to-GDP ratio would fall by 5.9 percentage points over the long run.

Distributionally, we find the reform would increase after-tax income overall by 2.1 percent in the long run, accounting for improved economic growth, with a larger boost of 2.7 percent for the bottom quintile of earners, and 3.0 percent for the second quintile.

More generally, the U.S. could learn from the experience of other countries in the OECD, which rely more heavily on consumption taxes than the U.S. does.⁴⁷ Value-added taxes (VATs) are a major source of revenue in virtually every developed country except the United States. VATs and other taxes on consumption are among the least economically harmful ways to raise revenue.⁴⁸

OECD countries have also tended to abandon more complicated means of taxing high earners such as wealth taxes due to their administrative and economic challenges.⁴⁹ Rather than high capital gains taxes, or any attempt to tax unrealized capital gains, most OECD countries have lower capital gains tax rates than the U.S., and tax capital income overall at lower average tax rates.⁵⁰

45 William McBride, "Biden's New Tax Proposals are Complicated and Rife with Double Taxation," Tax Foundation, Mar. 13, 2023, <https://taxfoundation.org/biden-tax-fairness/>.

46 William McBride, Huaiqin Li, Garrett Watson, Alex Durante, Erica York, and Alex Muresianu, "Details and Analysis of a Tax Reform Plan for Growth and Opportunity," Tax Foundation, Feb. 14, 2023, <https://taxfoundation.org/growth-opportunity-us-tax-reform-plan/>

47 Daniel Bunn and Cecilia Perez Weigel, "Sources of Government Revenue in the OECD," Tax Foundation, Feb. 23, 2023, <https://taxfoundation.org/oecd-tax-revenue-by-country-2023/>.

48 William McBride, "What Is the Evidence on Taxes and Growth," Tax Foundation, Dec. 18, 2012, <https://www.taxfoundation.org/what-evidence-taxes-and-growth/>.

49 Daniel Bunn, "What the U.S. Can Learn from the Adoption (and Repeal) of Wealth Taxes in the OECD," Tax Foundation, Jan. 18, 2022, <https://taxfoundation.org/wealth-taxes-in-the-oecd/>.

50 Daniel Bunn and Elke Asen, "Savings and Investment: The Tax Treatment of Stock and Retirement Accounts in the OECD," Tax Foundation, May 26, 2021, <https://taxfoundation.org/savings-and-investment-oecd/#Capital>; Jacob Lundberg and Johannes Nathell, "Taxing Capital—An International Comparison," Tax Foundation, May 11, 2021, <https://taxfoundation.org/tax-burden-on-capital-income/>.

Consumption taxes can be designed to progressively tax the consumption of higher earners without the administrative complexity and compliance costs of our current progressive income tax system. For example, by splitting the VAT base in two, businesses would pay taxes on their cash flow (sales less purchases and compensation paid), while households would pay taxes on compensation received. Applying a progressive rate schedule at the household level, with the top rate matching the rate on business cash flow, is a relatively simple way to achieve progressivity within a consumption tax.⁵¹ Under a more standard value-added tax, the most efficient way to increase progressivity would be to offer targeted relief to lower- and middle-income households.⁵²

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The Tax Foundation is the nation's leading independent tax policy research organization. Since 1937, our research, analysis, and experts have informed smarter tax policy at the federal, state, and global levels. We are a 501(c)(3) nonprofit organization.

⁵¹ This design is known as the "X Tax," developed by the late economist David Bradford. See Robert Carroll and Alan D. Viard, *Progressive Consumption Taxation: The X Tax*, (Washington, D.C: The Rowman & Littlefield Publishing Group, 2012).

⁵² See Rita de la Feria and Michael Walpole, "The Impact of Public Perceptions on General Consumption Taxes," *British Tax Review* 67:5 (Dec. 4, 2020), 637-669, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3723750 for a discussion on how other approaches, such as exemptions or reduced rates can, counterintuitively, increase regressivity by providing more benefits to higher-income households.

Chairman ARRINGTON. Thank you, Dr. McBride.
I now yield five minutes to Mr. Pomerleau.

STATEMENT OF KYLE POMERLEAU, SENIOR FELLOW ON TAX POLICY, AMERICAN ENTERPRISE INSTITUTE

Mr. POMERLEAU. Chairman Arrington, Ranking Member Boyle, and Members of the Committee, thank you for the opportunity to testify today. I am Kyle Pomerleau, Senior Fellow at the American Enterprise Institute.

In my testimony, I am going to put the Tax Cuts and Jobs Act's corporate tax proposals in an international context. I will make three points.

The first point is prior to the TCJA, the U.S. Corporate Tax Code was an outlier among the 38 countries of the Organization for Economic Cooperation and Development, the OECD. Two, the TCJA brought the U.S. Corporate Tax Code more in line with those of our major trading partners. And three, lawmakers should be cautious about some of the proposals in Biden's budget that could once again make the U.S. corporate code an outlier.

Before the TCJA, the U.S. corporate tax code was an outlier in the developed world in a few important ways. The statutory corporate tax rate was 38.9 percent, which was the highest in the OECD. At the same time, the U.S. also levied high effective tax rates on corporate investment. The U.S. was also one of the last OECD nations to tax U.S.-based multinationals on their worldwide income.

The pre-TCJA corporate income tax created several issues. First, the high statutory tax rate combined with the ability to defer additional U.S. tax on foreign profits encouraged corporations to shift profits and headquarters to lower tax jurisdictions. Second, high effective tax rates discouraged investment in the United States and encouraged corporations to locate highly mobile assets, such as intellectual property, overseas. And third, the high statutory tax rate combined with the ability to deduct interest expense resulted in a large bias in favor of debt-financed investment.

The TCJA addressed many of those issues and brought the U.S. code more in line with those of our major trading partners. Reducing the Federal statutory tax rate to 21 percent brought the combined statutory rate to about 25.8 percent, which is slightly below the OECD average of 26.2 percent. The lower rate reduced the tax burden on new investment and, in combination with the limitation on net interest expense, also reduced the bias in favor of debt-financed investment. In current law, tax treatment of U.S. multinationals' foreign activity, which exempts the returns to tangible assets but places a minimum tax on intangible assets, is more aligned with how other OECD countries treat their multinational corporations.

But by no means were the TCJA's corporate tax revisions perfect. For example, some of the TCJA's tax cuts for new investment were temporary, such as 100 percent bonus depreciation, and the Tax Cuts and Jobs Act raised the tax burden on research and development in the United States. And second, the new provisions aimed at preventing base erosions and profit shifting of U.S. multinationals have several known shortcomings, and the tax rate on

these provisions are scheduled to rise after 2025, creating uncertainty for corporations.

Lawmakers are right to want to extend both 100 percent depreciation and delaying amortization of R&D, but those changes should be made permanent and prospective, not temporary and retroactive. In looking forward, lawmakers should continue to expand expensing further and limit the deductibility of interest expense.

The last point I want to make is that lawmakers should be cautious about some of the proposals in the Biden Administration's budget. In his last couple budgets, the Administration proposed raising the statutory corporate income tax rate from 21 percent to 28 percent and proposed significant reforms to the tax treatment of multinational corporations' foreign profits. Under these proposals, the U.S. corporate tax rate would be 32.5 percent and the second highest in the OECD. Effective tax rates on new investment would also be among the highest, and despite new limitations on interest expense, the proposal would also increase the bias in favor of debt-financed investment.

The Biden Administration argues that its proposal to reform the tax treatment of multinational corporations would align the U.S. Code with the global minimum tax, or Pillar Two, the OECD's proposal, but there would remain meaningful differences. In fact, their proposal would place a heavier burden on multinational corporations headquartered in the United States in Pillar Two. So, under the Biden budget proposals, it would be less attractive to be a U.S.-headquartered corporation, even if all countries enacted Pillar Two.

Thank you, and I look forward to any questions.

[The information follows:]



Statement before the House Committee on the Budget
On Incentivizing Economic Excellence Through Tax Policy

The Tax Cuts and Jobs Act and Recent Corporate Tax Reform Proposals

Kyle Pomerleau
Senior Fellow

June 22, 2023

The American Enterprise Institute (AEI) is a nonpartisan, nonprofit, 501(c)(3) educational organization and does not take institutional positions on any issues. The views expressed in this testimony are those of the author.

Chairman Arrington and Ranking Member Boyle, thank you for the opportunity to speak today about corporate tax policy. I am Kyle Pomerleau, a senior fellow at the American Enterprise Institute, where I research federal tax policy and tax reform.

In this testimony, I will provide an international context for the Tax Cuts and Jobs Act (TCJA) and recent proposals to reform corporate taxes. I will make three main points:

1. Before the TCJA, the US corporate tax code was an outlier among the 38 countries in the Organisation for Economic Cooperation and Development (OECD).
2. The TCJA brought the US corporate tax code more in line with those of America's major trading partners.
3. Lawmakers should build on the TCJA's corporate tax reforms and avoid policies that increase economic distortions and risk making the US a global outlier again.

The Pre-TCJA Corporate Tax Code

Before the TCJA, the United States had a corporate tax code that differed from the rest of the developed world's tax codes in a few important ways.

The top statutory corporate income tax rate was 38.9 percent, which was the sum of the federal corporate income tax rate of 35 percent and the weighted average of state and local corporate income tax rates. If the US had maintained this rate, its statutory corporate income tax rate would be the highest among the 38 member nations of the OECD and 12.7 percentage points above average.¹

Effective tax rates would have been the highest in the OECD as well. Under previous law, the average marginal effective tax rate (METR),^{2,3} or the typical tax burden on new investment, was 24.6 percent. If this rate were still in place today, it would be the highest among the OECD nations and 13.6 percentage points above the average. Likewise, the average effective tax rate (AETR)⁴ would also have been the highest in the OECD, at 34.1 percent and 11.9 percentage points above the OECD average. See Table 1 for a summary of these results.

Table 1. US Pre-TCJA Tax Code Compared to 38 OECD Nations

	US	Rank	OECD Average
Statutory Tax Rate	38.9%	1 st	26.2%
Marginal Effective Tax Rate	24.6%	1 st	11.6%
Average Effective Tax Rate	34.1%	1 st	22.2%

Source: Author's calculations based on a methodology described in Pomerleau, "The Tax Burden on Corporations: A Comparison of Organisation for Economic Co-operation and Development Countries and Proposals to Reform the US Tax System."

The US was also out of step with most OECD nations in how it taxed multinational corporations. Previously, the US corporate tax was a worldwide or residence-based system with deferral. This meant that US-based multinational corporations paid US tax on both their US and foreign profits,

though these corporations could defer any US tax on foreign profits until those profits were repatriated to the US and received a US tax credit for foreign taxes paid.⁵

For example, a US corporation operating in Poland would first face the Polish corporate income tax rate of 19 percent on the returns on investment in that jurisdiction. Once those profits were repatriated into the United States, they would face the full 35 percent statutory federal corporate tax rate. However, the additional US tax would be reduced by a credit for the 19 percent paid to the Polish tax authorities. As a result, the additional tax paid to the United States would be 16 percent, for a total effective tax rate of 35 percent. A British multinational corporation operating in Poland would only face the Polish corporate tax of 19 percent.

Meanwhile, most OECD nations had moved towards source-based or “territorial” corporate income taxes. These systems only tax corporations on profits earned in that jurisdiction, regardless of where they are headquartered. These systems also typically have anti-avoidance provisions to prevent significant base erosion.⁶

The tax treatment of corporations in the United States under pre-TCJA law created several issues.

First, the high statutory corporate income tax rate and the ability to defer additional US tax on foreign profits, encouraged corporations to shift profits into low-tax jurisdictions. This is because corporations have the incentive to locate revenues in low-tax countries and expenses in high-tax countries to reduce their worldwide tax burden.

Second, high METRs discouraged investment in the United States. Corporations make investment decisions based on the return they must earn to cover their replacement, the minimum return required by shareholders, and taxes. Pre-TCJA law raised the required return and reduced the number of viable investment projects throughout the economy.⁷

Relatedly, a relatively high AETR can discourage corporations from locating high-return investments in the United States. If a corporation expects to earn a profit on a new project and can choose where to locate it, it will place that project where the total after-tax returns is highest. Therefore, if the AETR in the US is higher than in other countries, as it was under pre-TCJA law, corporations may choose to locate their projects elsewhere. This is especially true of intellectual property products, which are highly mobile.⁸

Third, the high statutory corporate income tax rate and the ability to deduct interest expense under pre-TCJA law increased the tax bias in favor of debt financing. Corporations that finance new investments with borrowed funds can deduct the costs of financing (interest), whereas equity-financed investment does not receive the same benefit. As a result, returns to debt financing are not taxed at the entity level, while equity faces a positive tax burden.⁹ Under previous law, debt-financed corporate investment faced an effective tax rate 72 percentage points lower than the tax burden on equity-financed investment.

Finally, the residence-based tax system encouraged corporations to expatriate or invert to jurisdictions with “territorial” tax systems. Before the TCJA, there were several prominent

inversions in which US-based corporations were purchased by foreign competitors and relocated to foreign jurisdictions such as Canada, Ireland, and the United Kingdom.

The TCJA

The TCJA addressed many of these issues and made important improvements to the corporate tax system.

It reduced the statutory corporate income tax rate from 35 percent to 21 percent. As a result, the combined federal, state, and local statutory corporate income tax rate fell from 38.9 percent to 25.8 percent.¹⁰

The law temporarily improved the tax treatment of some investments by enacting 100 percent bonus depreciation. This provision allows corporations to fully deduct the cost of new short-lived assets against taxable income. Short-lived assets have modified accelerated cost recovery system (MACRS) assets lives of 20 years or less. However, 100 percent bonus depreciation began phasing out this year. Currently, bonus depreciation is 80 percent. Next year it will fall to 60 percent and then decrease by 20 percentage points each subsequent year until it is fully phased out by 2027.

The TCJA also enacted a limitation on interest expense deductions. Businesses (both C corporations and pass-throughs) can only deduct interest (net of interest income) up to 30 percent of adjusted taxable income. From 2018 and 2021, adjusted taxable income was equal to earnings before interest, taxes, depreciation, and amortization (EBITDA). From 2022 onward, adjusted taxable income is equal to earnings before interest and taxes (EBIT).¹¹

The TCJA moved away from the worldwide tax system with deferral to a hybrid international tax system. Current law provides US-headquartered multinational corporations with source-based or “territorial” taxation for a deemed return on tangible assets (such as machines and factories). US corporations that earn foreign profits from tangible assets will face foreign income tax liability but no additional US liability. This was accomplished by enacting what is called a participation exemption.

At the same time, intangible assets that serve foreign markets are subject to a worldwide tax with no deferral on deemed returns, but at a lower rate between 10.5 percent and 13.125 percent. These profits, earned by US-headquartered multinational corporations, face US taxation regardless of where they are located. This worldwide tax on intangible income comprises two new definitions of income: Global Intangible Low-Tax Income (GILTI) and Foreign Derived Intangible Income (FDII).¹²

In addition to GILTI and FDII, the TCJA enacted a new minimum tax called the Base Erosion Anti-Abuse Tax (BEAT). BEAT aims to prevent corporations from using certain cross-border transactions to “strip” the US tax base. Under BEAT, corporations must pay the greater of their ordinary corporate tax liability or 10 percent of their taxable income plus “base-eroding”

payments. BEAT only applies to corporations with gross receipts above \$500 million for each of the past three years and base eroding payments that exceed 3 percent of overall deductions.

The effective tax rate on GILTI is scheduled to rise to between 13.125 percent and 16.406 percent, and the FDII effective tax rate is scheduled to increase to 16.406 percent in 2026. Additionally, the BEAT tax rate is scheduled to increase to 12.5 percent in the same year.

The TCJA brought the US system more in line with the rest of the OECD in three respects.

First, the 25.8 percent combined federal, state, and local statutory corporate income tax rate is slightly below the OECD weighted average of 26.2 percent and lower than rates levied by Germany (29.9 percent), Japan (29.7 percent), and Canada (26.2 percent).

Second, the lower corporate income tax rate has reduced the tax burden on new investment. Under the TCJA, the METR on investment has decreased from 24 percent to 18 percent. The lower statutory tax rate also made it more attractive to locate high-return investments in the United States. The AETR has decreased approximately ten percentage points from 33.4 percent to 23.3 percent. It is currently only 1.1 percentage points higher than the OECD average. See Table 2.

Third, the reforms to the tax treatment of multinational corporations' foreign profits are now more aligned with how other OECD countries treat their multinational corporations. For tangible assets, US multinational corporations face the same tax burden as their competitors do in foreign jurisdictions.¹³ At the same time, GILTI, FDII, and BEAT (combined with a lower statutory tax rate) address the significant base erosion and profit shifting that occurred under previous law.

Table 2. TCJA (Current Law) Compared to 38 OECD Nations

	US	Rank	OECD Average
Statutory Tax Rate	25.8%	13 th	26.2%
Marginal Effective Tax Rate	18.0%	5 th	11.6%
Average Effective Tax Rate	23.3%	8 th	22.2%

Source: Author's calculations based on a methodology described in Pomerleau, "The Tax Burden on Corporations: A Comparison of Organisation for Economic Co-operation and Development Countries and Proposals to Reform the US Tax System."

By no means were the TCJA's corporate tax provisions perfect.

First, some of TCJA's tax cuts for new investment were temporary. As discussed above, 100 percent bonus depreciation was only enacted temporarily. In addition, lawmakers raised the tax burden on research and development (R&D) by requiring corporations to amortize those expenses over five years starting in 2022.

Second, new provisions aimed at preventing base erosion and profit shifting have several known shortcomings. GILTI, for example, can apply to the foreign operations of US-based multinational corporations even when they face relatively high effective tax rates. This is due to GILTI's

interaction with foreign tax credit limitations.¹⁴ Likewise, BEAT is a somewhat arbitrary tool to address outbound profit shifting by multinational corporations.¹⁵

Lastly, the TCJA has created uncertainty for multinational corporations. As mentioned previously, the tax rates on GILTI, FDII, and BEAT are all scheduled to rise after 2025. These tax increases, in some cases, will be significant.¹⁶ This makes planning difficult for corporations and could discourage investment activities today.

Proposals to Alter Corporate Income Taxation in the United States

Lawmakers are currently debating the future of the corporate provisions of the Tax Cuts and Jobs Act. Over the past few years, lawmakers from both parties, including the President, have proposed changes to the corporate tax code.

Making TCJA Business Provisions Permanent

As discussed above, several important provisions of the TCJA are in the process of phasing out over the next couple of years. In addition, scheduled tax increases are going into force. Lawmakers on both sides of the aisle have proposed delaying or canceling these scheduled changes. Democrats, as part of the House-passed Build Back Better Act, included a provision to delay the amortization of research and development costs.¹⁷ Likewise, Republicans have proposed delaying the amortization of research and development costs and the switch to a tighter interest deduction cap and extending the bonus depreciation until 2025.¹⁸ Lawmakers have yet to discuss the future of GILTI, FDII, and BEAT.

If lawmakers permanently extend bonus depreciation and revert R&D amortization and the tighter interest limitation, it would further reduce the tax burden on new corporate investment. The marginal tax rate on new investment would fall to 11.2 percent, which is slightly below the average among other OECD nations of 11.6 percent. This would also modestly reduce the AETR from 23.3 percent to 21.5 percent. See Table 3.

A downside to reverting to 2018 TCJA tax policies is that it would raise the bias in favor of debt-financed investment. The difference between the marginal effective tax rate on debt- and equity-financed investment would rise from 30.5 to 38.2 percent.

Table 3. TCJA 2018 Permanent Provisions Compared to 38 OECD Nations

	Value	Rank	OECD Average
Statutory Tax Rate	25.8%	13 th	26.2%
Marginal Effective Tax Rate	11.2%	16 th	11.6%
Average Effective Tax Rate	21.5%	13 th	22.2%

Source: Author's calculations based on a methodology described in Pomerleau, "The Tax Burden on Corporations: A Comparison of Organisation for Economic Co-operation and Development Countries and Proposals to Reform the US Tax System."

The Biden Administration Budget

In its last three budgets, the Biden Administration proposed raising the statutory corporate income tax rate from 21 percent to 28 percent.¹⁹

In addition, the Administration has proposed reforms to the tax treatment of multinational corporations. This proposal would raise the GILTI tax rate to approximately 22 percent,²⁰ and repeal FDII and replace it with unspecified incentives for research and development. The reforms would also require corporations to calculate GILTI for each country in which they operate and repeal the 10 percent exclusion for qualified business asset investment (QBAI).²¹ They would replace BEAT with a proposal from the OECD's Pillar Two, called the Under Taxed Profit Rule (UTPR).²² Lastly, it would enact a new limitation on interest deductions for multinational corporations.

The Biden Budget proposals would, once again, make the US an outlier among OECD nations in several important respects. First, the 28 percent corporate income tax rate, combined with the average of state and local corporate taxes, would be 32.5 percent. Although this would be lower than the US corporate tax rate prior to the TCJA, it would be the second-highest corporate income tax rate in the OECD, behind only Colombia's 35 percent corporate income tax rate.

The higher statutory tax rate would also push up the US's effective tax rate on investment. The marginal effective tax rate would rise from 18 percent to 23.7 percent. This would be the second-highest marginal effective tax rate on new investment in the OECD, surpassed only by Colombia, and would be 12.4 percentage points higher than the OECD average. The average effective tax rate would also rise from 23.3 percent to 29.5 percent and would only be lower than Columbia's.

Table 4. The Biden Administration's Fiscal Year 2024 Budget Compared to the OECD

	Value	Rank	OECD Average
Statutory Tax Rate	32.3%	2 nd	26.2%
Marginal Effective Tax Rate	23.7%	2 nd	11.6%
Average Effective Tax Rate	29.5%	2 nd	22.2%

Source: Author's calculations based on a methodology described in Pomerleau, "The Tax Burden on Corporations: A Comparison of Organisation for Economic Co-operation and Development Countries and Proposals to Reform the US Tax System."

The proposal would not only increase the overall tax burden on new investment but increase the tax code's bias in favor debt-financed investment. Despite the new interest deduction limits in the budget, the higher corporate income tax rate would increase the value of the interest deduction and simultaneously raise the tax burden on equity-financed investment. As a result, the difference between the effective tax rate on debt-financed investment would rise from 30.5 percentage points to 36.9 percent points.

Besides effective tax rates, Biden's proposal would also put the US out of step in another regard: the treatment of multinational corporations' foreign profits.

Since entering office, the Biden Administration has focused on negotiating and implementing a global deal on taxing multinational corporations. A major component of this deal is a minimum tax on the profits of multinational corporations called Pillar Two. Pillar Two includes three main components: (1) an income inclusion rule (IIR), which taxes foreign profits of domestically headquartered corporations at a minimum rate of 15 percent; (2) an undertaxed payment rule (UTPR), which acts as a backstop to the IIR and can tax foreign headquartered corporations; and (3) a domestic minimum tax called the “qualified domestic minimum top-up tax” (QDMTT), which gives countries priority to tax low-taxed profits earned in their jurisdiction.

The Biden Administration argues that its proposal would align the US Tax Code with Pillar Two. However, there would be meaningful differences.²³

Most obviously, Pillar Two sets out a 15 percent minimum tax on foreign profits through the income inclusion rule, while the Biden Administration proposes taxing foreign profits through GILTI at a rate of 22 percent.

Other differences, however, are more subtle. Under Biden’s proposal, GILTI would no longer allow corporations to exclude 10 percent of tangible assets (QBAI). In contrast, Pillar Two would allow corporations to exclude 5 percent of assets and 5 percent of payroll. In most cases, Pillar Two would not claw back timing benefits such as accelerated depreciation. GILTI, however, requires US companies to recompute foreign taxable income under straight-line depreciation, which results in additional tax if companies benefit from accelerated depreciation in a foreign jurisdiction. Lastly, Pillar Two only applies to companies with revenues above EUR 750 million (approximately USD 820 million), while GILTI applies to all corporations.

As a result, even if every country adopted Pillar Two, the US would remain an outlier, placing a heavier burden on multinational corporations headquartered in the United States. This would maintain the incentive to invert out of the United States.

The Administration’s proposals would also work against one goal of the global minimum tax, which is to reduce the incentive to shift profits into low-tax jurisdictions. Profit-shifting incentives are primarily driven by differences in statutory tax rates. Setting a floor of 15 to 22 percent on foreign profits will reduce the tax savings of shifting profits into zero-tax jurisdictions. However, the administration’s proposal to raise the corporate tax rate to 28 percent would increase the incentive to shift profits out of the United States.²⁴

Conclusion

Prior to the TCJA, the US corporate income tax had several well-known problems and was out of line with the tax codes of much of the developed world. The TCJA addressed many of those problems and brought the US corporate tax code more in line with the rest of the OECD. However, the TCJA was not perfect and created uncertainty due to the temporary nature of certain provisions.

Future tax changes should build on the TCJA's reforms. Lawmakers should permanently extend bonus depreciation and repeal the amortization of research and development costs and do so prospectively, not retroactively. Looking forward, lawmakers should consider moving towards a cash flow tax by expanding expensing to other assets while further limiting the ability for corporations to deduct interest expense.²⁵

Lawmakers should be cautious about the corporate tax changes in the Biden Administration's budget. Under the Administration's proposals, the US would have the second highest statutory and effective corporate tax rates in the OECD. This would increase the incentive for multinational corporations to shift profits and high-return investments overseas. The Biden Administration also proposes policies that are meant to align the US tax code with the OECD's global tax deal. However, it is worth emphasizing that the Administration's proposals would be more burdensome for U.S.-based multinational corporations than the OECD's model rules.²⁶

Appendix Tables

Table 5. US Pre-TCJA Law, Current Law, and Proposals to Alter Corporate Income Taxation Compared to 38 OECD Nations

Statutory Tax Rate		Marginal Effective Tax Rate		Average Effective Tax Rate	
United States Pre-TCJA	38.9%	United States Pre-TCJA	24.6%	United States Pre-TCJA	34.1%
Columbia	35.0%	Columbia	23.9%	Columbia	31.3%
United States Biden Budget	32.3%	United States Biden Budget	23.7%	United States Biden Budget	29.5%
Portugal	31.5%	Japan	21.4%	Japan	27.1%
Costa Rica	30.0%	New Zealand	21.2%	Germany	27.0%
Mexico	30.0%	Germany	20.4%	Costa Rica	26.1%
Australia	30.0%	United States Current Law	18.0%	New Zealand	25.8%
Germany	29.9%	Costa Rica	17.2%	Mexico	25.7%
Japan	29.7%	Netherlands	16.5%	Australia	25.5%
New Zealand	28.0%	France	16.5%	United States Current Law	23.3%
Italy	27.8%	United Kingdom	16.2%	France	22.8%
Chile	27.0%	Spain	15.7%	Netherlands	22.7%
Korea	26.5%	Mexico	15.5%	OECD Average	22.2%
OECD Average	26.2%	Australia	14.8%	United Kingdom	22.1%
Canada	26.2%	Norway	14.4%	Spain	21.9%
France	25.8%	Luxembourg	13.5%	Korea	21.6%
Netherlands	25.8%	Greece	13.2%	United States Permanent TCJA	21.5%
United States Current Law	25.8%	OECD Average	11.6%	Luxembourg	21.1%
United States Permanent TCJA	25.8%	Denmark	11.3%	Canada	20.6%
United Kingdom	25.0%	United States Permanent TCJA	11.2%	Austria	20.1%
Spain	25.0%	Austria	10.1%	Norway	19.8%
Belgium	25.0%	Korea	10.1%	Greece	19.5%
Luxembourg	24.9%	Israel	10.0%	Israel	19.2%
Austria	24.0%	Sweden	9.8%	Denmark	19.0%
Israel	23.0%	Poland	9.7%	Chile	18.8%
Norway	22.0%	Slovenia	8.7%	Portugal	18.5%
Greece	22.0%	Finland	8.3%	Sweden	17.6%
Denmark	22.0%	Iceland	8.1%	Italy	17.6%
Slovakia	21.0%	Slovakia	7.8%	Slovakia	17.2%
Sweden	20.6%	Switzerland	6.5%	Finland	16.8%
Finland	20.0%	Ireland	5.9%	Iceland	16.8%
Iceland	20.0%	Czechia	5.2%	Slovenia	16.2%
Turkey	20.0%	Hungary	5.1%	Poland	16.1%
Switzerland	19.7%	Canada	5.1%	Estonia	16.0%
Poland	19.0%	Estonia	4.8%	Latvia	16.0%

Slovenia	19.0%	Latvia	4.8%	Switzerland	15.9%
Czechia	19.0%	Turkey	4.5%	Turkey	15.7%
Lithuania	15.0%	Lithuania	1.5%	Czechia	15.4%
Ireland	12.5%	Chile	-8.9%	Belgium	14.3%
Hungary	9.0%	Italy	-19.7%	Lithuania	11.2%
Estonia*	0.0%	Belgium	-25.3%	Ireland	10.6%
Latvia*	0.0%	Portugal	-35.7%	Hungary	7.9%

Source: Author's calculations based on a methodology described in Pomerleau, "The Tax Burden on Corporations: A Comparison of Organisation for Economic Co-operation and Development Countries and Proposals to Reform the US Tax System."

Note: *Estonia and Latvia do not have a traditional corporate income tax. Profits are not taxed each year. Rather, they are taxed at 20 percent when distributed.

Table 6. Debt-Equity Bias, Marginal Effective Tax Rate, and Corporate Investment

	Debt	Equity	Difference
Pre-TCJA	-33.1%	38.9%	-72.0%
Current Law	-4.1%	26.4%	-30.5%
Permanent TCJA	-16.8%	21.3%	-38.1%
FY2024 Biden Budget	-3.7%	33.2%	-36.9%

Source: Author's calculations based on a methodology described in Pomerleau, "The Tax Burden on Corporations: A Comparison of Organisation for Economic Co-operation and Development Countries and Proposals to Reform the US Tax System."

Notes

¹ Organisation for Economic Co-operation and Development, OECD Tax Database, <https://www.oecd.org/tax/tax-policy/tax-database>.

² The marginal effective tax rate is the tax burden on an investment that breaks even in present value. It generally measures the impact a tax code has on the level of investment.

³ Kyle Pomerleau, "The Tax Burden on Corporations: A Comparison of Organisation for Economic Co-operation and Development Countries and Proposals to Reform the US Tax System," American Enterprise Institute, October 13, 2021, <https://www.aei.org/research-products/report/the-tax-burden-on-corporations-a-comparison-of-organisation-for-economic-co-operation-and-development-countries-and-proposals-to-reform-the-us-tax-system/>.

⁴ The average effective tax rate is the total tax burden on an investment that earns profits in present value. It generally measures the attractiveness of locating an investment in one jurisdiction over another. See Pomerleau, "The Tax Burden on Corporations: A Comparison of Organisation for Economic Co-operation and Development Countries and Proposals to Reform the US Tax System."

⁵ Kyle Pomerleau, "Biden's Reforms to the Tax Treatment of US Multinational Corporations: The Knowns and Unknowns," *AEI Economic Perspectives* 2021, no. 5 (July 2021): 1-18, <https://www.aei.org/research-products/report/bidens-reforms-to-the-tax-treatment-of-us-multinational-corporations-the-knowns-and-unknowns/>.

⁶ Kyle Pomerleau, Daniel Bunn, and Thomas Locher, "Anti-Base Erosion Provisions and Territorial Tax Systems in OECD Countries," Tax Foundation, July 7, 2021, <https://taxfoundation.org/anti-base-erosion-territorial-tax-systems/>.

⁷ Pomerleau, "The Tax Burden on Corporations: A Comparison of Organisation for Economic Co-operation and Development Countries and Proposals to Reform the US Tax System."

⁸ Pomerleau, "The Tax Burden on Corporations: A Comparison of Organisation for Economic Co-operation and Development Countries and Proposals to Reform the US Tax System."

⁹ Kyle Pomerleau, "The Treatment of Business Interest Expense in the TCJA," *Tax Notes Federal* 171, (May 2021): 911-18, <https://www.aei.org/articles/the-treatment-of-business-interest-expense-in-the-tcja/>.

¹⁰ Pomerleau, "The Tax Burden on Corporations: A Comparison of Organisation for Economic Co-operation and Development Countries and Proposals to Reform the US Tax System."

¹¹ Pomerleau, "The Treatment of Business Interest Expense in the TCJA."

¹² Pomerleau, "Biden's Reforms to the Tax Treatment of US Multinational Corporations: The Knowns and Unknowns."

¹³ Pomerleau, "Biden's Reforms to the Tax Treatment of US Multinational Corporations: The Knowns and Unknowns."

¹⁴ Richard Rubin, "New Tax on Overseas Earnings Hits Unintended Targets," *The Wall Street Journal*, March 26, 2018, <https://www.wsj.com/articles/new-tax-on-overseas-earnings-hits-unintended-targets-1522056600>.

¹⁵ Martin A. Sullivan, "Economic Analysis: The Base Expansion Arbitrary Tax," *Tax Notes Federal* 160, (September 2018): 1662-4, <https://www.taxnotes.com/tax-notes-today-federal/tax-cuts-and-jobs-act/economic-analysis-base-expansion-arbitrary-tax/2018/09/17/28f2>.

¹⁶ Richard Rubin, "Global Tax Mess Awaits U.S. Companies, and Congress Isn't Helping," *The Wall Street Journal*, June 17, 2023, <https://www.wsj.com/articles/global-tax-mess-awaits-u-s-companies-and-congress-isnt-helping-eecl3f2c>.

¹⁷ Joint Committee on Taxation, *Estimated Budget Effects of The Revenue Provisions Of Title XIII – Committee On Ways And Means, Of H.R. 5376, The "Build Back Better Act," As Passed By The House Of Representatives*, JCX-46-21, (November 19, 2021), <https://www.jct.gov/publications/2021/jcx-46-21/>.

¹⁸ Alex Brill and Kyle Pomerleau, "Analyzing the Build It in America Act: Proposals for Business Tax Reform," AEIideas, June 12, 2023, <https://www.aei.org/economics/analyzing-the-build-it-in-america-act-proposals-for-business-tax-reform/>.

¹⁹ Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2024 Revenue Proposals*, (March 9, 2023), <https://home.treasury.gov/system/files/131/General-Explanations-FY2024.pdf>.

²⁰ Under the Administration's proposal, corporations could deduct 25 percent of GILTI against taxable income and would receive a 95 percent foreign tax credit. Thus, the effective tax rate is $28\% * (1 - 25\%) / 95\% = 22\%$.

²¹ Pomerleau, “Biden’s Reforms to the Tax Treatment of US Multinational Corporations: The Knowns and Unknowns.”

²² Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2024*, (March 2023), https://www.whitehouse.gov/wp-content/uploads/2023/03/budget_fy2024.pdf.

²³ Kyle Pomerleau, “Biden’s Tax Reforms Could Leave US Multinational Corporations at a Competitive Disadvantage,” *MNE Tax*, April 13, 2022, <https://www.aei.org/op-eds/bidens-tax-reforms-could-leave-us-multinational-corporations-at-a-competitive-disadvantage/>.

²⁴ Cody Kallen, “International Tax Proposals and Profit Shifting,” Tax Foundation, August 24, 2021, <https://taxfoundation.org/international-tax-proposals-profit-shifting/>.

²⁵ Kyle Pomerleau and Alex Brill, “A Simpler, More Responsible, and Pro-Growth Tax System,” in *American Renewal: A Conservative Plan to Strengthen the Social Contract and Save the Country’s Finances*, ed. Paul Ryan and Angela Rachidi (Washington, DC: AEI Press, 2022).

²⁶ Cody Kallen, “How Heavily Taxed Are U.S. Multinationals,” Tax Foundation, September 29, 2021, <https://taxfoundation.org/us-multinational-corporations-tax/>.

Chairman ARRINGTON. Thank you, Mr. Pomerleau.

Now, we would like to yield to Mr. Kuhlman five minutes for your opening remarks.

STATEMENT OF KEVIN KUHLMAN, VICE PRESIDENT OF FEDERAL GOVERNMENT RELATIONS, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. KUHLMAN. Thank you, and good afternoon, Chairman Arrington, Ranking Member Boyle, and Members of the Budget Committee. My name is Kevin Kuhlman. I am the Vice President of Federal Government Relations at the National Federation of Independent Business, NFIB. I appreciate the opportunity to share the small business perspective today.

Small businesses face economic challenges, including stubbornly high inflation and pervasive workforce shortages. Additionally, small businesses face a very uncertain tax future that makes business planning extremely difficult.

Beginning this year, certain business provisions of the Tax Cuts and Jobs Act of 2017 expire. In about two and a half years, the vast majority of the provisions that benefit individuals and small businesses will also expire. If Congress fails to act, there will be a detrimental and substantial tax increase on millions of small businesses. Further, proposals to increase taxes on businesses cloud business optimism and complicate business planning.

Small businesses received significant tax relief upon the enactment of the Tax Cuts and Jobs Act. More than three-quarters of businesses organize as passthrough businesses, either S corporations, LLCs, sole proprietorships, or partnerships. Business income is passed through to the individual owner's income tax, Form 1040, where individual income tax rates are applied. For passthrough businesses, the 20 percent small business deduction, also known as Section 199A, combined with the lower individual tax rates and broader income brackets provided tax relief that was invested in small businesses and their employees.

For example, Lana Pol, owner of Greetings in Pella, Iowa, testified before this Committee a couple years ago that, "The new small business deduction will provide around \$40,000 in tax relief for our businesses. This tax relief provides crucial cash flow that allowed us to provide up to \$4,000 raises for our employees, the largest compensation increases we have been able to provide in recent years. Retaining highly valued employees is key for our businesses to function."

The small business tax relief was ploughed back into people and production, not owners' pockets. Unfortunately, these provisions expire on December 31, 2025. Nearly half of small business owners reported that uncertainty of expiring tax provisions is impacting their current and future business plans.

Fortunately, Congressman Lloyd Smucker, a Member of the Budget Committee, will reintroduce the Main Street Tax Certainty Act during the next congressional work period. This legislation would make permanent the 20 percent small business deduction, providing tax certainty for small business owners to grow their businesses. NFIB urges Members of Congress to support this legislation by joining as an original cosponsor.

Further clouding business planning are proposed tax increases on small businesses. President Biden's Fiscal Year 2024 budget request would increase taxes on small businesses organized as corporations and passthroughs.

I included a list of certain tax increase proposals in my written testimony, but I would like to focus on the proposed five percent small business surtax on passthrough business income. The President's budget request describes this small business surtax as "closing a loophole." The tax was originally created as part of the Affordable Care Act's reconciliation bill as a tax on investment or passive income. It was a deliberate policy choice to not apply the tax to active business income, which of course is not passive income. As former chairman of President Obama's Council of Economic Advisers, Jason Furman described, it was not applied to active business income "because it could be demonized as a tax on small businesses and doctors."

A deliberate policy choice is not a loophole. The proposed expansion of the tax would more than double the revenue collected, further demonstrating that the tax increase proposal does not close a loophole. If it is ultimately enacted, this substantial tax increase would reduce the ability of passthrough business owners to invest in their businesses and employees, as well as leaving them at a further disadvantage relative to corporations.

Over a few months, NFIB collected over 21,000 signatures from small business owners throughout the country opposing this small business surtax, and stating emphatically that small business is not a tax loophole.

Small business owners shared their concern. For example, John Sullivan, owner of Dana Wallboard in Westford, Massachusetts, wrote that, "As a passthrough entity, we pass through a million dollars, but that doesn't mean we keep it for ourselves. We still pay out of that, long-term debt, mortgages, truck leases, et cetera. We don't take it home. When all is said and done, we take home less than 400,000. By taxing us on everything over 400,000, assumes we are keeping that money for personal consumption, and that is just not true. I recommend rethinking this 3.8 percent small business surtax on small businesses who are hanging on with all the issues they've had to deal with over the past two and a half years."

In conclusion, small businesses continue to face economic headwinds. Congress can help mitigate economic challenges by extending beneficial small business tax provisions, reducing paperwork, and rejecting tax increases on small businesses. Tax certainty will help businesses plan for the future and increase small business confidence.

I appreciate your time and attention to these concerns. Thank you for this opportunity.

[The information follows:]

TESTIMONY BEFORE THE UNITED STATES CONGRESS
ON BEHALF OF THE

NATIONAL FEDERATION OF INDEPENDENT BUSINESS



Statement for the Record of Kevin Kuhlman
Vice President, Federal Government Relations

**United States House of Representatives
Committee on Budget**

Reigniting American Growth and Prosperity Series:
Incentivizing Economic Excellence Through Tax Policy

June 22, 2023

National Federation of Independent Business
555 12th Street NW, Suite 1001
Washington, DC 20004

Good afternoon, Chairman Arrington, Ranking Member Boyle, and members of the House Budget Committee. My name is Kevin Kuhlman; I am the Vice President of Federal Government Relations at the National Federation of Independent Business (NFIB).

NFIB is the nation's leading small business advocacy organization, advocating on behalf of nearly 300,000 small business owner members in Washington, D.C., and all 50 state capitals. NFIB's mission is to promote and protect the right of our members to own, operate, and grow their businesses.

Small businesses face economic challenges including stubbornly high inflation and pervasive workforce shortages.¹ Nearly half of small business owners cannot fill open positions. Small business optimism remains well below the nearly 50-year historical average. Small business owners' expectations of better business conditions six months from now remain near historic lows.

Additionally, small businesses face a very uncertain tax future that makes business planning extremely difficult. Beginning this year, certain business provisions of the Tax Cuts and Jobs Act (TCJA) of 2017 expire or wind down. In 2.5 years, the vast majority of the provisions that benefit individuals and small businesses will also expire. If Congress fails to act, there will be a detrimental and substantial tax increase on millions of small businesses. Further, proposals to increase taxes on businesses cloud optimism and further complicate business planning. Finally, the small business paperwork burden is increasing, which complicates tax compliance, while the IRS disproportionately expands enforcement efforts over compliance assistance and customer service improvements.

Small Business Benefits of Tax Cuts and Jobs Act of 2017

Small businesses received significant tax relief upon enactment of the Tax Cuts and Jobs Act of 2017. More than three-quarters of businesses are organized as pass-through businesses (S-Corporations, LLCs, Sole Proprietorships, and Partnerships). Business income is passed through to the business owners' individual income tax return (Form 1040), where individual income tax rates are applied. These businesses invest much of their post-tax dollars back into their businesses and employees.

¹ William C. Dunkelberg and Holly Wade, *NFIB Small Business Economic Trends*, NFIB Research Center, May 2023, <https://strgnfibcom.blob.core.windows.net/nfibcom/SBET-May-2023.pdf>.

For pass-through businesses, the 20% Small Business Deduction (also known as Section 199A), combined with the lower individual tax rates and broader income brackets, provided tax relief that was invested in small businesses and employees.^{2,3} These provisions expire on December 31, 2025. Nearly half of small business owners (48%) reported the uncertainty of expiring tax provisions is impacting their current and future business plans.⁴

Fortunately, Congressman Lloyd Smucker (PA), a member of the Budget Committee, will re-introduce the *Main Street Tax Certainty Act* during the next Congressional work period. This legislation would make permanent the 20% Small Business Deduction, providing tax certainty for small business owners to grow their businesses. NFIB urges Members of Congress to support this legislation by joining as an original cosponsor.

The TCJA also contained provisions that encouraged business investment by allowing for the immediate deduction of equipment and capital expenses. These provisions include permanently extending Section 179 expensing and temporarily extending bonus depreciation and R&D expensing (Section 174).^{5,6} Unfortunately, the latter two provisions expired last year. R&D expensing is a big deal when cashflow is tight, which is currently happening due to inflation and rising interest rates. The sooner that the positive small business and expensing provisions are extended, the better small businesses will be able to plan for the future. The proposed *Build It in America Act* (H.R. 3938) would extend these pro-growth provisions while the proposed *Small Business Jobs Act* (H.R. 3937) would expand Section 179 expensing.

Small Business Concerns with Fiscal Year 2024 Budget Request

² The Small Employer column shows 77.9% are organized as passthroughs (Sole Proprietors, Partnerships, and S-Corporations) and 22.3% are organized as C-Corporations and Other. Table 2, Legal Form of Organization (2019), Frequently Asked Questions About Small Business, U.S. Small Business Office of Advocacy, March 2023, <https://advocacy.sba.gov/wp-content/uploads/2023/03/Frequently-Asked-Questions-About-Small-Business-March-2023-508c.pdf>.

³ "A quarter of small business owners who reported a tax saving raised spending on employee compensation (Q#14a6). The second most frequently reported increase in spending was on business investment and expansion (Q#14a5). Tax savings motivated 16% of small business owners to hire additional employees (Q#14a3) and another 20% to pay down debt obligations (Q#14a7)." *The Tax Cuts and Jobs Act, One Year Later: Part II*, NFIB Research Center, September 2019, <https://assets.nfib.com/nfibcom/TCJA-Part-2.pdf>.

⁴ NFIB Tax Survey, NFIB Research Center, 2021, <https://assets.nfib.com/nfibcom/NFIB-Tax-Survey-Full-Report.pdf>.

⁵ "Congress made a number of significant changes in the [bonus depreciation allowance] BDA in P.L. 115-97. Specifically, the act set the rate for the BDA at 100% for qualified property acquired and placed in service between September 28, 2017, and December 31, 2022. The rate then is scheduled to decrease to 80% for property placed in service in 2023, 60% for property placed in service in 2024, 40% for property placed in service in 2025, 20% for property placed in service in 2026, and 0% starting in 2027 and thereafter." Gary Guenther, *The Section 179 and Bonus Depreciation Expensing Allowances: Current Law and Economic Effects*, Congressional Research Service, May 1, 2018, <https://www.everycrsreport.com/reports/RL31852.html>.

⁶ Beginning in tax year 2022, small businesses are now required to capitalize R&D costs and amortize them over a minimum of 5 years for domestic research and development.

Further clouding business planning are proposed tax increases on small businesses. President Biden's Fiscal Year 2024 Budget Request would increase taxes on small businesses organized as corporations and pass-throughs. For the nearly one-quarter of small employers organized as corporations, the budget proposes increasing the corporate tax rate from 21% to 28%.⁷ For the more than three-quarters of small employers that are pass-throughs, the budget proposes increasing the top marginal income tax rate, lowering the threshold that the top rate begins, creating a new 5% tax on business income above \$400,000,⁸ increasing capital gains tax rates above \$1 million, and further limiting the ability to smooth out business losses. For businesses of all types, the President's budget limits like-kind exchanges and changes the tax treatment of stepped-up basis for family businesses and farms. While small businesses may not be impacted by these proposed tax changes every year, they will be impacted when they have profitable years, when they sell their businesses to fund their retirement, or when they pass along their businesses to the next generation.⁹

The President's Budget Request describes certain tax increases misleadingly as "closing loopholes." One example of this mischaracterization is the proposed expansion of the 3.8% "Net Investment Income Tax" (NIIT) to active business income and increase that tax rate to 5%.¹⁰ This tax was originally created as part of the Affordable Care Act reconciliation bill as a tax on investment, or passive, income above \$200,000.^{11,12,13} It was a deliberate policy choice to exempt active business

⁷ The Build Back Better Act that was considered by the Ways and Means Committee would have created a graduated corporate rate structure, as did the Senate amendment offered by Senators Sanders (I-VT) and Whitehouse (D-RJ). The President's FY2024 Budget Proposal does not.

⁸ The threshold for joint filers is \$450,000. These thresholds are not indexed for inflation so it will absorb an increasing number of small businesses and a greater percentage of small business income every year.

⁹ "The majority (52%) of small business owners plan to sell their business when they retire or move on from it. Additionally, about a third (33%) plan to pass it on to a family member when it's time to move on. Of the respondents who plan on passing their business on to family, half (49%) have talked to a tax professional already and 29% plan to but haven't yet. Many small business owners believe that if a capital gains tax were assessed on business inheritance, the next generation would have to take out a loan (38%) or sell part of the business (26%) to pay the tax. About a quarter (26%) believe the next generation would pay for the tax using savings or other income." NFIB 2021 Tax Survey, NFIB Research Center, June 2021, <https://assets.nfib.com/nfibcom/NFIB-Tax-Survey-Full-Report.pdf>.

¹⁰ "The Budget closes the loophole that allows certain business owners to avoid paying Medicare taxes on these profits, and dedicates revenue raised by the Net Investment Income Tax (NIIT) to the Medicare HI Trust Fund, as originally intended. In addition, the Budget raises the Medicare tax rate on earned and unearned income and the NIIT rate from 3.8% to 5% for the wealthiest Americans." Budget of the U.S. Government, Fiscal Year 2024, Office of Management and Budget, page 45, March 9, 2023, https://www.whitehouse.gov/wp-content/uploads/2023/03/budget_fy2024.pdf.

¹¹ The NIIT was neither included in the House or Senate ACA proposals; it was added during reconciliation after the Cadillac tax (which has since been repealed) was delayed and Cadillac tax thresholds were increased.

¹² The threshold for joint filers is \$250,000. These thresholds are also not indexed for inflation.

¹³ "In summary, the NIIT arose as a last-minute revenue replacement to offset the revenue loss from Congress's delayed implementation of the 40% excise tax on high-cost, or Cadillac, health insurance plans. As a direct substitute for the Cadillac tax's general fund revenues, the receipts from the NIIT needed to flow into the Treasury's general fund instead of being dedicated to either of Medicare's trust funds. In other words, while helpful to supporting federal expenditures, including Medicare, the ACA did not directly link the NIIT to Medicare." Ausher M.B. Kofsky and Bryan P. Schmutz, *What a Long Strange Trip It's Been for the 3.8% Net Investment Income Tax*, May 15, 2019, <https://digitalcommons.law.umaryland.edu/cgi/viewcontent.cgi?article=1057&context=endnotes>.

income, which is not investment income, from the tax. As former Chairman of President Obama's Council of Economic Advisors Jason Furman described, it was not applied to active business income, "because it could be demonized as a tax on small businesses and doctors."¹⁴

A deliberate policy choice is not a "loophole." The proposed expansion of the tax would more than double the revenue collected, further demonstrating that the tax increase proposal is not "closing a loophole."^{15,16} If it is ultimately enacted, this substantial tax increase would reduce the ability of passthrough business owners to invest in their businesses and employees, leaving them at a further disadvantage relative to corporations.

Over a few months, NFIB collected over 21,000 signatures from small business owners throughout the country opposing this "Small Business Surtax" and stating that "small business is not a tax loophole." Fortunately, none of these proposed tax increases were included in the recent debt limit increase.

Tax Complexity

Tax compliance is a challenge for small business owners.¹⁷ More than 90% use a tax professional to prepare and submit their taxes. Among this group, "compliance" and "complexity" were the two dominant factors leading business owners to use a professional. Paperwork burdens are increasing, and enforcement efforts are ramping up. The Inflation Reduction Act of 2022 provided nearly \$80 billion in new funding for the Internal Revenue Service (IRS), primarily focused on enforcement. Unfortunately, only 4% of that funding was designated for IRS customer service, which is in need of significant improvement. Small business owners are concerned about the implementation of increased enforcement efforts, the continued backlog of tax returns, and increased paperwork.

Currently, business owners are inundated with paperwork and current Form 1099 information reports. The forthcoming expansion of Form 1099-K reporting could further complicate tax preparation and require more reconciliation of paperwork. It

¹⁴ Jason Furman, Twitter, October 28, 2021, <https://twitter.com/jasonfurman/status/1453756933689823241>.

¹⁵ According to IRS Statistics of Income, the NIIT collected \$3.1 billion in taxes in 2020, <https://www.irs.gov/statistics/soi-tax-stats-individual-income-tax-returns-with-small-business-income-and-losses>.

¹⁶ According to the FY2024 Treasury Greenbook, the proposed tax increase would collect an average of \$65 billion per year over ten years – expansion of 3.89% NIIT to active business income (average \$30.6 billion per year over ten years) and increase NIIT rate to 5% (average \$34.4 billion per year over ten years), <https://home.treasury.gov/system/files/131/General-Explanations-FY2024.pdf>.

¹⁷ "Despite the high proportion of business owners enlisting the help of a tax professional, most respondents indicated a persistent administrative burden associated with preparing and paying their taxes. Specifically, as shown in Figure 5, more than 60% of respondents found the administrative burden of federal business income taxes and payroll taxes to be moderately or very burdensome." NFIB 2021 Tax Survey, NFIB Research Center, June 2021, <https://assets.nfib.com/nfibcom/NFIB-Tax-Survey-Full-Report.pdf>.

has already been delayed once administratively as a result. The proposed *Small Business Jobs Act* (H.R. 3937) would provide paperwork relief from Form 1099 reporting requirements, rolling back the Form 1099-K expansion and revising upward the Form 1099-MISC threshold for the first time in decades. The genesis of this proposed change was testimony from NFIB member Alison Couch at a Ways and Means Field Committee hearing in Peachtree, Georgia, earlier this spring.

Small business owners must also file burdensome beneficial ownership reporting paperwork with Treasury beginning January 1, 2024. The statutory requirements for this new paperwork requirement are four pieces of personally identifiable information (full legal name, business or residential address, date of birth, and unique identifying number). Yet the draft application spans 6 pages and is 50 questions long, with many more pieces of information appearing to be required. The outreach and education efforts on both of these new reporting requirements have been lacking and businesses remain concerned by what these added burdens will have on their operations.

Small businesses continue to face economic headwinds. Congress can help mitigate economic challenges by extending beneficial small business tax provisions, reducing paperwork, and rejecting tax increases on small businesses. Tax certainty will help businesses plan for the future and increase small business confidence. I appreciate your time and attention to these concerns. Thank you for the opportunity to testify today on behalf of small businesses.

Chairman ARRINGTON. Thank you, Mr. Kuhlman.
I now yield five minutes to Dr. Mazur.

Dr. MAZUR. Mazur.

Chairman ARRINGTON. Mazur. You know, I asked that question and I still couldn't get it right. So, I apologize.

STATEMENT OF THE HONORABLE MARK MAZUR, FORMER ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY

Dr. MAZUR. No problem. Chairman Arrington, Ranking Member Boyle, Members of the Committee, thank you very much for having me here today to discuss this important topic concerning the Federal tax code.

The Federal tax code administered by the Internal Revenue Service is responsible for raising four and a half trillion dollars a year. That pays for all the goods and services provided by the Federal Government.

Just to review some basics, when we think about any taxes, there are four main criteria we use to evaluate it. One, revenue adequacy. Does it raise enough revenue to pay for the goods and services that are demanded by the population? Two, efficiency. Is the revenue raised in a way that minimizes distortions? And distortions accompany any tax system, so minimize them in that context. Third, is it equitable? That means two things. One, are similarly situated taxpayers treated roughly the same, horizontal equity? And are taxpayers with greater ability to pay asked to contribute a larger share of their resources than those with less ability to pay, vertical equity? And finally, simplicity, where taxpayers know what the obligations are, know what the rules are, and can comply with the system without too much burden. Those are the ideals. Obviously, our system falls short on all four dimensions.

We can talk about revenue adequacy to start. In the late 1990s, early 2000s, the last time the Federal budget was balanced, the Federal Government raised about 20 percent of GDP in terms of revenues. Since then, as a country, we have decided to increase spending on things like national defense, and demographically, we have way more retirees than we used to have who claim benefits from Social Security, Medicare, Medicaid, and so on.

And so, if we are serious about balancing the budget, we would be looking at something above 20 percent of GDP, not below. Last year, we had a one-time apparition to get up to 19.6 percent GDP. That would be a good start if we were able to maintain that, but that would take some action from Congress to actually raise revenues relative to the baseline in order to do that.

In my testimony, I just do a quick little example of my personal situation. So, in 1988, I looked at my effective tax rate. It was 21 percent. In 2018, 30 years later, my adjusted gross income was about 50 percent higher in inflation-adjusted terms. My effective tax rate was 19 percent. It was actually lower. So, I was paying less to the Federal Government for the services I was getting, which are roughly the same level of services 30 years later, even though my income was substantially higher.

Why is that? Because we have had a series of tax cuts that have occurred over a long period of time, in 2001, 2003, they were ex-

tended again in 2012, in 2017, and several other times, and those outweighed the tax increases in 1993 and with the Affordable Care Act.

And so, really, we are asking people, relatively well-off people, to pay less than they used to pay to support the Federal Government. That doesn't seem like a strategy for getting the budget balanced.

I know the hearing today is focused on tax incentives. Largely, one of the things that you should keep in mind is almost all the tax incentives we have in place are inefficient, that they are not the most cost-effective way to generate the behavior that Congress is trying to generate. What we do with the current set of tax incentives is largely pay taxpayers to do what they would have done anyway.

And so, just one example, bonus depreciation, which I know my colleagues here like. Basically, bonus depreciation says if you are investing in your business to maintain it and keep it profitable and so on, completely deduct the cost of those investments. You would have done that anyway. We are not encouraging people to do much more than they would have done.

Similarly, I talk a little bit in my testimony about things like 529 plans, which basically have people shift investments from taxable accounts into tax-favored accounts. Really doesn't change their behavior very much, but it does cost the Federal Government revenue.

And so, if we are looking about designing tax incentives, what we would focus on is where the behavior occurs, and then try very hard to focus attention on changing that behavior in a very cost-effective way, and as Kyle Pomerleau said, one of the things that we would certainly not do is do retroactive tax cuts because, frankly, that behavior has already occurred in the past. We are not changing it by changing the tax law with that. So, really, you would want to try the minimum, not do those things that will not change behavior.

And with that, I will just conclude here. Thank you for the opportunity to be here. Happy to take your questions.

[The information follows:]

U.S House of Representatives

Committee on the Budget

Hearing Entitled "Incentivizing Economic Excellence Through Tax Policy"

June 22, 2023

Chairman Arrington, Ranking Member Boyle, and Members of the Committee, thank you for having me here today to discuss this important topic concerning the Federal Tax Code.

The Federal Tax Code, administered by the Internal Revenue Service (IRS), is responsible for raising over \$4.5 trillion per year, which helps pay for the goods and services that the Federal government provides to the Nation.

When evaluating any tax system, there are four main criteria: revenue adequacy, efficiency, equity, and simplicity. Revenue adequacy simply means raising the revenues necessary to support all the activities of the Federal government. Efficiency means raising the desired revenue in ways that minimize the economic distortions that accompany tax systems. Equity means treating similarly situated taxpayers in a similar fashion (horizontal equity) and ensuring that those with the greatest means to do so contribute a larger share of their resources to funding the government (vertical equity). Finally, simplicity (while in the eye of the beholder) means creating a tax system where taxpayers know their obligations and the rules and can comply without excessive administrative burden.

These are the ideals that the Federal government should aim for in developing tax policy. Unfortunately, as a Nation, we fall short across all these dimensions.

Revenue Adequacy

The last time the Federal government had a balanced budget was in the late 1990s/early 2000s, when revenue raised totaled approximately 20 percent of Gross Domestic Product (GDP). Given the changes in the U.S. economy, in the Nation's demographics, and in fiscal policy – namely greater investments in national defense and a growing share of retirees who rely on Social Security and Medicare -- we should probably be aiming for a revenue share that is a couple percentage points higher than it was over two decades ago. This means revenues should be significantly over 20 percent of GDP in order to balance the Federal budget this decade or even to stabilize Federal debt as a share of GDP.¹

Revenues have generally declined as a share of the economy over the past 25 years for a variety of reasons. Taxes on capital income are lower due to reduced corporate income tax rates, preferential tax

¹ In Fiscal Year 2022, Federal revenues reached 19.6 percent of GDP, a result that appears to represent a one-time confluence of events, including a bounce-back from a pandemic-induced economic contraction and the impact of Federal government spending to combat the effects of the pandemic. The Congressional Budget Office forecasts that Federal revenues will decline by 1-2 percentage points of GDP in the next couple years.

rates on capital gains and dividend income, and reduced taxes on estates and gifts. The last 25 years also have seen greater use of tax incentives, a substantial rollback of the Alternative Minimum Tax (AMT), stagnant or reduced excise taxes, and a reduction in individual income tax rates across the board, with effectively larger reductions for those with higher incomes.

While I was at the Urban-Brookings Tax Policy Center, I wrote about my own personal income tax history. I compared my Federal income tax burden in 2018 with that for 1988 (the first full year of implementation after the 1986 Tax Reform Act). In both years, I had similar household composition, but my income in 2018 was substantially higher, about 50 percent higher in inflation-adjusted terms. However, my effective Federal income tax rate (income tax paid divided by adjusted gross income) was about 19 percent in 2018, a full 2 percentage points lower than my 21 percent effective tax rate for 1988. How did this occur? Well, Congress cut taxes for households like mine in 2001 and 2003, and largely continued those tax cuts in 2012. And in 2017, the Tax Cuts and Jobs Act further reduced my taxes (though there were provisions going in both directions). Overall, these tax cuts far outweighed the tax increases on households like mine from the 1993 tax legislation and the 2010 Affordable Care Act.²

Over the same 30 year time frame, Federal spending bounced around a bit but has averaged around 20 percent of GDP. So while I benefitted about the same amount from the various public goods provided by the Federal government over three decades, my relative contribution declined even while my ability to pay increased. And this simple example helps illustrate one of the reasons we struggle with revenue adequacy as a Nation.

Tax Incentives

In general, tax incentives attempt to shift taxpayer behavior in a way that Congress desires. Also in general, tax incentives are inefficient policy tools. This is because tax incentives, unless very well-designed, will subsidize many taxpayers for doing what they would have done even in the absence of the tax incentive. To put it another way, for most tax incentives the amount of behavior that is changed as a result of the incentive tends to be very small compared to the amount of tax benefit that accrues to taxpayers who do not change their underlying behavior.

The list of inefficient tax incentives is large. Bonus depreciation largely rewards firms for making the investments necessary for an ongoing business to become and remain profitable. When bonus depreciation was first enacted, it may have helped accelerate investment into a year prior to when it would have ordinarily occurred, but that effect has largely gone away as Congress has made some form of bonus depreciation routine. Section 529 accounts (to promote saving for higher education) are intended to encourage parents (and grandparents) to save for the college education expenses of their children by allowing accumulated earnings on these accounts to escape taxation if the distributions from these accounts are used for a wide range of expenses associated with higher education. There may have been some taxpayers who would have foregone saving for college expenses except for the creation of these tax-preferred accounts. But a much, much greater number of taxpayers moved investment funds from a fully-taxable investment account to a tax-preferred Tuition Saving Program (Section 529

² Since 2018, my income has dropped a bit but so has my effective tax rate, so the situation is about the same.

account). Opportunity Zones have rewarded real estate investors who have long made use of a technique to defer taxes on the capital gains generated by real estate investments called “like-kind exchange”. Under the provisions of the Opportunity Zone legislation, future gains on these properties can be reduced or even eliminated, a benefit much greater than deferral, provided the property is located in an area designated as an Opportunity Zone. And the process for designating Opportunity Zones provides these benefits to many fast-growing areas in the country, meaning that the benefits can accrue to real estate investors who are merely following their traditional business behavior. Even the excise tax reductions that Congress has provided to support craft brewers apply to a portion of the production of extremely large brewing companies, such as Anheuser-Busch, an obvious design flaw if the goal is to encourage small brewers to enter the business and expand.

The list of inefficient tax preferences is long and covers a wide range of activities. Here are just a few more: preferential tax rates on capital gains from assets held over 1 year, preferential tax rates on dividend income, the home mortgage interest deduction, a zero capital gains tax rate applied to certain “Small Business” stock, the deduction for a portion of income from pass-through businesses, and Roth IRAs. In all these cases, the desired behavioral change generated is relatively small compared to the revenue foregone from the tax preference.

There also are tax incentives which reward prior behavior, where taxpayers can claim a tax benefit a year or two after filing an initial tax return covering the period where the tax-preferred expenditure was made. Cottage industries have cropped up to help taxpayers make these delayed claims for things like the Research and Experimentation (R&E) Tax Credit or the Employee Retention Credit based on expenditures made in prior years. Obviously, these tax benefits go to firms that already made decisions and investments regarding their operations a year or two ago, and so the prospect of tax benefits did not figure into their decisions. Claiming the tax benefits on an amended return does not change the firm’s underlying behavior, but does add to the cash flow of the firm (and the companies who help the firms file their belated claims for the tax benefits).

There are some tax incentives, however, that do appear to encourage the desired behavior to an extent greater than the total cost of the tax subsidy. Research on the R&E Tax Credit has shown that it can be cost-effective in generating additional research investments. The original design of the R&E credit rewarded research investments above a prior year baseline, encouraging firms to continually increase their research investments. Congress over time has essentially removed this feature, blunting, but not entirely eliminating the effectiveness of this tax credit at changing firm behavior in the desired direction. That is, the credit still seems to generate a bit more than \$1 of additional research investment for each \$1 of foregone tax revenue.

The point of effective tax incentives is to encourage desired behavior that would not otherwise occur. And the value of the changed behavior should exceed the cost of the tax expenditure over the life of the program, not just over the traditional 10-year budget window. The goal should be to enact only those tax incentives that have a return on investment substantially greater than \$1 for each \$1 of foregone tax revenue. Given that the cost in foregone tax revenue from existing tax expenditures probably exceeds \$1 trillion per year, adding new tax expenditures should be a rare occurrence.

High ROI Investments

When looking at Federal Government expenditures, it is important to fund necessary ongoing operations as well as to meet the service expectations of citizens. In addition, it is also key to support outlays with a high rate of return on investment (ROI).

For example, well-considered investments in transportation infrastructure can have high returns that accrue to travelers, shippers and consumers, covering just about the entire population. Well-chosen projects that have significant and widespread benefits exist in every state and lead to a high aggregate ROI. That is why the recently enacted infrastructure bill is so important. The funding it makes available can be put to good use all across the country, repairing and upgrading existing infrastructure, relieving bottlenecks through new approaches, and adding new capacity where needed. Congress missed an opportunity, however, to fund part of this investment package by increasing motor fuels excise taxes which act as a user fee for many of those who utilize transportation assets. These taxes were last raised nearly three decades ago.

There also are important investments that can help government work better. Congress used to have its own Office of Technology Assessment, which provided independent and objective expertise on a wide range of complex technological matters. It was abolished in 1995. And now Congress learns about topics such as artificial intelligence, advanced battery and storage technology, privacy in electronic communications, and new approaches to health care from industry representatives and other interested parties instead of from its own set of objective experts.

Another important investment with a large return is the multi-year funding provided to the IRS in the Inflation Reduction Act last year. Traditional estimates are that the IRS generates a 4:1 or a 5:1 return on its investments in enforcement activities. In a recent working paper, Professor Natasha Sarin and I argue that this is a substantial under-estimate. Once the benefits of deterrence and better technology and resource allocation are incorporated, the returns could be twice the traditional estimates.³ This work implies that the recent reduction of IRS funding contained in the debt-limit agreement is both short-sighted and counter-productive. The Congressional Budget Office estimated that the \$21.4 billion reduction in IRS funding would reduce tax collections by around \$40 billion over the current 10-year budget window. Our estimate would be at least twice that amount, meaning that this rescission of funds would leave the accumulated Federal budget deficits at least \$60 billion larger than would otherwise be the case. This is counter-productive to the goal of moving toward a more balanced Federal budget.

Another benefit from the multi-year investment in the IRS is a potential improvement in taxpayer morale. While few people enjoy paying taxes, we all know that we should make our best efforts to comply. The multi-year IRS funding will allow for improved services, making it easier for taxpayers to meet their tax obligations. And increased scrutiny applied to high-income taxpayers and corporations

³ A recent paper by a team of economists examined IRS audit results to compile costs and additional tax collections. The paper concluded that once deterrent effects were factored in, the rate of return on resources devoted to auditing high-income individuals could exceed 10:1.

will help convince people that the Nation does not have a two-tier tax system, with one set of rules for ordinary wage earners and another set for everyone else.

Summary

The Federal Tax Code is primarily about raising the resources to fund the goods and services provided by the Federal government. Key features of a desirable tax system are revenue adequacy, efficiency, equity, and simplicity. Our Tax Code falls short on all these dimensions and the large ongoing Federal budget deficits are indicative that the revenues generated are inadequate, given the economic and demographic changes we have experienced.

When designing tax incentives, it is important to focus on the effectiveness at generating the desired behavioral changes compared to the cost of the foregone tax revenue. In this regard, most of the existing tax incentives are quite inefficient.

In running a government enterprise, it is important to fund activities with high rates of return on the investments. The recent infrastructure bill has the potential for being evaluated by future policy analysts as a desirable set of investments and good fiscal policy. The recent agreement to rescind part of the multi-year funding for the IRS is a step in the opposite policy direction.

Chairman ARRINGTON. Thank you, Dr. Mazur.

We will now begin our question-and-answer session. I will yield myself five minutes.

Let me start with you, Dr. Mazur. I think your comments were very thoughtful. I want to know, as a tax policy expert, is there a point at which—because you mentioned some of the tax incentives don't have the return on investment that some—

Dr. MAZUR. Mm-hmm.

Chairman ARRINGTON [continuing]. Would say they do, but where is the point at which you have diminishing returns? And is there a point at which you tax either businesses or individuals where you get less revenue because you have reduced investment, growth, et cetera? Is there such an inflection point, in your mind?

Dr. MAZUR. Well, for sure. You have heard of the Laffer Curve, right? You have seen that picture drawn. So, surely at 100 percent, that is not giving you much incentive, right? And so, as you move back a little bit from that, you are able to generate additional revenue, but where we are looking at in today's world, with tax rates of, between 20, 30, 40 percent, that is not even close to where an inflection point occurs. We are really far away. I think when President Kennedy talked about cutting tax rates, maybe we were close to it then, but really, we are not there now.

Chairman ARRINGTON. I am not an expert on tax policy, but I am on the Tax Subcommittee of Ways and Means, and I have pondered what is the right rate for many years now, and I am not dogmatic.

Dr. MAZUR. Mm-hmm.

Chairman ARRINGTON. It is not theology for me, but practically speaking, you look at our competitors around the globe and you say to yourself, do we want to be the highest taxed business, job creators in the world or do we want to be the most competitive, or somewhere in between? Because capital is going to flow in this global market to where it is going to get the best return, and I think about pre-TCJA and how much capital was overseas and how uncompetitive we were from a tax code standpoint.

So, you touched on this, Mr. Pomerleau, about bringing us in line. Let's just say, you know, nobody knows the magic rate, but we know our rates relative to our competitors, and you said that if we implement President Biden's tax rates that he proposes in his budget, number one, it is almost \$5 trillion dollars in new taxes, but you said it would bring us to the top taxed corporate rate or business rate in the OECD field, with the exception of one country. Who is the one country that would be taxing higher than the United States in that scenario?

Mr. POMERLEAU. It is actually a small country, Colombia.

Chairman ARRINGTON. Colombia. Who is in the top five with the United States in that scenario where we would increase the corporate rates to 28 percent?

Mr. POMERLEAU. So, the countries that would be up there with us would be some of the larger countries, like Germany, France, Japan.

Chairman ARRINGTON. I read from a progressive, more liberal tax policy think tank where corporate rates, the majority of corporate rate increases are passed onto consumers. It is as high as 70 percent, but we can debate that, but are corporate rate in-

creases passed to consumers in lower wages, in higher prices, and to what extent does that dynamic occur?

Mr. POMERLEAU. Yeah, this is a complex issue, and it also depends on what the base of your tax looks like, how much it distorts investment, but it is generally true that, you know, any tax is going to fall on either workers or owners of companies, and the corporate tax is no exception, but the exact share really depends.

Dr. MAZUR. But the—

Chairman ARRINGTON. Go ahead. Yeah.

Dr. MAZUR. But the Treasury Department and Joint Tax Committee, who have studied this, basically show that 70 or 80 percent goes to capital.

Chairman ARRINGTON. Goes to what?

Dr. MAZUR. Capital. Not labor, not consumers.

Mr. POMERLEAU. One reason for that, by the way, is because the base of the corporate tax has a lot of expensing, which makes the corporate tax more neutral and less distortive for corporate investment.

Chairman ARRINGTON. Dr. McBride talked about the progressivity of the tax code, and many would say it is the most progressive of the OECD countries. Did the TCJA make the tax code less progressive or more progressive?

Dr. MCBRIDE. A couple of studies on this indicate that it was basically a wash or made it slightly more progressive actually.

Chairman ARRINGTON. Okay. So, it wasn't less progressive?

Dr. MCBRIDE. No. No. Certainly demonstrably, when CBO looked at it, there were tax cuts across the entire income scale.

Chairman ARRINGTON. And we have heard the tired talking point about it was a giveaway to the rich, but my understanding is that lower-income and middle-income folks benefited as a percentage more than the higher income in terms of retained income, retained earnings. Is that correct?

Dr. MCBRIDE. I believe that is correct, but I am not entirely sure. I don't have the numbers in front of me here.

Chairman ARRINGTON. Well, my time has expired and I yield to my Ranking Member for his Q&A.

Mr. BOYLE. And so, on the TCJA, Dr. Mazur, you may know this, but am I correct when I recall that the Congressional Budget Office found that by 2026, 83 percent of the tax cut from the TCJA went to the wealthiest one percent?

Dr. MAZUR. I am not aware of the actual numbers, but I do know that the benefits tended to go to higher income people, especially when you considered the corporate benefits being, going to capital.

Mr. BOYLE. And not just the richest one percent, but the richest one-tenth of one percent received a majority of the tax cut in the TCJA.

Now, for most of this year, actually all of this year up until a few weeks ago, the major issue in the Capitol was the debt ceiling and whether or not it would be raised, whether or not the United States would suffer a first-ever default. The alleged driver for those who didn't want to raise the debt limit was to win cuts because they were so concerned about the size of the national debt.

Well, here we are just last week, the House Ways and Means Committee passed a piece of legislation that would extend the

TCJA, the GOP tax scam, and extend those tax cuts. Are you aware perhaps of how much that would cost in terms of adding to our national debt?

Dr. MAZUR. Tens or perhaps hundreds of billions of dollars.

Mr. BOYLE. Yeah. I believe over \$2 trillion is what was found. Sorry, I am not—

Dr. MAZUR. No, it just depends—

Mr. BOYLE [continuing]. Intending to put you on the spot.

Dr. MAZUR. No, no. It depends how long you do the extension.

Mr. BOYLE. Extension for. That is correct. Yeah. So, I believe this was an extension that would cover ten years or so, or at least make them permanent, as far as the budget window.

So, I mean, it is remarkable to me that the majority for months and months and months was talking about national debt, national debt, national debt, and then, as soon as the debt ceiling is raised, they immediately pivot to making tax cuts for the richest one percent permanent that would add trillions of dollars to our national debt. It certainly calls into question the extent to which some are really concerned about our national debt.

Now, you had, you know, I think an interesting point in your written testimony, and you talked about it just kind of orally here. The level of taxation that you were paying decades ago, same individual, right, relatively I think same income—

Dr. MAZUR. Same house.

Mr. BOYLE [continuing]. Not to pry, but that was what I read.

Dr. MAZUR. Yeah.

Mr. BOYLE. And just how much less you are paying now versus decades ago, and looking at that in relation to our deficit and debt issue, and I was wondering if you could just kind of expound on that because I thought it was very interesting.

Dr. MAZUR. Sure. So, I am a pack rat and I do keep my old taxes, and probably some of you older people do as well, and I looked when I did my 2018 tax return, it was after the Tax Cuts and Jobs Act, and looked at what my effective tax rate was, taxes paid over adjusted gross income, and it was 19 percent, and I compared it to what it was in 1988. Roughly same household composition, but my income in 2018 was like 50 percent higher in inflation-adjusted terms, and my tax rate was two percentage points lower. My effective tax rate was two percentage points lower.

And so, I guess what I took away from that was I am benefiting at least as much from the Federal Government now as I did 30 years ago in terms of public goods that have been provided, and I am paying less for it, and frankly, I could afford to pay more, right. I am not near the poverty level or anything like that.

So, really, I think what it shows is just as a country, we have kind of shirked our responsibilities for ensuring that we are paying for the goods and services that our Nation demands.

Mr. BOYLE. And to be clear, it is just reclaiming my time because this was something else that needed to be corrected, and we have two sides of this obviously, the corporate income tax side and the personal income tax side. Personal income tax side, our top marginal rate 37 percent, significantly lower than where it was in the 1940s, 1950s, 1960s, 1970s. Brief period in the 1980s it was a little bit lower, but for most of Reagan's Presidency it was higher, and

then, of course Clinton when he came in raised the top marginal tax rate, and what followed was a remarkable period of economic growth for most Americans, as well as our stock market and reduction in poverty.

Now, on the corporate side, in the 15 seconds I have left, the TCJA of course lowered the top tax rate, nominal rate, from 35 percent to 21 percent. Compared to what CBO predicted we would be getting in corporate tax revenues before the TCJA versus what happened afterwards, \$119 billion shortfall a year after the TCJA took effect, another \$100 billion shortfall, \$160 billion shortfall. Those were all in the next three years, again according not to my figures but the nonpartisan Congressional Budget Office.

So, there is no question that the so-called Tax Cuts and Jobs Act was a massive tax reduction for corporations and the richest one percent.

With that, I yield back.

Chairman ARRINGTON. Thank you, Mr. Boyle.

We will now yield five minutes to the gentleman from California, Mr. McClintock.

Mr. MCCLINTOCK. Thank you, Mr. Chairman. The Ranking Member's view of the Trump tax cuts reminds me of the story of the economist who said, well, that might work in practice, but it will never work in theory. My Democratic colleagues seem to believe that taxes are simply a cashbox with a dial. Turn it up, they produce more revenue. Turn it down, it produces less.

But Dr. Mazur touched on this, the Laffer Curve, which explains why that view is so wrong. A zero percent tax rate of course produces zero revenues, but so does a 100 percent tax rate produce zero revenues because it utterly destroys the incentive to produce. So, as the tax rate rises, the incentives to produce new wealth slowly diminish and the incentives to avoid or evade the tax slowly increase at the same time, until the curve reaches a point of equilibrium, in which any increase in tax rates actually produces lower tax revenues.

Dr. McBride, do I have that right?

Dr. MCBRIDE. That is correct. That is certainly a real thing.

Mr. MCCLINTOCK. And history teaches us very clearly that this is the case. In the last 60 years, the top income tax rate has been as high as 91 percent and it has been as low as 28 percent, but Federal tax revenues have stayed remarkably steady at between 13 percent and 20 percent of GDP, and indeed, some of the lowest tax revenues came when the top tax rate was at its highest and some of the highest revenues came when the top tax rate was quite low.

But although the tax rates within this envelope has remarkably little effect on revenues, I do think that it has a big impact on economic growth, and experience, practice, tells us that that is the case as well.

We keep hearing that the Trump tax cuts favored the wealthy. Well, Dr. McBride, you are Tax Foundation, right?

Dr. MCBRIDE. Correct.

Mr. MCCLINTOCK. Didn't you folks report that the taxes paid by the top one percent went up while the other 99 percent of Americans saw their taxes go down with the Trump tax cuts?

Dr. MCBRIDE. The share of taxes paid by the top one percent, yes, reached a, I believe at least a 20-year high.

Mr. MCCLINTOCK. The top one percent actually saw their share rise from 38 percent to 40 percent. Correct?

Dr. MCBRIDE. Correct.

Mr. MCCLINTOCK. And the top one percent of taxpayers, they earned 19 percent of all income in the country, and yet they ended up paying 40 percent of all of the income tax revenues. Do I have that right?

Dr. MCBRIDE. That is right.

Mr. MCCLINTOCK. So, when they say the wealthy ought to pay their fair share, what they are really arguing for is to cut their taxes in half. Do I have that right?

Dr. MCBRIDE. Sounds right. Yes.

Mr. MCCLINTOCK. Dr. McBride, when we cut taxes during the Trump Administration, did tax revenues go up or go down?

Dr. MCBRIDE. They certainly went up, and they went up beyond expectations.

Mr. MCCLINTOCK. But the deficit also went up. Why was that?

Dr. MCBRIDE. Spending went up.

Mr. MCCLINTOCK. And faster, right?

Dr. MCBRIDE. Much more. Yes. It remains considerably higher.

Mr. MCCLINTOCK. I have been trying to point out to my friends on the other side it is the spending, stupid, and that is the point, deficits are simply a deferred tax. We borrow now and then we have to pay it back in the future or we simply inflate the economy and everybody pays it back at the grocery store and the gas station, and this Administration has made a science of both of those.

When Reagan cut taxes, did tax revenues go up or go down?

Dr. MCBRIDE. They went up eventually.

Mr. MCCLINTOCK. Yeah. Well, eventually because the tax cut was postponed for two years, and as Art Laffer had explained to President Reagan at the time, Mr. President, how much shopping do you do at a store the day before they have their year-end sale? But the point is the economy responds to these things, and the Democrats used to understand that. When Truman took office, he abolished the excess profits tax, he slashed Federal income tax rates, and we had the post-war economic boom.

Look, the Ranking Member is right, Clinton did raise taxes shortly after taking office, and he took such a drubbing at the polls, they lost the congressional majority. He completely reversed course, came to the Congress, and declared the era of Big Government is over, and what did he do? He provided what amounted to the biggest capital gains tax cut in American history. He restrained Federal spending, actually reduced Federal spending as a percentage of GDP, and we had explosive economic growth and four years of balanced budgets.

You would think that with that practice in hand, the left would abandon their socialist theories, which have never worked, here or anywhere else they have been tried.

I see my time is up. I yield back.

Chairman ARRINGTON. I thank the gentleman from California, and yield five minutes to my friend, Mr. Higgins, from New York.

Mr. HIGGINS. Thank you, Mr. Chairman. Just a couple of things. You know, America remains the world's richest, most dynamic, and productive economy. It is the largest economy. It is 25 percent of the world's economy. It is a \$24.5 trillion economy. America was 40 percent of the world's seven largest economies in 1998. Today, it is 58 percent, or an 18 percent increase. America is home to 11 of the top 15 universities in the world. Tech investment raised \$150 billion, or 49 percent of the global total, and more than double that of China.

In the United States today, as the Ranking Member has said, that U.S. recovered from the coronavirus pandemic faster than any major economy in the world. Unemployment is at a stunning low, 3.4 percent. Biden's economy grew three times the average pace of the previous economy. Real incomes are rising. Manufacturing is booming with 800,000 new jobs. Employment has grown under this Administration by 14 million jobs. Even inflation, which this month was at 4.1 percent, is lower than the global average of 5.2 percent, and two percentage points lower than the average inflation in Europe. Even the budget deficit, 15.6 percent of the economy at the end of the Trump Administration, has dropped to 5.5 percent at the end of last year.

Now, I was just looking at the last 34 years. You have had three Republican administrations and you have had four Democratic administrations. We have had four recessions and four recoveries.

Under George H.W. Bush, Bush one, the deficit grew by \$300 billion and drove the economy into recession.

Under the Clinton Administration, he fixed the broken Bush economy and grew the economy by four percent each year, sustained over an 8-year period, a \$400 billion in debt reduction and left Bush two, George W. Bush, with a \$260 billion surplus.

Bush two took the Clinton surplus and turned it into a \$1.2 trillion deficit and drove the economy into its worst recession since the Great Depression in 2008.

Obama came in, cut the Bush deficit by \$600 billion.

Trump increased the deficit by nearly \$2 trillion, lost three million jobs, including 200,000 manufacturing jobs, and accumulated \$8 trillion in debt, which necessitated the raising of the debt ceiling three times.

Biden created 14 million jobs.

I mean there is a trend here, and each of these Administrations that failed economically adopted a supply side economic policy that disproportionately gave tax cuts to the very wealthy, and each time, those economies have failed miserably and then were saved by the Democratic Administrations that came in, invested in the growth of the American economy, and that is what the economy did under those Administrations.

Dr. Mazur, what am I missing here?

Dr. MAZUR. I think one thing that we all tend to do is overstate the role of the tax system in what is going on in the U.S. economy. It is a contributor, but it is not the driving force.

The U.S. is a very strong economy, as you point out, four percent of the population, 25 percent of the world's economic output. That means we are in a position where we have lots of strengths: a good labor force, good capital markets, good rule of law, supportive Fed-

eral Government, supportive rules, and so on. So, the tax system is just part of the process.

I guess I might quibble a little bit with assigning blame to each of these Administrations or credit. It is true that the economic policies of the Democratic Administrations tended to raise taxes and put you in a better fiscal position. That part is true, but whether—

Mr. HIGGINS. Does infrastructure investment grow the economy?

Dr. MAZUR. Yeah. I think that one of the major benefits of the infrastructure bill that was passed is it allows there to be high rates of return investment in every state of the country.

Mr. HIGGINS. Because that is an investment in the growth and the productivity of the American economy. Tax cuts that end up as stock buybacks do not contribute to the growth of the economy, and what I am simply pointing out here is that there is a trend that is historical and factual.

Mr. MCCLINTOCK [presiding]. The gentleman's time has expired. Mr. Estes.

Mr. ESTES. Well, thank you, Mr. Acting Chairman. I appreciate the opportunity. Thank you to our witnesses for being here today. I am glad we are having this hearing today. Talked a lot about last week's CPI numbers and confirmed that the American economy does need help to be reignited.

The Kansans I represent are still suffering under Bidenflation, and tax policy lays an important foundation for helping economic growth for everyday Americans. You know, families and small businesses have suffered for more than two years under the failings in these economic policies of the Biden Administration.

Inflation is up five and a half percent since Joe Biden took office in January of 2021, much higher than any of his predecessors over the same period of time, and instead of addressing this issue, the President in his budget proposed \$4.7 trillion in tax increases at a time when Kansans are already paying 14 cents out of every dollar they earn in direct Federal taxes, not including the taxes they have to pay through the purchases of businesses, that ultimately pay taxes, from the income from Kansans. You know, this is the opposite of incentivizing of economic growth, if we want to increase that amount.

I do have a couple of ideas about tax policy that the President could put in place to make that important, and I want to talk about that a little bit, but one of the things I want to at least touch on that was brought up earlier and, you know, talking about the difference between in theory versus in practice. You know, the Tax Cuts and Jobs Act that was passed in 2017 obviously is sort of like an investment that you might make in a business, is that you change the tax code to make sure that you incentivize the behavior you want, and as a result, we have seen the economy take off and grow.

So, the first few years you may have lower tax revenue, as mentioned by my friend, the Ranking Member, for the first couple of years, first three years that that went into place, the tax revenue was down over prior years, but the last two years we have already seen we have turned a corner. That investment from the Tax Cuts and Jobs Act, I mean, raised over \$200 billion more than the CBO

estimated in 2021, and in 2022 raised over \$900 billion in actual tax receipts more than what the CBO had estimated. So, obviously we are seeing some positive results out of that by making sure the economy keeps going.

I mentioned there are a couple bills that the President could consider to help get the economy going. One is a bipartisan bill, the American Innovation and R&D Competitiveness Act. That restores immediate expensing for research and development cost. This legislation was part of the larger tax cut and economic growth package that we passed through Ways and Means last week, the Build It in America Act, and it has already been reported out of committee.

It is a promising start. I mean, it will change our tax code to help generate innovation and foster job growth, so that we don't cede any more ground to our adversaries. You know, just as a point of reference, you know, our main competitor, China, has seen its R&D investments increase 400 percent in just two decades. While the United States' share of global R&D investment in 2019 was 30 percent, China's was 24 percent. You know, that is a far cry from where we were in 1999 when the U.S. was at 40 percent and China was at nine percent. So, obviously we have seen a huge growth making those smart investments.

Mr. Kuhlman, will restoring R&D expensing reduce the tax burden on new investments, and how will that help spur economic growth?

Mr. KUHLMAN. Yeah. I think, yes, R&D spending will. It is especially a big deal when cash flow is tight and as interest rates are increasing. That is certainly the case. I have been hearing particularly from manufacturers, engineering firms, architecture firms, technology companies that it certainly would be helpful.

Mr. ESTES. Well, thank you, and a second thing we need to do, talking about tax policy, we need to focus on what is being bantered about by the Biden Administration on the OECD Pillar Two tax scheme that the Administration has been pursuing. Basically, what their proposal is that the OECD would dictate what U.S. companies pay as a tax rate on operations inside the United States, and actually would be detrimental to U.S. tax receipts.

So, according to the Joint Committee on Taxation, if this global implementation of the global minimum tax as defined in Pillar Two is implemented, the United States will lose \$120 billion in tax revenue that will be lost, and even if the United States changes its tax code to match and to copy what the rest of the world does, we would still lose \$58 billion in tax revenue. So, businesses are going to lose money and we are going to get less tax revenue in the United States. That is just a poor policy, and we need to make sure we don't proceed down that route.

So, I know I could go on for a whole lot longer, but I am out of time, and I yield back, Mr. Chairman.

Mr. MCCLINTOCK. Mr. Blumenauer.

Mr. BLUMENAUER. Thank you, Mr. Chairman. I hesitate to contradict my Ranking Member, but there were actually—

Mr. BOYLE. Ms. Schakowsky is now recognized.

Mr. BLUMENAUER [continuing]. There were actually more Democrats who voted for the NAFTA revision than Republicans. Just keep the record straight, but I do appreciate you and Mr. Higgins

laying out what the facts are regarding whether or not, somehow the economy is some sort of rapid decline as a result of 29 months of the Biden Administration. There have, in fact, been more jobs created, 13 million additional jobs, compared to the miserable experience that we had under the four years of the previous President. Those are facts that can be verified. We have 28 consecutive months of job growth under the “failed” policies of President Biden. Doesn’t seem to make sense. We are at historic low record of unemployment, and for Black Americans, it is an all-time record. Hardly the characteristics of failed policies. To the contrary, in terms of growth, in terms of jobs, those are examples of where it is in fact working, and as have been pointed out here before this panel, problems of inflation are not unique to the United States, but in fact, the record of the United States is that we have done a better job of dealing with inflation than the other major economies around the world. I mean, again, Germany, France, Italy, the United Kingdom have experienced far more unemployment and inflation than we have, and I would suggest that it is important to try and put this—we can go ahead on our rhetorical flourishes and talk about theories about what would work or what not, and make rhetorical attacks based on socialist policies and communism and other delusional theories, but the fact is our democracy and its economy are doing better than any other major economy in the world, and it is time that we will be able to reflect on the performance of the Biden Administration.

It seems to me as we are talking about taxation and generating revenues, I am saddened to say that my colleagues, when they got their hands on the levers of power and be able to advance policies, one of the first policies they advance would increase the deficit by slashing enforcement of our taxes. Now, we can debate about what the right level is and who should pay it, but I think it is unconvertible that people should pay the taxes they owe now under the existing system, and those of you who purport to represent small business, I would think that you would want to make sure that they are protected by making sure that people who owe taxes pay what they are responsible for doing. That should not be an item of contention. The tax system that has the least friction is collecting the taxes that are already due and are not being paid, and sadly, the evidence is the further up the food chain you get, the richer you are, the larger the corporations, they have less compliance, not more. We ought to embrace those investments to inject a sense of fairness, so that they are not disadvantaged by people who cheat. That is not in anybody’s interest.

Finally, it seems to me that the recent proposal from my Republican colleagues to gut the inflation reduction proposals to incent investments in alternative energy, which are working, there are billions of dollars that are being committed, largely in red states, to take advantage of those provisions, and it is sad that the majority wants to strip those out of the tax code. Mercifully, they won’t be successful and they shouldn’t be because they are working for the American people.

Thank you and I yield back.

Mr. MCCLINTOCK. Mr. Bergman.

Mr. BERGMAN. Thank you, Mr. Chairman. I find it interesting that too many of us in our 435-member body spend the five minutes of valuable oxygen consumption time talking rather than listening, but it is what it is. We all run every two years and we have to figure out a way to get back here.

So, let's talk to the folks that are sitting somewhere in a mom-and-pop restaurant today or in a machine shop that maybe employs four or five folks, and so, if they were listening to this, it is on their lunch break, and all their employees are listening, how much of what has been said here today do you think they would understand, as it relates to their daily lives? And are we, whether it be us here on the dais or you at the table, are you actually, not necessarily thinking in terms that they will understand, but utilizing examples that a small mom-and-pop business understands?

Anybody want to offer comment? Are we in our own little bubble here as we have these high-level, philosophical, a lot of cases non-decision-making discussions? Anybody want to offer comment?

Mr. KUHLMAN. Congressman Bergman, thank you. Just last week, there were about 200 NFIB small business owner members in town. Met with many offices, including yours and you. So, thank you for meeting with them, but it was, we just encouraged them to tell their story, share their story about it. We follow it at a macro level but we always think that the individual stories are much more important, and it was, you know, how tax relief was reinvested back into the people and into their production, and not into their bank accounts.

Mr. BERGMAN. Have we as the Federal Government made it too complicated?

Mr. KUHLMAN. Yes, and they do acknowledge that things are very complicated.

Mr. BERGMAN. So, the point is if we have made it too complicated, if we looked at and when we talk about corporate taxes, where we talk about taxing the wealthy, which is I think, if I remember in my first term in Budget seven years ago, the math was said if you taxed the wealthiest one percent 115 percent of their income, which seemed a little weird, that it still didn't even come close to beginning to reducing the national debt. The numbers don't match. It is a nice soundbite to play, but the math doesn't work.

So, I would like to hear from whoever wants to offer comment on the following statement. If we eliminated—well, is it a fair statement to say that corporate income tax is very simply passed along to the end to the consumer? If I am a business and I pay corporate tax and I do my structure and I do what my market forces will allow me to do as a business, is it fair to say that corporate taxes are passed—those expenses and paying the corporate taxes, eventually are passed along to the consumer?

Mr. KUHLMAN. Yes, and especially in an environment now where businesses have become as efficient and productive as they possibly can. They are dealing with stubbornly high inflation. Certainly the costs do have to be passed along.

Mr. BERGMAN. So, the point is, is it time that we—should we just consider getting rid of the corporate income tax because the consumer pays it anyway? And if you are a corporate executive mak-

ing \$20 million a year, you just pay that tax on it and that revenue comes direct to the Government?

Dr. MAZUR. I think I want to disagree with that, that the literature shows, and we talked about this a moment ago, from Treasury, Joint Tax Committee, Congressional Budget Office shows that about 80 percent of the corporate income tax is borne by capital. So, shareholders generally pay for that, not consumers. Now, the other 20 percent, 20, 30 percent is borne by labor and consumers. So, there is a portion of it, but the largest portion—

Mr. BERGMAN. Okay. So, but you said borne by capital.

Dr. MAZUR. Yeah. The shareholders.

Mr. BERGMAN. Okay. So, the point is in the long term, if we are trying to create an economy that is streamlined so that people working, whether you are the business owner or just that employee working there and paying your personal income tax, that you can live the kind of life that your grandparents had hoped for when they were struggling through the 1930s and 1940s, and I see my time has run out, so I guess we will have to take that for another time, but I always appreciate, I will always defer to Mr. McClin-tock because of his ability to take these complex things and break them down for folks like me.

Mr. MCCLINTOCK. As much as it pains me to interrupt the gentleman in such a compliment, the gentleman's time has expired.

Ms. Balint. Ms. Balint.

Ms. BALINT. Thank you, Mr. Chair. Thank you all for being here today to talk about these issues. They are very important to me.

I come to this hearing as a teacher from Vermont who has worked in four different rural public schools, and have really direct experience with dealing with rural poverty, and right now, one in 18 Americans live in what writer Matthew Desmond has called deep poverty. One in 18. He said it is so low he refers to it as subterranean level of scarcity, and rates of poverty in this country have really not changed since the 1970s, and today, a minimum wage full-time worker cannot afford a two-bedroom apartment anywhere in America. Anywhere. So, in all of our districts, and this obviously should trouble all of us, that people are working as hard as they possibly can and they—you know, we can talk about investments, we can talk about stocks, we can talk about, you know, who is better off. I can tell you most folks are not better off right now.

Dr. Mazur, as you know, for decades, the Republican Party has carried out essentially the same playbook of cutting taxes for the rich and then feigning concern over the deficit. We just went through this. It is really fresh in our minds, and then, proposing spending cuts to vital programs, such as Social Security and Medicare, and I know my colleagues are also teeing up part two of the Trump tax cuts when we haven't even been able to pay for the first phase. First phase cost us a whopping \$1.9 trillion and has led to a proliferation of billionaires in the United States, and in 2018, for the first time ever in our country's history, the richest class of Americans paid a lower tax rate than working Americans and the average effective tax rate of the top 0.1 percent of households dropped by 2.5 percentage points. The greatest legislative achievement did nothing to address the unbelievable wealth inequality in this country, and according to April data from Forbes, the United

States now has 735 billionaires, the highest number of billionaires in the world, who consistently use our tax code to the maximum advantage at the expense of American working families, like the Vermonters in my district.

And just this week, we learned that one of these billionaires may be exerting influence over the Supreme Court. According to ProPublica, hedge fund billionaire Paul Singer spent some of his vast fortune to take Justice Samuel Alito on a luxury fishing trip, and he repeatedly had cases concerning his company in front of the Supreme Court.

Now, I am a daughter of an immigrant, and my parents, like so many others, sought to achieve the American Dream here. However, the current American Tax Code has rendered the American Dream basically unattainable for most people.

Dr. Mazur, it is difficult for many of us to imagine it, but what would a more equitable tax structure look like today? What is possible?

Dr. MAZUR. So, a couple things are possible, I guess. One is that you could rebalance the tax code so that higher income people pay a larger share of their income for taxes, and that could be either through payroll taxes for Social Security and Medicare or through income taxes.

You could look at the preferential rate on capital gains and dividends. There is a lower rate put on dividends that was supposed to account for the 35 percent corporate tax rate. It did not get changed when the corporate tax rate went to 21 percent. You could imagine changing that.

Ms. BALINT. Can you unpack that a little bit more for people? Because I think it is really important.

Dr. MAZUR. Sure. So, Congress passed a lower tax rate on dividend income back when the corporate tax rate was higher than it is today, and part of the stated reason was that, well, corporations already pay a high rate of tax. You are being double taxed on this dividend as it comes through, but when the corporate tax rate was dropped, the preferential rate wasn't changed at all. So, you kind of get a double benefit from that.

So, that's just a few things. One point that you made that I think deserves emphasis is looking at the minimum wage.

Ms. BALINT. Yeah.

Dr. MAZUR. We have not increased the minimum wage in the United States in decades.

Ms. BALINT. It is disgusting is what it is. It is disgusting.

Dr. MAZUR. Yeah, and you are right that you can't afford to live on a minimum wage job.

Ms. BALINT. No. You can work 40 hours a week in this country making minimum wage and not be able to afford housing, basic housing, not great housing, basic housing for your family. This should not be happening, and we should not be letting it happen.

So, I yield back.

Mr. MCCLINTOCK. The gentlelady yields back. Mr. Ferguson.

Mr. FERGUSON. Thank you, Mr. Chairman, and thank you all for being here today.

So, I just want to go through a couple of things here that just kind of make my brain hurt a little bit. We have got, my colleagues

on the other side of the aisle are screaming about corporate America paying their fair share, okay. Whatever that number is, okay, because of the Inflation Reduction Act and the infrastructure plan, there have been over a trillion dollar's worth of tax credits made available to corporate America, right? So, the very people that my colleagues on the other side of the aisle say they want to pay higher taxes, the wealthiest corporations and the wealthiest individuals can now buy these tax credits and their effective rate becomes zero. Correct?

Dr. MCBRIDE. That is correct. Yeah. That is—

Mr. FERGUSON. All right. So, we are screaming about corporate America paying more taxes, and yet we are going to turn around and give them what now is about a \$1.2 trillion tax credit to offset the tax rates. So, we are going to raise you, but we are going to allow you to pay zero. I just want to make sure I am right on that, right?

Dr. MCBRIDE. That is absolutely correct.

Mr. FERGUSON. Okay. I got that.

Dr. MCBRIDE. It is called—

Mr. FERGUSON. Number two—

Dr. MCBRIDE [continuing]. Subsidizing and penalizing at the same time.

Mr. FERGUSON. Exactly. So, that is number one. Number two, Pillar Two, OECD, that is going to remove \$300-plus billion from the revenue stream if that goes through. \$300 billion. So, now, we are telling corporate America we want you to pay more in higher taxes but we are going to give you a \$1.2 trillion offset, and then, by the way, we are going to give about \$300 billion of our taxing authority away to other countries. Now, that to me just is a really bad policy.

I then hear my colleagues talking about raising tax rate, lowering tax rate, doing it with Clinton, doing it after Clinton, before Clinton. We need to recognize that we are in a global economy and we need to be doing everything that we can with our economy to make America the best place in the world to invest, create jobs, and sell around the world, period. So, we can have a lot of discussions over spending, where things should go, but the unifying philosophy for this body should be, are the decisions that we are making make America more competitive or less competitive? Do they create more jobs, do they take away more jobs? Are we doing more to invest in research and development and come up with new ideas or are we trading that away to other parts of the world?

So, when we look at all of this debate about revenue and spending, raise the corporate rate ten percent. Raise the individual rate to 40 percent. These folks are going to take advantage of the refundable credits and make their effective tax rate zero. So, how in the heck does that make sense? I mean—

Dr. MCBRIDE. It doesn't make a lot of sense. I agree. The major outcome of that approach is complication, further complication of the tax code. So, lots of measures of how complex the tax code is, but one is the number of words, about four million words and counting.

Mr. FERGUSON. All right. So, for folks that have not lived in an area or that currently do live in an area without a manufacturing

base, okay, it is incredibly difficult to sustain a community or a county or a state unless you have manufacturing there, okay. I mean it just is, and when I say manufacturing, a major job creator that is the economic backbone of a county or a city or a region. That is what feeds off all of the other small jobs and small businesses that we see growing in a community.

So, if we raise the corporate tax rate, okay, and we don't move off the snide on this trade policy that we have got, we are falling further behind, and by the way, we are going to see less tax revenue coming in because we are giving people refundable credits and we are giving away part of our taxing authority to the tune of about \$300 billion, and by the way, does that do anything for American competitiveness and job creation? Dr. McBride, I will let you answer that question.

Dr. MCBRIDE. No. What it does is you could say level the playing field, but it levels the playing field across the world with a higher level of corporate taxes, which dozens of studies show are—

Mr. FERGUSON. But let me add—

Dr. MCBRIDE [continuing]. Detrimental to economic growth.

Mr. FERGUSON [continuing]. Level it with higher taxes, but our biggest corporations aren't going to be paying taxes because they are going to use the refundable credits.

Dr. MCBRIDE. That is right. So, what we are getting is a high marginal rate that applies generally combined with a bunch of preferences for specific companies, industries, and taxpayers.

Mr. FERGUSON. Time has expired, but thank you for helping me expose the hypocrisy of this conversation. Thank you.

Mr. MCCLINTOCK. Ms. Schakowsky.

Mr. FERGUSON. Yield back.

Mr. MCCLINTOCK. Ms. Schakowsky.

Ms. SCHAKOWSKY. Thank you.

So, you know, this Committee comes up with very interesting titles. The second part of the title of today's hearing is Incentivizing Economic Excellence Through Tax Policy, but I would think that it is more accurate by saying what we have right now is incentivizing economic inequality through tax policy, and, you know, we are the richest country in the world, except that we are also, I think, number one in the world of industrialized nations of the unequal distribution of that wealth right now. There are three American families, it is Bezos and, let's see, what are the three, Musk. No, it isn't Musk. It is Buffett and who was the third? Okay. Anyway, three American families, I don't want to take my own time, that has as much wealth as the bottom half of Americans. Think about that, and you heard, I thought, a really good explanation and examples of how this has affected Americans in our country, and so, it just seems to me that we need to focus, if we are really concerned about not just equity—and let me ask you, Secretary Mazur. You mentioned what it takes to have—and I don't want to blame everything on tax policy, but you did say that you thought the people that have the most ought to pay more. How would you justify this to some people in this room?

Dr. MAZUR. I think one of the basic criteria of good tax policy is vertical equity, and what vertical equity means is higher income people pay a larger share of their income than lower income people.

That is reflected in a progressive tax rate schedule, but there could be other ways to do that as well, and it really is just a basic sense of fairness, that those who get the most from the system sort of pay the most for maintaining that system.

Ms. SCHAKOWSKY. So, right now, what we are seeing is that the Republicans are coming up, as you have heard, with a proposal of a major tax cut, it looks like it will also go to the wealthiest Americans, and at the same time talking about paying for it through things like, that have been suggested, cutting Social Security, raising the age to now 69 is the proposal by the majority of the Republicans right now, and looking at so-called entitlements, which of course people pay for through every paycheck, and is this, in your view, as someone who deals with the economy, going to make our economy stronger, these choices of lowering the tax cuts mostly to the wealthy and cutting the benefits and the programs that help lower income people?

Dr. MAZUR. I mean, I think making the country stronger from a fiscal perspective requires two things: one, more revenue, and two, some breaks on spending, and I think Chairman Arrington talked about that as these are the two levers that you can move, and really, it is a matter of balance getting that right. Our revenues today are too low to pay for the goods and services that we as a country demand. If we want to demand less, that is okay, but we still need to raise the revenues to pay for the ones that we demand that are out there, and you are right about some of the entitlements. People have paid into them with the understanding that they will be there for them when they retire, Medicare and Social Security in particular, and so, those are promises to future generations that we as a country need to redeem.

Ms. SCHAKOWSKY. The other wealthiest person was—let me see, they are, thank you, I appreciate that, Gates, Warren, and Buffett.

But—oh, time. Okay. I yield back.

Mr. MCCLINTOCK. Mr. Moore.

Mr. MOORE. We know it is not me and probably anybody in this room.

Ms. SCHAKOWSKY. Thank you.

Mr. MOORE. I wish the Chairman was here because I don't like to give other people compliments on my birthday. I try to reserve those solely for myself, but I will be remiss if I didn't just hit on the topic of credibility. It is a currency that is dwindling in this place of Congress, unfortunately, and I really appreciated his opening statements. To be able to stand in front of a sitting Committee and fully state that he wishes his party, my party, and I share the sentiment, could have done more and would have done more about spending, overall spending, mandatory direct spending or discretionary spending across the board, wished in 2017 when we had majorities in the White House, the House, and the Senate, wish we would have done more, and we would have had an even stronger argument, in my opinion, of what I think is a pretty strong argument with respect to the Tax Cut and Jobs Act, but I truly wish that would have been the case, and I appreciate his willingness to be—he is somebody that has always led that way. He has inspired me. It is why I want to be close. I am on both of the major committees that he is on, and it is a currency that we just don't have

much of back here, and I appreciate that from our Chairman, and also, the minority witness, Dr. Mazur, you earlier said I would quibble or I would hesitate to just fully lay blame or cast the context that it is, you know, laid out that it is this President did this, this President did this. I have heard it communicated oftentimes sometimes the economy is what makes the President actually, and, you know, our economic cycles go in a certain way that sometimes you catch the tail end. I don't blame the entire 2008 financial crisis on President George W. Bush. No way. Right. That has been policy that has gone on for years and neglect of a lot of different things with lots of players. So, I appreciate, you know, that concept of credibility.

I was back in Utah with my colleague from the third District, John Curtis, Representative Curtis, and he actually put it better than I have ever heard anybody say it, and I am going to talk about calling the tax scam, calling the Tax Cut and Jobs Act the tax scam for the rich. I am going to just emphasize the way he communicated it. He said, it is uncanny to me that when the Democrats have an—you know, they can communicate a message and stay on that point so much that ultimately the media and a large group of people will ultimately believe it, and, you know, we will stand up as Republicans and list out all this data. I am going to do it again. List out all this data and all this good information that refutes that fact, and oftentimes, my colleagues from the other side of the aisle, all they have to do sometimes is stand up and say, this is a tax cut for the rich, and literally that is the narrative that continues on.

I resent and I would hope that we could actually agree that the Child Tax Credit is not a tax scam, that real wage growth—because the Tax Cut and Jobs Act didn't create an enormous amount of inflation. It didn't create any. We were able to see real wage growth take place. You had a doubling of the standard deduction. Is that a, you know, direct benefit to the wealthy?

In fact, I will ask the question. Dr. Mazur even, asking the minority witness a question. Would you say that the standard deduction is a benefit to the wealthy? Would you also say that SALT, the way we address SALT, by saying what was the average across the country of state and local taxes in that deduction, let's double it, and is that a benefit to the wealthy, what we did on SALT?

Dr. MAZUR. There are pros and cons to all these things, right. So, if you take individual items, you can say they benefited high-income people or lower-income people. The Tax Cuts and Jobs Act had lots of moving parts. So—

Mr. MOORE. Yeah. Oh, it is a very large piece of legislation. In fact—

Dr. MAZUR. And so, when you talk about the SALT deduction, you also largely repealed the alternative minimum tax, and many people who feel that they lost the deduction for their state and local taxes actually lost it under prior law through the alternative minimum tax.

Mr. MOORE. Right. So, I don't disagree with any of that, and I am trying to make the point here that so many provisions in the Tax Cut and Jobs Act weren't just this benefit to the wealthy, and I think it is a disingenuous narrative, but this place is what it is,

I get it, and I would like to just, with my remaining time that I used way too much, focus on just one last thing. We had the R&D tax credit. To Dr. McBride, the R&D tax credit, can we look at that and say this is something we have got to preserve and work together? Would you suggest that Congress try to work together on a bipartisan way to make this happen, so we can make sure that we can write off these expenses in that first year?

Dr. MCBRIDE. Well, you mentioned R&D credit. I think you mean R&D expensing, and that is the item that—

Mr. MOORE. R&D expensing, yes.

Dr. MCBRIDE [continuing]. Has now expired and we are now faced for the first time ever in this tax code we have had for 100 years where businesses are required to wait for those deductions and suddenly figure out how to amortize R&D expenses, which are primarily labor expenses, about 70 percent. So, this is, yeah, paying scientists and stuff like this.

Mr. MCCLINTOCK [continuing]. Sadly, the gentleman's time—

Mr. MOORE. Thank you.

Mr. MCCLINTOCK [continuing]. Has expired.

Mr. MOORE. Appreciate it.

Mr. MCCLINTOCK. Even more sadly, they have called one of these pesky annoying votes that just disrupt the schedule and are just very annoying, but there it is. So, I think there are three votes scheduled, so it will probably be about 30, 35 minutes or so. So, you all go out and get a cup of coffee or whatever and I apologize for that, but it is an occupational hazard at this job. We are all going to go vote. You go out to coffee and we will all come back in about a half-hour or so. Thanks. Committee stands in recess.

[Recess.]

Chairman ARRINGTON. We now have the requisite Members of the Committee from both sides of the aisle. So, we are going to reconvene here. The Committee will come to order, and now, Mr. Scott, I know you are getting yourself situated. So, I don't want to start the clock on you. He is walking up here ladies and gentlemen of the upper deck. He is going to take full control of the Ranking Member's chair and let's hope he doesn't drive us into the ditch like Brendan Boyle has done too many times. This is what you get. It is an open mic when everybody else is gone.

Mr. SCOTT. He made it.

Chairman ARRINGTON. Yeah, so—

Mr. SCOTT. He got away.

Chairman ARRINGTON [continuing]. Feel free to pick on a few of my guys that aren't here.

Mr. SCOTT. Well, I will pick on—thank you, Mr. Chairman.

Chairman ARRINGTON. Ranking Member Scott, the floor is yours. I yield five minutes for your questions and answers.

Mr. SCOTT. Thank you, Mr. Chairman. Well, I hope I don't put us in the ditch like every Republican President since Nixon has done. Everyone, every Republican Administration since Nixon has left for the Democratic successors a worse deficit than they inherited. Every Democrat Administration since Kennedy has left for their Republican successors a better deficit situation than they inherited. President Trump was on the way to doing that before the pandemic. President Biden is doing that already.

So, let me see, Dr. Mazur, we have heard about inflation and blaming the President. How is the United States' inflation rate compared to the rest of the world?

Dr. MAZUR. Generally, the U.S. inflation rate now is lower than other developed countries like in Europe for instance.

Mr. SCOTT. So, we have got a global inflation problem and we are actually doing better than most.

Dr. MAZUR. Relatively better, yeah.

Mr. SCOTT. Dr. Mazur, do tax cuts affect the budget?

Dr. MAZUR. By arithmetic, yes, they affect the budget.

Mr. SCOTT. Well, some don't apparently believe in simple arithmetic like adding and subtracting because you know that the, under PAYGO, that Democrats have as a budget rule, if you have new spending, you have to pay for it with either new taxes or other spending cuts. You got to pay for it. If you have a tax cut, you got to pay for it. Either raise somebody else's taxes or spending cuts to pay for it.

Under the Republican plan, if you have a new spending plan, you have to pay for it, but if you have a tax cut, you don't have to pay for it. As if they didn't understand what you just said that it is simple arithmetic. So, we have heard about taxing policy, different tax cuts or different spending initiatives can stimulate the economy but on a differential basis. Isn't it true that reducing taxes on dividends has a negligible effect on, as a stimulus to the economy?

Dr. MAZUR. Yeah, I would think that relative to other potential tax cuts, given who the owners of shares are, giving them a lower tax rate probably doesn't boost the economy that much, and probably doesn't change corporate behavior that much in terms of dividends paid.

Mr. SCOTT. And you said compared to other tax cuts like what?

Dr. MAZUR. Well, if you are thinking you want to boost consumption, then you would probably want to provide resources to people who are going to consume those tax cuts. So, lower-income, middle-income people.

Mr. SCOTT. Like the Child Tax Credit?

Dr. MAZUR. Child Tax Credit would be one example and I think you saw when it was a refundable credit paid monthly that it had a pretty substantial benefit to the recipient families.

Mr. SCOTT. And the Earned Income Tax Credit?

Dr. MAZUR. Earned Income Tax Credit is similar though one caveat in the Earned Income Tax Credit is that for many years, the Earned Income Tax Credit has been used as a replacement for increasing the minimum wage. Largely to say, we are not going to increase the minimum but we are going to give a tax credit instead. That works for the people who are eligible for the tax credit but not those who don't have qualifying children living in their household.

Mr. SCOTT. And certain spending would have the same thing, like if you increased unemployment benefits, it would have a very good stimulus, or food stamps, increase that, that would go right back into the economy.

Dr. MAZUR. Generally true.

Mr. SCOTT. So, we know which tax policies work and which ones don't work. Who basically benefitted from the 2017 Tax Cuts and Jobs Act, better known as the Trump tax scam?

Dr. MAZUR. So, the Tax Cuts and Jobs Act that was passed in 2017 had lots of moving parts. Basically, two-thirds of people in the country probably got a tax cut. The tax benefits for corporations were generally permanent. The tax benefits for individuals were generally temporary. I think there was a slightly larger proportional benefit to higher-income people in part because they benefit from the corporate tax cuts.

Mr. SCOTT. Thank you, Mr. Chairman. I yield back.

Chairman ARRINGTON. I thank my new Ranking Member, and now I yield five minutes to the gentleman from Wisconsin, Mr. Grothman.

Mr. GROTHMAN. I got ten questions so you got to answer quick. We didn't get all we wanted in our tax cut, or I didn't, and one of my concerns was I thought the purpose of the tax cut was to a degree, to make us more competitive with countries abroad and there are segments of the population that are more important than other segments.

Manufacturing was always treated special in this country through a special credit. That disappeared with the tax cut. We only have so much money to pay for tax cuts. Somebody even said we don't have enough money to pay for any more tax cuts, but I do have a problem if we target it at manufacturing, which has to compete with other countries abroad, and maybe if we have to target it even more, the machines that are used in the factory to make other machines. I tour my manufacturers all the time. There is always very important machines printing, that sort of thing. Where do they make that machine? It is always Germany, Italy, Belgium, Korea, or Japan. Do you think there is a problem with targeting the tax cut to those manufacturers as opposed to say retail, which is going to be here anyway?

Dr. MCBRIDE. I will take that one. I have a problem with that. I mean, I think targeting manufacturing is, first of all not a very small target, right? Manufacturing is a huge sector. There was a manufacturing deduction years ago that—

Mr. GROTHMAN. Before we got rid of it, it was a manufacturing credit.

Dr. MCBRIDE. That is correct, and it was taken by all sorts of taxpayers including publishers. You know, coffeemakers, stuff like this. So, manufacturing is just a huge sector, and the other thing is that I agree that they are subject to competition from abroad. So are other sectors like information technology. There is lots of mobility in a lot of sectors.

Mr. GROTHMAN. Okay.

Dr. MCBRIDE. I suggest—

Mr. GROTHMAN. I am going to cut you off.

Dr. MCBRIDE [continuing]. Generally lowering the corporate rate.

Mr. GROTHMAN. Yeah, I am going to cut you off a little bit. There is an economic argument if you are solely concerned in the short term that one business is the same as another business. I thought we saw a little in the COVID that there are some businesses that are more important for our national security than for our wealth.

Which is why I wondered about targeting manufacturing as opposed to retail or say law offices. Do any one of you want to comment on that at all? I mean, we used to treat manufacturing better.

Mr. POMERLEAU. Yeah, so it is possible that you could make an argument that for national security purposes, certain types of production should be in the United States, but I don't think that the tax code is a good tool to accomplish that. I think tax systems should be primarily used to raise revenue in a neutral manner, but if there are national security concerns—

Mr. GROTHMAN. Okay.

Mr. POMERLEAU [continuing]. That should be dealt with elsewhere.

Mr. GROTHMAN. You can tell me how later, but okay, next question we have, we are sometimes criticized for having our tax cuts favor the rich. That is inevitable I think because the poor don't pay any taxes in the first place, but I do think it would be good if to a degree we went after credits that clearly are benefitting the wealthy. One of those is carried interest. Does anyone want to say that we should get rid of carried interest? You can do it if our guys won't.

Dr. MAZUR. No, you should. I think this is an area where basically it is ordinary compensation to people in various businesses and it is treated in a preferential way.

Mr. GROTHMAN. Yeah, we are helping the hyper wealthy with a different tax treatment. Well, thank you. Any of our guys agree with that? Any of our guys, I mean the left three?

Mr. POMERLEAU. I agree with Mark. I think that the—

Mr. GROTHMAN. Okay, well we—

Mr. POMERLEAU [continuing]. Treatment is under current law do support—

Mr. GROTHMAN. We will try to do that, and I will give you another one. Section 42, low-income housing. That is, you know, you are giving some guy or gal 85, 95 percent of the value of a new building if they rent to low-income people. It offends me out of my mind because you have this group of people, who probably gives a lot of money up here to, who are getting wildly generous tax cuts. Maybe they sell these credits to other businesses. Do you feel that is something we should get rid of? Or is that, I mean, just say it, you are just overwhelmingly benefit very wealthy developers. You want to comment on getting rid of that?

Dr. MAZUR. I mean I think the important thing to recognize is that that is pretty much the only low-income housing project—

Mr. GROTHMAN. So, you don't think we can—

Dr. MAZUR [continuing]. The Government has.

Mr. GROTHMAN [continuing]. First of all, low-income housing isn't a Federal problem. It is a state problem, but you don't think there is any way to get money for housing for poor people other than to, in essence give very wealthy developers—

Dr. MAZUR. No, no, if you want to do it through a spending side program it could be way more targeted, way better targeted than it is, but Congress decided to do it through the tax code and as Kyle has said, the tax code's a very blunt tool.

Mr. GROTHMAN. Any of you other guys? I hate Section 42 more than anything that is why I bring it up. Will anyone of you guys

say it is wrong? It is not good to make the wealthiest of developers wildly more wealthy? That is the only way we can—

Dr. MCBRIDE. Yeah, I say it is wrong. I mean, I think most of us probably would say that. It is wrong in the same way that targeting manufacturing with a special provision is wrong. I think the general principle is that the law should apply generally, and so, this thing for low-income housing should go in favor of lowering rates generally for all taxpayers.

Mr. GROTHMAN. I guess I am up. I can talk forever if you want me to, Chair.

Chairman ARRINGTON. No, well, we—

Mr. GROTHMAN. You are going to cut me off, okay. That is okay. That is good.

Chairman ARRINGTON. The gentleman's time has expired. I appreciate his comments and questions. I will now yield five minutes to my friend Dan Kildee from Michigan.

Mr. KILDEE. Thank you so much, Mr. Chairman, and to temporary Ranking Member Scott. Good to see you, thank you. Listening to my friend from Wisconsin, it is obvious that there are some areas where we have significant disagreement, but interestingly enough, some areas where we might find agreement when it comes to tax policy. So, I do think it would make sense for us as a body, and I serve on the Ways and Means Committee, the tax writing committee, to try to focus on tax policy that is a bipartisan approach. It is very difficult to do, I acknowledge it, but if we are going to have sustainable policy, we are going to have to figure out a way to do this in a bipartisan fashion that ensures that people and organizations pay their fair share and that the obligations for those who have significant resources are applied to them, and also, that we do have incentives built into the code.

Now, we can argue about whether or not we do a direct spend approach or we use the tax code as a way to get at it. It is a blunt instrument, but I don't think we can deny that there are priorities that are Federal priorities that we ought to focus upon, and I do believe that housing, a fundamental aspect of the hierarchy of human needs, ought to be on the agenda for the Federal Government, and whatever method we want to use to get at it, I am interested in a conversation on that, but I think unfortunately what we have seen most recently in the legislation that House Republicans have advanced doesn't meet those tests. It doesn't substantially cut taxes for working families. It certainly doesn't deal with some of the needs of the most at-risk people that we face, and we have had conversations about the low-income individuals. We certainly had conversations about the Child Tax Credit but that didn't make it into the legislation. Instead, it overwhelmingly would cut taxes for the largest and wealthiest corporations. So, it is not a fiscally responsible approach. It increases our deficits and exacerbates the inequities in the tax code.

So, I mean, obviously we may not all agree on that particular point, but I think any thoughtful analysis of the Republican plan would cause that conclusion to be drawn. For example, as a result of Republican tax legislation in 2020, 55 of the largest Fortune 500 companies don't pay Federal taxes. I don't think anybody can defend that when those organizations and high wealth individuals

pay less in Federal income taxes than a teacher in my communities of Bay City or a nurse in Saginaw or a factory worker in Midland. So, I am disappointed in that, but, Dr. Mazur, I wonder if you might just take a moment to comment on the economic and fiscal benefits of first cutting taxes for workers in middle-income families to grow the economy, and second, making sure that those large corporations and wealthy individuals pay more, just to be blunt, more meaning their fair share in order to reduce our deficit. I mean, it is a fundamental question but that really is the question before us.

Dr. MAZUR. Oh, let's start with the second part. Basically, if you have a set of goods and services that the Federal Government is providing, you should find a way to pay for them, and the system that we have in place does not raise an adequate amount of revenue to meet that, and so, you need to find sources of additional revenue, and you are right to focus on large corporations who are paying nothing or small amounts of tax and high-income individuals who similarly pay less tax than folks further down the income distribution. So, that would be the first place to start.

I guess in terms of tax cuts, I would put that a little bit aside before you got the fiscal house in order. Tax cuts are not going to be a driving force for making the economy work better, right? You want to have a good labor force, good infrastructure, well educated population, and so on. Tax cuts are sort of secondary to that.

Mr. KILDEE. But in that context though, when I think about tax obligations, if you could just briefly address the economic impact of, say for instance, the refundable Child Tax Credit.

Dr. MAZUR. So, the refundable Child Tax Credit we saw this occur when it was paid on a monthly basis, we saw it improve the life situations of the recipients significantly, and so, that is a situation where getting additional money into the pockets of those people was a good thing. Whether the tax code has to do that or if it is some other way, is a discussion. I mean, I would be much more in favor of increasing the minimum wage than increasing the Child Tax Credit by a similar amount.

Mr. KILDEE. Well, I appreciate that. I appreciate this conversation. Obviously, we have a lot of work to do, but I would like to pursue some areas of common ground. Mr. Grothman made a mention of a particular tax provision that I think we all could maybe have a conversation about, and I appreciate the fact that the witnesses at least share some common ground when it comes to that subject. With that, thank you, Mr. Chairman. I yield back.

Chairman ARRINGTON. I thank the gentleman from Michigan, and yield five minutes to my friend Rudy Yakym from Indiana.

Mr. YAKYM. Thank you, Mr. Chairman. I ask unanimous consent to submit into the record a report from the Heritage Foundation titled, *The Tax Cuts and Jobs Act: 12 Myths Debunked*.

Chairman ARRINGTON. So ordered.

[The information follows:]



CHAIR JODEY ARRINGTON
**HOUSE BUDGET
COMMITTEE**

ARTICLE:
“The Tax Cuts and Jobs Act: 12 Myths Debunked”
By: Adam Michael | Heritage Foundation | March 23, 2021

Description: Three years later, the Tax Cuts and Jobs Act (TCJA) is the subject of countless lingering mischaracterizations.

- **Most People Got a Tax Cut:** “More than nine of 10 taxpayers received a tax cut or saw no change because of the TCJA. According to the left-leaning Tax Policy Center, only 4.8 percent of taxpayers were projected to see a tax increase, and 80 percent benefited from a tax cut.”
- **TCJA Is Not the Driver of the Federal Budget Deficit:** “Tax cuts, even if made permanent, only represent about 16 percent of the projected, non-pandemic-related 2021–2030 budget deficit forecast. Repealing the 2017 tax cuts would not change the trajectory of increasing federal deficits.”

REPORT Taxes

The Tax Cuts and Jobs Act: 12 Myths Debunked

March 23, 2021 36 min read



Adam Michel
Former Senior Policy Analyst, Grover M. Hermann Center

— SUMMARY

Three years after the passage of the 2017 Tax Cuts and Jobs Act, partisan mischaracterizations have left the law deeply misunderstood. The tax cuts benefited typical American workers through direct tax cuts and higher wages. The changes did not raise taxes on the middle class, did not devastate home prices, and did not reduce charitable giving. Businesses have created domestic jobs, and the new 21 percent corporate tax rate still leaves American employers paying rates higher than most competitors. As the law begins to expire in the coming years, lawmakers will be better able to assess the merits of keeping the tax cuts if they understand 12 common myths.

KEY TAKEAWAYS

- 1 **Congress should address growing deficits to keep taxes low and ensure that reforms from the Tax Cuts and Jobs Act continue to benefit American business and workers.**
- 2 **The tax cuts should be made permanent before they expire in 2026 and result in tax increases on American families in every income bracket.**
- 3 **Setting the record straight for lawmakers and the American people is crucial to ensuring that Congress understands the historic benefits of the reforms.**



In December 2017, Congress passed a \$1.5 trillion tax cut and reform package that became the subject of heated, partisan politicking.^[1] Three years later, the Tax Cuts and

Jobs Act (TCJA) is the subject of countless lingering mischaracterizations. Much of the law is temporary; major provisions begin to expire on January 1, 2023, with the largest automatic tax increases arriving in 2026. Setting the record straight for lawmakers and the American people is crucial to ensuring that Congress keeps taxes low and makes the TCJA reforms permanent. Reversing the tax cuts would make the COVID-19 economic recovery more challenging by increasing the cost of rebuilding a strong labor market that benefits American workers.

The tax cuts' most important legacy is their benefits for American workers at every income level. In the years after the reform, the labor market improved, resulting in annual wages of more than \$1,400 above trend, business investment increased, and the economy expanded. The individual tax cuts benefited more than 80 percent of Americans, and some of the largest reductions in tax bills accrued to the lowest-income Americans. Changes to the state and local tax (SALT) deduction and mortgage interest deductions (MID) did not negatively affect middle-class taxpayers, devastate the housing market, or reduce trends in charitable giving.

The lowered 21 percent corporate income tax rate and other reforms made American businesses and the millions of American workers they employ more competitive. However, the U.S. corporate tax rate is still higher than most of the United States' largest trading partners. The law was not expected to pay for itself over the 10-year budget window, but tax cuts are also not the cause of the systemic budget deficit. Mandatory spending growth for Social Security and health care entitlements drives budget unsustainability.^[2]

Following are 12 myths about the TCJA and explanations to set the record straight.

Myth #1: It was “Just” a Tax Cut

When deciding on a name for the 2017 bill, President Donald Trump notably wanted to call it the “Cut Cut Cut Act.”^[3] This sentiment is reflected in common references to the “2017 tax cuts,” “Trump’s tax cuts,” or the “GOP tax cuts.” While the bill did include a significant tax cut for most Americans, and lowered average tax rates for every income group, it was also the most significant reform to many parts of the tax code in 30 years—since the Reagan-era 1986 tax reform. The TCJA made it easier for millions of Americans to pay their taxes, simplified family benefits, and overhauled the international tax system, among many other reforms.^[4]

Here are some of the most significant changes in the law. The TCJA:

- Lowered individual income tax rates and thresholds.
- Nearly doubled standard deductions of \$12,000 for single filers, \$24,000 for married couples filing jointly, and \$18,000 for head of household filers in 2018.
- Repealed all personal and dependent exemptions.
- Doubled the child tax credit to \$2,000. The phase-out threshold for the tax credit for married joint filers increased from \$110,000 to \$400,000. The refundable portion of the credit increased from \$1,000 to \$1,400. The TCJA also added a new \$500 non-child dependent credit.
- Included a new \$10,000 cap on the state and local tax deduction and a \$250,000 reduction (to \$750,000) to the cap on the mortgage interest deduction for new mortgages. The phase-out of itemized deductions (Pease limitation) is eliminated along with other smaller itemized deductions.
- Increased the alternative minimum tax (AMT) exemption from \$86,200 to \$109,400 for married filers. The new exemption phases out starting at \$1 million, up from \$164,100.
- Lowered the federal corporate income tax rate to 21 percent, down from 35 percent.
- Expanded full expensing for business investments with asset class lives of 20 years or fewer.
- Added a new 20 percent deduction for certain non-salary pass-through business income. The deduction phases out for certain service providers with incomes that exceed \$157,000 for single filers and \$315,000 for married couples filing jointly.
- Repealed the domestic production activities deduction and overhauled the international tax rules.

Each of the changes for individuals expire after December 31, 2025. Business expensing begins to phase out after December 31, 2022.

These changes made it easier for most individuals to pay taxes each year. Under the TCJA, the number of people who were able to complete their own tax returns in 2018 increased by 4 percent.^[5] The Tax Foundation estimated that the simplifications would save Americans between \$3 billion and \$5 billion in compliance costs.^[6] For most Americans, the most significant simplification is the larger standard deduction, paired with SALT and MID reductions. The percentage of taxpayers who use the more complicated system of itemizing their tax deductions decreased from 30 percent to 10 percent between 2017 and 2018.^[7]

The reforms also simplified family tax benefits by eliminating the personal and dependent tax exemption and expanding the child tax credit to compensate. A larger AMT exemption means that thousands of higher-income taxpayers are no longer subject to the overly complicated parallel tax system.

Business taxes were simplified by eliminating the corporate AMT, expanding business expensing, and eliminating the domestic production activities deduction. However, the law's 20 percent deduction for privately owned pass-through businesses adds significant complications and perverse incentives to the tax code.^[8] As described under Myth #s 8 and 9, the international tax rules were also almost entirely rewritten, creating a break from the previous regime. While these changes were not a simplification, they do represent an important structural reform to the tax code.

Myth #2: The Tax Cuts Benefited Corporations, Not Workers or the Economy

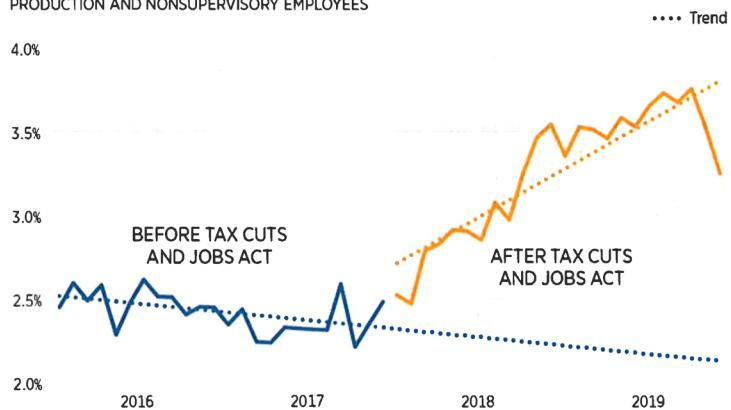
The 2017 business tax cuts have been widely maligned as contrary to workers' interests and a detriment to the economy.^[9] In reality, the corporate tax cut supported jobs and wage growth. There are clear indications that the TCJA succeeded in allowing new business investment, which is a key component of how the law is intended to support a strong labor market and a bigger economy. For a more comprehensive review, see The Heritage Foundation Backgrounder "An Economic History of the Tax Cuts and Jobs Act."^[10]

Critics often point to lackluster business investment trends toward the end of 2019 to claim that the law did not boost domestic investment. However, following the tax cuts, business investment increased by more than government scorekeepers predicted and remained above their pre-reform forecasts through the end of 2019.^[11] Other measures, such as new manufacturer orders, small business plans to expand, and new business applications, showed significant improvements in early 2018.^[12] Some of these gains were undermined by trade uncertainty and costly tariffs through 2019.

In 2018 and 2019, the labor market also improved significantly. A significant increase in wage growth marked the beginning of 2018. Chart 1 shows that nominal year-over-year average hourly earnings had declined slowly through 2016 and 2017, averaging 2.4 percent. Following the tax cuts, wage growth for production and nonsupervisory workers increased to 3.8 percent by October of 2019. Because of these gains, the average production and nonsupervisory worker received \$1,406 in above-trend annualized earnings in March 2020. There was also a significant and sustained increase in job availability and job mobility after 2017. Other measures of real wages, unexpected bonuses, paid family leave policies, and better retirement benefits show similar positive bounces in the years after tax reform.

Faster Wage Growth After Tax Cuts

YEAR-OVER-YEAR AVERAGE HOURLY EARNINGS GROWTH,
PRODUCTION AND NONSUPERVISORY EMPLOYEES



SOURCES: U.S. Bureau of Labor Statistics, "Average Hourly Earnings of Production and Nonsupervisory Employees, Total Private, Seasonally Adjusted," <https://data.bls.gov/timeseries/CE5050000008> (accessed January 25, 2021), and author's calculations.

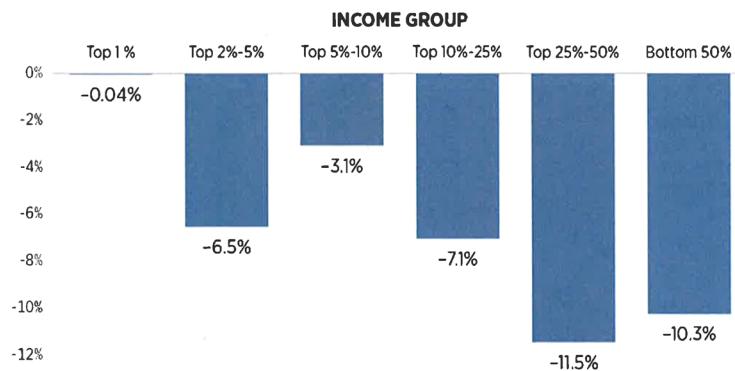
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Myth #3: The TCJA Was Only a Tax Cut for the Rich

Many Americans believe that they are not benefiting from the tax cuts because it was widely reported that the reform primarily benefited corporations and the wealthy.^[13] This narrative is highly misleading.

Lower-Income Americans Received Larger Tax Cuts

CHANGE IN TAXES PAID, 2017 TO 2018, AS PERCENTAGE OF 2017 TAXES



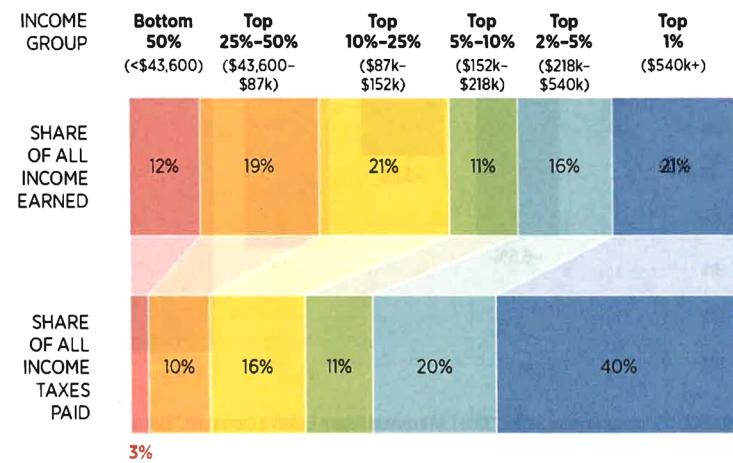
SOURCE: U.S. Internal Revenue Service, "Table 1. All Individual Returns Excluding Dependents," Statistics of Income Division, <https://www.irs.gov/statistics/soi-tax-stats-individual-income-tax-rates-and-tax-shares> (accessed February 5, 2021).

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In October 2020, the IRS released its final report on taxes paid by income group in the 2018 tax year (the first year for which people paid taxes under the TCJA regime). The data in Chart 2 show that the tax cuts as a percentage of taxes paid in 2017 were largest for the lowest-income Americans and smallest for the top 1 percent, measured by adjusted gross income (AGI). Similarly, the percentage decrease in effective tax rates was about 5 percent for the highest-income group, and 16 percent for the half of Americans whose income is below the median. After the TCJA, higher-income taxpayers now pay a larger share of all taxes. By this metric, the income tax system was made more progressive. The top 1 percent of taxpayers paid 40 percent of income taxes in 2018, and 38 percent in 2017.^[14]

Do the Rich Pay Their Fair Share?

FEDERAL INCOME TAXES AND ADJUSTED GROSS INCOME EARNED IN 2018



SOURCE: U.S. Internal Revenue Service, "Table 1. All Individual Returns Excluding Dependents," Statistics of Income Division, <https://www.irs.gov/statistics/soi-tax-stats-individual-income-tax-rates-and-tax-shares> (accessed February 5, 2021).

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Critics of the law point out that the dollar value of the total tax cut and the tax cut as a percentage of income are skewed toward higher-income taxpayers. This is simply a mathematical fact of most any reform that attempts to cut marginal tax rates for all income groups. The latest IRS data in Chart 3 show that in 2018, the top 1 percent of income earners—those who earned more than \$540,000—earned 21 percent of all U.S. income while paying 40 percent of all federal income taxes. The top 10 percent earned 48 percent of all income and paid 71 percent of all federal income taxes. Those who pay the most taxes and pay the highest effective tax rates will also see commensurate benefits when rates are lowered. This does not mean that middle-class Americans were left out of the reforms.

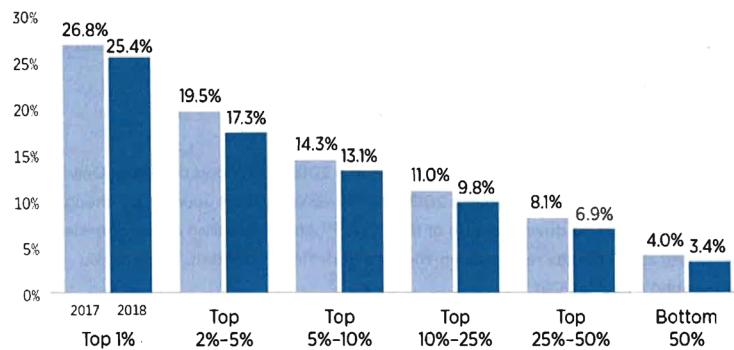
Of the \$1.5 trillion bill, 78 percent (\$1.1 trillion) of the total tax cut was for individual taxpayers.^[15] Corporations received a \$329 billion tax cut, but even these changes benefited workers. Workers primarily pay the cost of the corporate income tax through lower wages. Economic estimates typically show that labor bears between 75 percent and 100 percent of the corporate tax's revenue cost.^[16] As shown in Myth #2, cutting business taxes benefited working Americans.^[17]

Myth #4: Most People Did Not Get a Tax Cut

Americans who think they did not get a tax cut in 2018 are in good company. Only 17 percent of Americans surveyed in a 2019 NBC News/Wall Street Journal poll thought their taxes would go down because of the TCJA.^[18] After more than a year of misleading reporting about the tax reform, even The New York Times admitted, "Face It: You (Probably) Got a Tax Cut."^[19]

More than nine of 10 taxpayers received a tax cut or saw no change because of the TCJA. According to the left-leaning Tax Policy Center, only 4.8 percent of taxpayers were projected to see a tax increase, and 80 percent benefited from a tax cut.^[20] After filing taxes, IRS data confirm that Americans in every income group benefited from lower effective tax rates, as shown in Chart 4. Average effective tax rates declined by 9.3 percent (about 1.4 percentage points) in 2018.^[21]

CHART 4

Average Income Tax Rates, by Income Group

SOURCE: U.S. Internal Revenue Service, "Table 1. All Individual Returns Excluding Dependents," Statistics of Income Division, <https://www.irs.gov/statistics/soi-tax-stats-individual-income-tax-rates-and-tax-shares> (accessed February 5, 2021).

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Myth #5: The SALT Cap Increased Taxes on the Middle Class

The TCJA included a \$10,000 cap on the deduction for state and local taxes (SALT), which is available to taxpayers who itemize their tax deductions—instead of selecting the now larger standard deduction. Before 2018, 70 percent of taxpayers received no benefit from the SALT deduction. Those who did claim the credit tended to be wealthy taxpayers in high-tax states.^[22] Even the high-income taxpayers who face the new SALT limit likely still got a tax cut for three reasons.

First, the tax law doubled the standard deduction, which means that about half the people who previously chose to itemize their taxes now voluntarily decided to take the new larger standard deduction. Most of these people are better off than they were before. Second, tax rates were lowered across the board. Even if taxable income increased slightly because of the SALT cap, lower tax rates mean most people still came out ahead. Third, because the tax law raised the exemption for the AMT, millions of higher-income AMT-paying taxpayers saw the SALT deduction increase from zero to

\$10,000 under the TCJA because they no longer have to pay the AMT, which disallows the SALT deduction.^[23]

Capping the SALT deduction was a good reform. The SALT deduction creates the largest subsidy for high-income taxpayers in high-tax states, paid for by the rest of Americans. Before the TCJA cap, a taxpayer in New York making between \$50,000 and \$75,000 a year deducted on average \$3,375 worth of SALT from his federal taxable income. A taxpayer in Tennessee, making the same income, only deducted \$924 on average, which increased his federal taxes by about \$400 compared to his identical New York counterpart. These middle-class taxpayers are unlikely to be affected by the new SALT cap.

The disparity among high-income taxpayers was even larger: The average millionaire living in New York or California deducted more than \$450,000 worth of SALT; the average millionaire in Texas deducted only \$50,000 and therefore paid close to \$180,000 more per year in federal taxes. These high-income taxpayers are likely limited by the new SALT cap but benefited from other changes in the tax code.

Repealing the SALT cap in isolation, as proposed by congressional Democrats and a few Republicans, would be a \$500 billion tax cut almost exclusively for the top 20 percent of income earners. About 60 percent of the benefit—a roughly \$300 billion windfall—would go to the highest-income 1 percent of households making \$755,000 and up.^[24] If Congress wants to reduce taxes for the highest-income earners, lowering the top marginal tax rate would be far more equitable and efficient, as it would stimulate economic growth instead of stimulating higher state and local taxes.

Myth #6: Limits on Itemized Deductions Reduced Charitable Giving

It was widely predicted that the TCJA would reduce charitable giving by limiting the tax incentive to donate.^[25] Expanding the standard deduction and limiting other itemized deductions (such as SALT and MID) means that about 28 million fewer taxpayers itemized their taxes in 2018. Because the deduction for charitable contributions is an itemized deduction, more people now receive no tax benefit from charitable giving.^[26] The tax benefit from giving also decreases when tax rates fall.

The data in Chart 5 indicate that charitable giving increased following the tax cuts. In 2017, individuals' real charitable giving increased by 8 percent, from \$279 billion in 2016 to \$302 billion in 2017. A portion of this increase represents people artificially moving some of their planned 2018 donations into the 2017 tax year to take advantage of the higher tax rates. Deductions are worth more when tax rates are higher.

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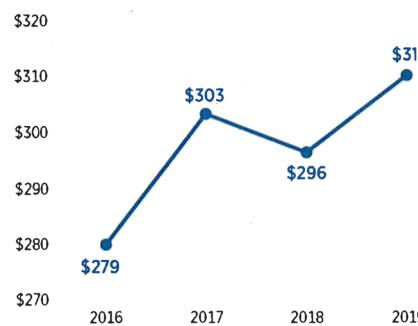
The timing shift of donations led to a small 2 percent drop in 2018 giving compared to 2017, but still a 6 percent increase over 2016 giving in real, inflation-adjusted dollars. In 2019, charitable giving resumed its increasing trend, jumping by 8 percent from 2018, and 11 percent from 2016.^[27] Corporate giving also increased, following similar trends.^[28]

CHART 5

Individual Charitable Donations

SOURCE: Scott A. Hodge, "Latest Data Shows That the Tax Cuts and Jobs Act Did Not Dampen Charitable Giving," June 22, 2020, Tax Foundation, <https://taxfoundation.org/tax-cuts-jobs-act-affect-charitable-giving/> (accessed February 17, 2021).

IN BILLIONS OF REAL U.S. DOLLARS



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Tax benefits are not the reason why most Americans donate to charity. Less than 40 percent of Americans who donate to charity write it off on their taxes.^[29] Religious conviction, care for others, and dedication to community are much stronger incentives to give than the incentives in the tax code. People also tend to give more when they feel wealthier, and people feel wealthier in good economic times, which tend to follow pro-growth tax reform.

Myth #7: Reducing the Mortgage Interest Deduction Would Devastate Home Prices

In 2017, a report commissioned by the National Association of Realtors projected that a reform to the MID similar to the one ultimately passed in the TCJA would decrease housing prices by between 8 percent and 12 percent in the short run.^[30] Instead, housing prices increased at an average annual rate of 5.5 percent in the two years after the reform.

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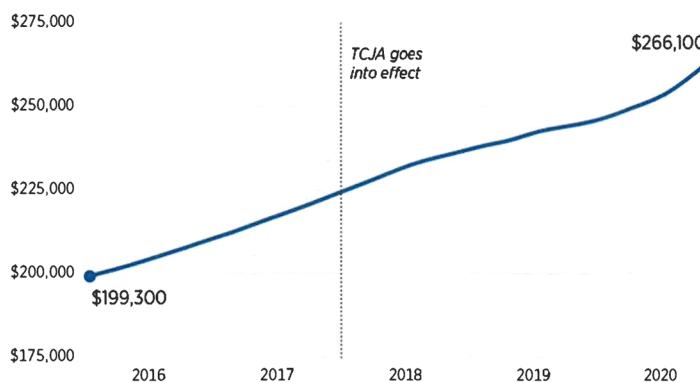
The TCJA reduced the maximum mortgage balance eligible for the MID by \$250,000 to \$750,000 for new debt incurred after December 15, 2017.^[31] In addition to the SALT cap and larger standard deduction, the smaller MID substantially reduced new homeowners' reliance on the tax preference. The MID and the SALT deduction act as a relative subsidy for owner-occupied housing.^[32]

In the first eight months after the law passed, the Zillow Home Value Index's nominal year-over-year growth rate remained almost constant at 6.6 percent.^[33] In 2018 and 2019, the positive growth rate for home values never dipped below 3.7 percent. Across three other indices, real housing prices also increased through 2018.^[34] Chart 6 shows that although the growth rate slowed slightly, the overall price level continued to increase after the 2017 reforms. The slowdown was more pronounced in high-income population centers. In these places, home prices had risen faster than wages for multiple years, and the deceleration likely had "little to do with the tax law," according to an economist at Zillow.^[35] Homeownership rates also continued to increase in the years following the reform.^[36]

CHART 6

Housing Prices Continue to Climb Post-TCJA

ZILLOW HOME VALUE INDEX, IN NOMINAL DOLLARS



SOURCE: Zillow.com, "Zillow Home Value Index (ZHVI)." <https://www.zillow.com/research/data/> (accessed February 11, 2021).

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These trends should not be surprising. Research generally finds that the MID does not increase rates of homeownership. Empirical investigations typically conclude that the deduction's primary effect is that it enables higher-income families to take on larger debts and thus purchase homes 10 percent to 20 percent larger than they would buy without the tax benefit.^[37] Any downward price pressure from the new limits would therefore be felt only at the very top end of the market.

Myth #8: The Corporate Tax Cut Hurt Workers by Increasing Stock Buybacks

In 2018, publicly traded corporations increased "stock buybacks"—a maneuver that allows the business to repurchase its own stock at market value from current investors. These routine actions were quickly used as evidence that corporate America was paying out investors instead of reinvesting in their workers and other core functions.^[38] This analysis misrepresents the economics of share repurchases and misses the effects of changes to the international tax system.

When a firm repurchases its stock, the transaction does not make the shareholders wealthier. It is merely a voluntary transfer of cash for the value of the stock. In this regard, a stock buyback is no different from a dividend payment. In both transactions, the business pays out part of its profit to the firm's owners (the shareholders).^[39] Rather than removing resources for workers, it frees up resources to be better deployed, hiring workers and expanding investment in new and under-invested industries.

Stock buybacks and dividend payments are typically more extensive when the business does not have suitable investment options for all its profits, so it gives part of the profit back to their investors to reinvest in other, more productive endeavors.^[40] For example, at the same time that stock buybacks were peaking, the U.S. venture capital industry—which invests in some of the most innovative start-up firms in the world—saw a \$78 billion increase in assets under management, the largest single-year jump reported.^[41] It is likely that some of the capital being returned to investors through stock buybacks ended up fueling an increase in venture capital funding and other similar investments.

Corporate stock buybacks in the S&P 500 Index increased in 2018 by about \$350 billion over their previous trend, totaling \$800 billion. Buybacks remained elevated in 2019. The one-time spike was primarily driven by firms that repatriated funds previously held by a foreign affiliate. The pre-TCJA system incentivized multinational firms to hold profits overseas as a way to delay U.S. taxes on profits not earned in the U.S. The TCJA moved the U.S. tax code from a "worldwide system" toward a territorial system that no longer

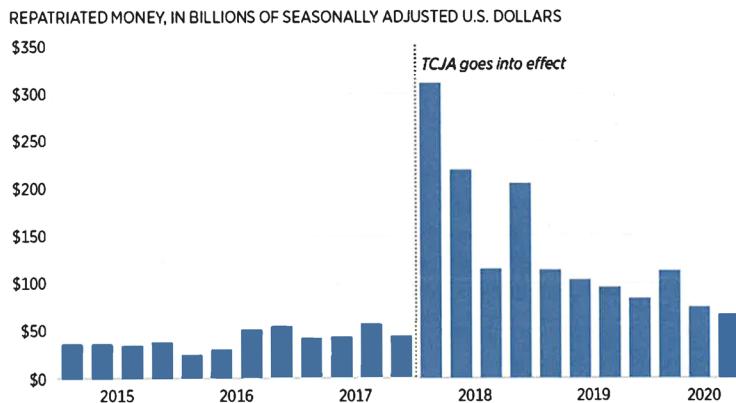
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tries to tax all overseas profits. After these changes, U.S. businesses repatriated more than \$1 trillion above their previous trends. (See Chart 7.)^[42] Research from the Federal Reserve shows that firms with larger overseas holdings were significantly more likely to buy back shares in 2018. Similar trends were found in 2004 after a temporary change allowed firms to bring foreign funds home.^[43]

CHART 7

U.S. Corporations Brought More Than \$1 Trillion Home After TCJA



SOURCE: U.S. Bureau of Economic Analysis, "International Data," Table 4.2, December 18, 2020, <https://apps.bea.gov/itable/itable.cfm?reqid=62&step=9&isuri=1&product=4> (accessed January 26, 2021).

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The large spike in repatriated funds is primarily an accounting change and not a shift in any real activity. Repatriated earnings are commonly misunderstood as newly available funds for U.S. investment. However, most multinational firms were able to access profits held overseas through international debt and capital markets. Accessing these funds still came with real frictions, which increase the cost of accessing foreign-booked profits.

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more for some firms than for others, depending on business structure and access to external financing. Firms with higher costs for accessing foreign cash were more likely to increase stock buybacks after the TCJA.^[44] This relationship indicates that these one-time rebalancing actions likely benefited domestic workers and investors by lowering the costs of accessing foreign cash for some firms.

Myth #9: The TCJA Rewards Companies that Offshore Jobs

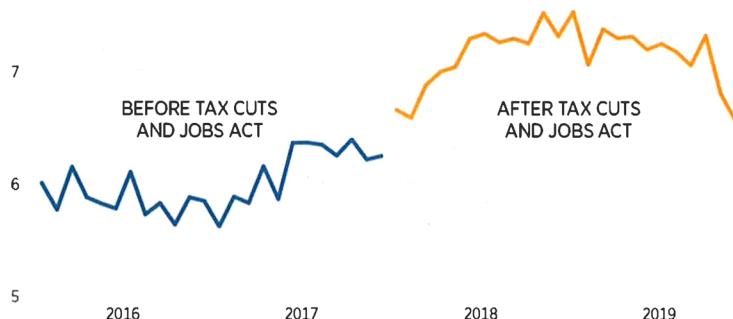
Campaigning in Warren, Michigan, candidate Joe Biden claimed that the tax cuts rewarded "companies that sent production and jobs overseas," repeating a common claim about the reform.^[45] However, in 2018 and 2019, available jobs and wage growth performed better than before the reforms, especially for production and nonsupervisory workers.

Corporate taxes on multinational businesses are levied based on highly complex rules. Given this complexity, critics like to pick out one narrow component of the TCJA reform and critique its impacts without accounting for the myriad other offsetting changes. When investigated holistically, the TCJA unambiguously benefits American workers. Chart 8 shows that available job openings increased by more than 1 million, from an average of 6 million in 2016 and 2017 to 7.5 million at the end of 2018, which was an unprecedented 1.4 million more jobs than the number of unemployed workers.^[46] The decline at the end of 2019 happened concurrently to increasing tariffs and other trade frictions that likely cost well over a million jobs.^[47]

No Evidence of Job Offshoring After TCJA

JOB OPENINGS, IN MILLIONS

8



SOURCE: U.S. Bureau of Labor Statistics, "Job Openings and Labor Turnover Survey," Job Openings, <https://data.bls.gov/timeseries/JTS00000000000000000000JOL> (accessed January 25, 2021).

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The TCJA abandoned the outdated worldwide international tax system for a new quasi-territorial regime. The previous worldwide system applied an internationally high 35 percent federal corporate tax rate to all U.S.-headquartered firms' profits, no matter where the profits were earned. The tax was only due when the profits were repatriated to the U.S., creating large tax deferrals on profits held overseas. This system created an incentive for U.S. firms to acquire foreign firms and move their legal residence, and sometimes physical production, out of the U.S. The U.S. was one of just six Organization for Economic Co-operation and Development (OECD) countries with such a penalizing worldwide tax system.^[48]

In principle, the new quasi-territorial system only taxes corporate income earned in the U.S., but it includes a series of three new, complex international levies to maintain U.S. taxing rights on highly mobile income.^[49] Critics point to a dynamic in the new minimum tax that could be gamed by increasing tangible foreign property.^[50] While the new

international system could be improved by further lowering U.S. taxes on domestic investment and fixing some perverse incentives in the new formulas, the existing law has offsetting reforms that encourage on-shoring and additional domestic investment. For example, in 2018, employment, capital expenditures, and R&D spending growth by U.S. parent companies outpaced that of foreign affiliates.^[51]

Studies have consistently found that the post-TCJA regime reduced firms' incentive to move their headquarters overseas by acquiring foreign firms in a maneuver called an "inversion." One of President Biden's Treasury nominees found that similar incentives against artificial profit-shifting have increased the base of corporate profits subject to tax by the U.S., an incentive counter to the claim that firms moved jobs overseas.^[52] An analysis of different types of investments by multinational firms found that the U.S. is now a more attractive location for intangible investments and did not significantly change the incentive for tangible assets.^[53] The incentives for U.S. firms are important, but foreign-headquartered firms also have new incentives to invest in the U.S.^[54] In addition to the international rules, lower tax rates and full business expensing have reduced incentives to move physical production, jobs, and business income overseas.

Myth #10: The 21 Percent Corporate Tax Rate Is Lower than Necessary

The TCJA permanently lowered the federal corporate income tax rate to 21 percent in 2018. A key campaign pledge made by candidate Biden and congressional Democrats in 2020 is to raise the rate to 28 percent.^[55] Before the tax cut, the U.S. levied one of the world's highest corporate income tax rates. The high rate made it more expensive to invest or expand in America. Instead, businesses moved their headquarters overseas and chose lower-tax countries for their new projects.

In 2017, the federal corporate tax rate was 35 percent, and the federal-state combined rate was 39 percent. Forty U.S. states have a corporate income tax, with rates that range from 11.5 percent in New Jersey to 2.5 percent in North Carolina.^[56] In the years leading up to 2017, U.S. headquartered corporations faced the highest statutory tax rate in the developed world. The U.S. was also consistently ranked one of the least competitive tax environments by several other measures of marginal, effective, and average tax rates.^[57]

A 21 percent federal corporate tax rate was the upper bound for global tax competitiveness. Chart 9 shows that among the OECD—a group of America's international peers—the U.S. still has a combined corporate tax rate that is two percentage points higher than the non-U.S. international average. In 2020, 25 OECD

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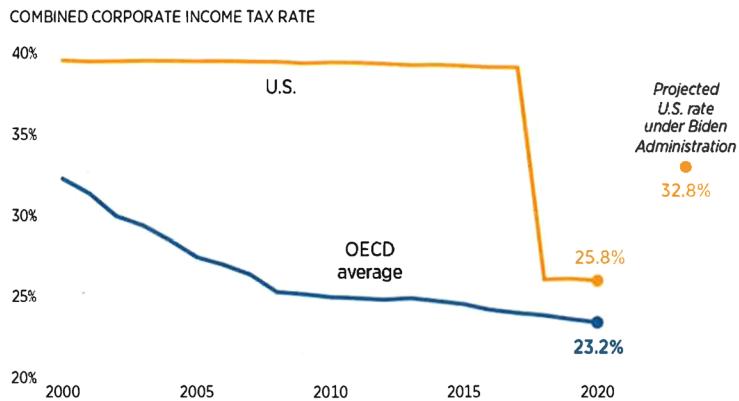
member countries, including Denmark, Norway, and Sweden, had corporate tax rates lower than the U.S.^[58]

Other countries realize that a competitive business tax rate is an essential domestic policy. Given this dynamic, Congress should work to further lower, rather than raise, the U.S. corporate tax rate. The corporate income tax should ultimately be eliminated, but a federal rate lower than Hungary's 9 percent (the lowest in the OECD) would make America a leader in business tax rates and would benefit U.S. consumers, workers, and investors.

Raising the corporate tax rate would hurt U.S. competitiveness and make the U.S. a global leader again in punitive business tax rates. Raising the federal rate to President Biden's proposed 28 percent (shown in Chart 9) would make American companies pay the highest tax rates in the developed world.

CHART 9

Despite Corporate Tax Reforms, American Employers Still Pay High Tax Rates



SOURCE: OECD Tax Database, "Table II.1 Statutory Corporate Income Tax Rate," https://stats.oecd.org/index.aspx?DataSetCode=Table_III (accessed February 16, 2021).

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Myth #11: The Tax Cut Pays for Itself

President Donald Trump and other Administration officials often claimed that tax reform would pay for itself.^[59] This claim was misleading and distract from the real purpose of the reform. The belief was rooted in the truth that the tax cuts would spur economic growth to help the Treasury recoup some lost revenue. However, over the conventional 10-year budget window, the tax cuts reduced net revenue and increased the deficit, even under optimistic growth scenarios. If Congress also curtails spending growth, lower revenue is precisely the goal of a tax cut. The purpose of cutting taxes is to allow Americans to keep more of their hard-earned money, not maximize revenue for the Treasury.

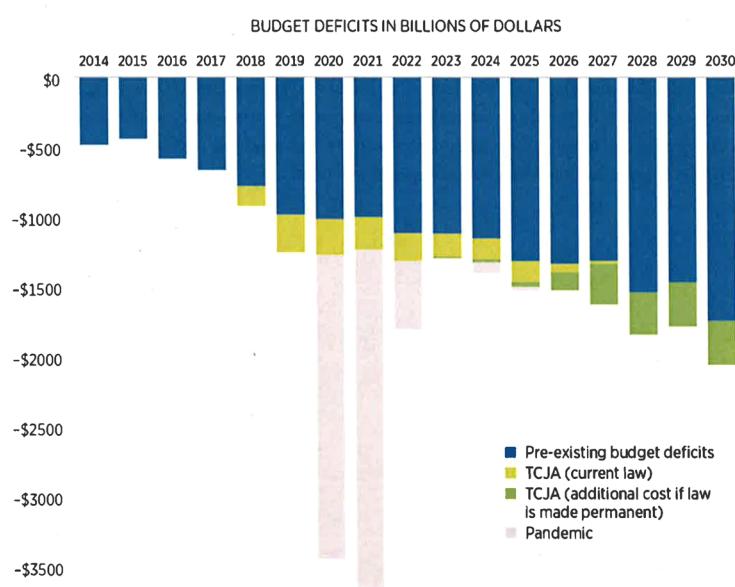
It is theoretically possible for a tax cut to increase economic growth or change taxpayers' reporting behavior so that the reforms lead to a net increase in revenue. Especially over longer time horizons, a pro-growth tax cut can more easily recoup the initial lost revenue. According to a Tax Foundation estimate from 2017, the tax cuts would only reduce revenues temporarily. By 2024, due mainly to additional economic growth, the tax cuts begin to raise more yearly revenue than before the reform.^[60] However, breaking even in one year does not mean the additional \$448 billion in projected new debt will be quickly paid down by a larger economy. If the tax cuts are made permanent, it is possible that during the second decade of the reform, the initial deficits could be recouped. However, this hypothetical assumes a materially different law than the one passed by Congress and an expanded budget window.

Myth #12: The Tax Cuts Caused the Federal Budget Deficit

Democrats and many Republicans rightly worried that the TCJA would contribute unnecessarily to the federal debt. However, claims that the tax cuts are responsible for the federal government's poor fiscal health represent a misdiagnosis of trends that are decades in the making.

In June 2017, pre-TCJA, the CBO projected that the federal government would reach an annual budget deficit of \$1 trillion in 2022.^[61] In April 2018, the CBO projected \$1 trillion deficits arriving in 2020, showing the effects of the tax cuts and the 2018 budget deals, which increased federal spending by more than \$500 billion in 2019.^[62] By this measure, the TCJA moved the trajectory of large and growing deficits up by between one year and two years.

The TCJA did increase the deficit, but the law is not the underlying cause of the unsustainable U.S. budget. The systemic gap between revenues and expenditures is driven by sustained growth in mandatory spending programs since the 1970s.^[63] Chart 10 shows that the tax cuts, even if made permanent, only represent about 16 percent of the projected, non-pandemic-related 2021-2030 budget deficit forecast. Repealing the 2017 tax cuts would not change the trajectory of increasing federal deficits. Because the budget deficit is driven by spending growth and not lack of revenue, no politically viable tax increase can cover projected outlay growth.^[64] For example, one year's deficit in 2030 is larger than the entire 10-year cost of the TCJA.

Tax Cuts Not the Cause of Growing Deficits

NOTE: Not shown are small offsetting deficit reductions from pandemic-related legislation in 2023 and 2026–2030. These effects do not materially change the trend of the total deficit.

SOURCES:

- Congressional Budget Office, "The Budget and Economic Outlook: 2021 to 2031," February 11, 2021, <https://www.cbo.gov/publication/56970> (accessed February 16, 2021).
- Congressional Budget Office, "Updated Budget Projections: 2019 to 2029," May 2, 2019, <https://www.cbo.gov/publication/55151> (accessed February 16, 2021).
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- Congressional Budget Office, "H.R. 6074, Coronavirus Preparedness and Response Supplemental Appropriations Act, 2020," March 4, 2020, <https://www.cbo.gov/publication/56227> (accessed March 12, 2021).
- Congressional Budget Office, "H.R. 6201, Families First Coronavirus Response Act," April 2, 2020, <https://www.cbo.gov/publication/56316> (accessed March 12, 2021).
- Congressional Budget Office, "H.R. 748, CARES Act, Public Law 116-136," April 16, 2020, <https://www.cbo.gov/publication/56334> (accessed March 12, 2021).

6/21/23, 12:07 PM

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- Congressional Budget Office, "H.R. 268, Paycheck Protection Program and Health Care Enhancement Act," April 22, 2020, <https://www.cbo.gov/publication/56338> (accessed March 12, 2021).
- Congressional Budget Office, "H.R. 133, Summary Estimate for Divisions M Through FF Consolidated Appropriations Act, 2021 Public Law 116-260," January 14, 2021, <https://www.cbo.gov/publication/56963> (accessed March 12, 2021).
- Congressional Budget Office, "Estimated Budgetary Effects of H.R. 1319, American Rescue Plan Act of 2021," March 10, 2021, <https://www.cbo.gov/publication/57056> (accessed March 12, 2021).

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Regardless of the cause, congressional inability to constrain spending growth resulted in a deficit-financed tax cut, which was followed by spending increases rather than the necessary reforms. Keeping taxes low and restraining spending growth are mutually reinforcing goals.^[65] Without spending reform, today's lower taxes must result in higher taxes on future generations.

Conclusion

The 2017 tax cuts have likely made the COVID-19 economic crisis less severe, helping the economy to bridge the 2020 disruptions. While there is still a long way to go, the economy has consistently outperformed economic projections due in part to pro-growth policies put into place before the crisis.^[66]

First, the 2017 law boosted businesses' available cash by cutting tax rates and allowing easier access to the \$1 trillion in repatriated foreign profits. These and other reforms have likely given a large portion of the economy an extra cushion to draw on over the past year. Second, the structural reforms that encourage higher business investment levels do not go away in a pandemic.^[67] Because of lower business tax rates and business expensing, firms that are investing are investing a bit more than they would have otherwise. When the pandemic subsides, incentives to invest, hire, and expand will help propel the economic recovery.

In the coming years, Congress will need to preserve the TCJA's gains. Beginning in 2023, the most pro-growth reform—full expensing—begins to phase out, and three years later, the rest of the tax cuts for individuals expire. Pressure from the political left and ballooning deficits are already threatening the gains from tax reform. Setting the record of the TCJA straight is crucial to ensuring that Congress chooses to keep taxes low and makes 2017 reforms permanent. Reversing the tax cuts would make the COVID-19 economic recovery that much more challenging.

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Mr. YAKYM. Thank you, and thank you to our witnesses for being here today to share your expertise on this critical issue. It is no secret that state and Federal tax policies strongly impact economic growth and opportunities for all Americans. Every tax dollar that the IRS collects is a dollar that hard working families don't get to put towards food on the table or a night out at the movies, and it is a dollar that businesses don't get to put towards raises for their employees or capital expenditures. Repeatedly, we have seen the positive impact of tax cuts on everyday Americans.

For example, in the two years after the passage of the Tax Cuts and Jobs Act, real median household income increased by over \$5,000. Yet President Biden and congressional Democrats continue to push for higher taxes and spending with complete disregard for the impact on inflation, the impact on long-term economic growth, and the impact on American, and even more specifically, Hoosier families and businesses.

The American Rescue Plan, which was rammed through without a single Republican vote, supercharged inflation, saddled everyday Americans and small business owners with burdensome new paperwork requirements on transactions over \$600. The Inflation Reduction Act, was also rammed through without a single Republican vote, imposed American manufacturers with over \$100 billion in new taxes.

Meanwhile, the Biden Administration's loose regulatory interpretations have ballooned the costs of new tax credits to over 700 percent of their original projected costs. What we should be focused on is how to incentivize growth, how to incentivize more research and more development within the United States. For example, a study published in the *Journal of Public Economics* estimated that when a business received a ten percent reduction in their R&D costs, they increased research spending in intensity by about 19.8 percent. Additionally, they found that most of the increased spending went to increases in wages and supplies. This clearly illustrates the broad benefits in allowing businesses to expense or receive tax credits for research and development.

So, my question for Dr. McBride to start, can you speak to the economic impact of R&D tax credits and deductions on everyday Americans?

Dr. MCBRIDE. Sure. So, this gets to the discussion we were having earlier about consumption being a driver of the economy. It is true that consumption is about 70 percent of GDP for instance, but it is investment that happens first to get to that consumption. It is investment that creates the income ultimately out of which we consume, and so, it is investment that should be prioritized here and that is what we should be discussing here, and it is R&D investment in particular that is incentivized by R&D expensing. So, yes, it is a very important provision.

Mr. YAKYM. And how would that help everyday Americans or even Hoosiers that, you know, just median income Hoosiers?

Dr. MCBRIDE. So, it leads to greater R&D expenditures. R&D leads to innovation. Innovation leads to better products, better consumer products, more efficiencies in the workplace, which in turn leads to higher productivity ultimately, and workers are paid based on their productivity. So, that means higher wages.

Mr. YAKYM. All right. Estimates by the Cato Institute show that “if Congress confiscated every dollar earned by individuals, and businesses past their first \$500,000, it would still be about \$200 billion short of covering the cost of next year’s projected \$1.7 trillion deficit.” Dr. McBride, do you believe that this shows that we have a spending problem or a revenue problem in Washington?

Dr. MCBRIDE. I think the clearest picture is from the CBO when they simply do their 10-year projection. Looking forward, they are showing on average, spending is going to be about 24 percent of GDP over the next ten years. It is about three to four percentage points higher than the historic average, okay? And then we have revenues also higher than the historic average, coming in about 18 percent. So, I think that is all you need to know going forward if it is spending or revenues that are the problem.

Mr. YAKYM. Thank you, and, Dr. Mazur, part of my job is ensuring that Hoosiers and small businesses and families don’t pay higher taxes that is the result of Washington’s overspending, and in your opening testimony you stated and complained that you now pay less taxes today as a percentage than what you did prior. So, I just want to make sure that you are aware that the Treasury Department actually has a program where if you don’t feel like you are paying enough taxes, you can send in additional dollars and that would help make sure that my constituents don’t bear the cost of the overspending here in Washington. Thank you, Mr. Chairman. I yield back.

Dr. MAZUR. I am well aware of that program. I also don’t have a Roth IRA for a similar reason that I enjoy paying my taxes because like they say, tax is the price you pay for a civilized society.

Chairman ARRINGTON. I thank the gentleman from Indiana, and now yield five minutes to my colleague from Oklahoma, Josh Brecheen.

Mr. BRECHEEN. Thank you, Mr. Chairman. I heard earlier today one of our colleagues, one of our Democrat colleagues. I wrote down the comment. They were concerned about “a proliferation of billionaires in our country.” That is an exact quote from what they said. They were also concerned “that we have as the United States, the highest number of billionaires in the world.” It made me think about John F. Kennedy and his famous commentary that a rising tide lifts all ships, all boats, and how this ideology of wanting to weaken our country’s ability to have people invest and create jobs, how it has taken over and it misuses facts.

I greatly enjoyed studying the Tax Foundation’s state by state comparisons, and with the Tax Cuts and Jobs Act, what we know is the corporate income tax rate, which made America have among the highest corporate income taxes in the world, with the Tax Cuts and Jobs Act we went back to the average, and then last year if you look at the 2022 income tax collections, what you find is, is that the top one percent paid 42 percent of all income taxes, and the top 50 percent paid 97—of income earners, paid 97 percent of all income taxes, and the bottom income earners in the United States only paid 2.3 percent of all income taxes.

So, it is amazing to me the rhetoric that continues to come out when we already have seven graduated tax rates. We are totally in contrast to what in 1935 William John Henry Boucher once said,

you can't hit the poor man by destroying the rich man. You can't strengthen the weak by weakening the strong. You can't lift the wage earner up by pulling the wage payer down. It is just an astounding contrast in America that we don't want to create an environment that makes people successful, and then when you actually look at who is paying taxes, as I just recited, it doesn't match the rhetoric of, we got to get them to pay more.

So, Dr. Mazur, you made a comment about vertical equity. You defined it a minute ago about vertical equity is to get those who do better to pay more. With 97 percent of the income tax burden paid by the highest 50 percent of earners, and the bottom 50 percent of earners pay only 2.3 percent, and the top one percent that is talked about all the time pay 42 percent of all income taxes, and we are at the average of corporate income tax rates and you look at where we are at historically in terms of our gross domestic product and the amount of tax collection, that we are on par with history of our Nation. Can you explain to me where do you expect people to pay more when we have this system already in place?

Dr. MAZUR. Sure. So, you are focused on income taxes. If you would go back to your constituents, probably more than half of them pay way more in payroll taxes than income taxes, and you are leaving payroll taxes out of the calculations here when you are going through who pays how much.

Mr. BRECHEEN. Can I ask you a question?

Dr. MAZUR. Sure.

Mr. BRECHEEN. Payroll taxes, you are talking about FICA and the—

Dr. MAZUR. I am talking about, yeah, Social Security and Medicare.

Mr. BRECHEEN. Yeah, Medicare.

Dr. MAZUR. Yeah.

Mr. BRECHEEN. So, what we know by looking at that is, is that when we look at our budget deficits—

Dr. MAZUR. Yeah.

Mr. BRECHEEN [continuing]. Our annual budget deficit is \$1.5 trillion this year, that is not inclusive of the insolvency of those programs you are discussing. Most of us, you know, we know we have got to solve that problem.

Dr. MAZUR. Yeah.

Mr. BRECHEEN. But that is a totally different conversation than when we are looking at budgets.

Dr. MAZUR. Not totally different. It is part of the entire fiscal package.

Mr. BRECHEEN. Of unfunded obligations I agree with you there.

Dr. MAZUR. And you are right. Then you know how to solve this. There is like six dials you can turn, and you can get the Ways and Means Committee together to figure out how you want to address Social Security. Whether you want to do something on the benefits side, the tax side, the retirement age side, cost of living side. There aren't that many dials.

Mr. BRECHEEN. Can I pivot once?

Dr. MAZUR. Sure, please.

Mr. BRECHEEN. I just need to pivot because there is limited time here. I want to go back to something that, it was part of your intro-

ductory testimony where you talked about the ability for us as a Nation to look at a simplification of our tax code. We have about a \$100 billion expense to just pay our taxes in the United States, and the Tax Foundation has got some ideas and I want to give you just a moment to talk about Estonia and what they are doing to simplify within minutes to be able to file your taxes, and, you know, what we can learn—what I love about what the Tax Foundation has done, state-by-state comparison to help states get an idea of how you can improve the ability to find out what is working and look at the laboratories of experimentation, laboratories of democracy state by state, but also, by looking at different countries. I would like to have you speak in my time limit here. You got 20 seconds if you can talk about Estonia.

Dr. MCBRIDE. 20 seconds, I think some people from Estonia might actually file their taxes in 20 seconds. The claim there is that you can file your taxes in five minutes or less, and we have talked—my friend Kyle here—we had talked to the folks in Estonia at the Ministry of Finance and they confirmed that, indeed, it is five minutes or less to file your taxes, which is, should be mind blowing for Americans, but they do it because they have a very simple system. A simple system that actually collects plenty of revenue about the same—

Mr. BRECHEEN. It is not 72,000 pages when you talk—

Dr. MCBRIDE. Absolutely not.

Mr. BRECHEEN [continuing]. Look at court cases like the—

Dr. MCBRIDE. It is about—

Mr. BRECHEEN [continuing]. United States.

Dr. MCBRIDE [continuing]. 88 pages, the entire Federal tax code. So, it can be done.

Mr. BRECHEEN. Mr. Chairman, I yield, and thank you for your indulgence.

Chairman ARRINGTON. You bet. I thank the gentleman from Oklahoma. I now yield five minutes to my friend from North Carolina, Chuck Edwards.

Mr. EDWARDS. Thank you, Mr. Chair. Dr. Mazur, I heard you mention something a while ago that seems to be a typical political talking point and that is there are corporations in America that do not pay any taxes. Do you think they are doing anything illegal?

Dr. MAZUR. I don't know. The situation you know that they are taking advantage, full advantage of the law and shipping income to other tax jurisdictions, and they are taking advantage of the tax incentives that are provided. Whether they, as Mr. Grothman was talking about, some of the tax credits that they have available or the deductions that they have available.

Mr. EDWARDS. And so, do you think that is wrong that they take advantage of—

Dr. MAZUR. So, Congress used to have an alternative minimum tax for corporations, and part of the reason for having alternative minimum tax was that it provided a backstop. It said no matter how many deductions or credits you get you still—

Mr. EDWARDS. Dr. Mazur—

Dr. MAZUR [continuing]. Have to pay this much.

Mr. EDWARDS [continuing]. Thank you. Thank you for that. Have you ever paid alternative minimum tax?

Dr. MAZUR. Yes, I have paid alternative minimum tax many times.

Mr. EDWARDS. Yes, and you recognize that the reason that one would pay that is because there was no income in the first place. I mean that is—

Dr. MAZUR. No, that is not true. I paid alternative minimum tax personally—

Mr. EDWARDS. Yeah.

Dr. MAZUR [continuing]. When my income was probably around \$200,000 a year, similar to your income, and it was because I had a lot of state and local taxes that are not allowed as a deduction under the alternative minimum tax.

Mr. EDWARDS. I can tell you as a businessperson I paid lots of alternative—

Dr. MAZUR. Mm-hmm.

Mr. EDWARDS [continuing]. Minimum tax, and it is because there was no income, and I believe that is what is the case with most businesses out there today. The goal of every business is to have income to be able to pay taxes. Would you not also agree that even those companies that do not generate income to the level to pay the income taxes that you might want them to pay do pay Social Security taxes.

Dr. MAZUR. Yeah.

Mr. EDWARDS. They do pay FICA taxes. They do pay property taxes. They do pay unemployment taxes. There are still plenty of taxes out there for those companies that have not generated the income to pay. You do recognize—

Dr. MAZUR. No, agreed they pay—

Mr. EDWARDS [continuing]. There is a—

Dr. MAZUR [continuing]. A whole range of taxes.

Mr. EDWARDS. Yeah.

Dr. MAZUR. I agree with that.

Mr. EDWARDS. All right, thank you. Mr. Pomerleau, the TCJA reduced the Federal corporate tax rate from 35 percent to 21 percent. What did that do for international competitiveness?

Mr. POMERLEAU. So, as I described in my testimony, prior to the Tax Cuts and Jobs Act the U.S. had the highest statutory tax rate in the developed world, and the Tax Cuts and Jobs Act brought that down to roughly about average. That had a couple benefits sort of internationally. So, the first one is that it just, it reduced the incentive for corporations to locate their profits in low tax jurisdictions. The amount a company can save depends on the differential in tax rates, and when the U.S. had a very high tax rate and other jurisdictions had lower rates, companies could save more by shifting overseas.

The second benefit is it also reduced the incentive to locate intellectual property offshore as well. When a company is deciding where to place a highly mobile asset, they are going to ask themselves, all right where can I get the highest after-tax return on this investment? And a lot of that is determined by the statutory tax rate that the U.S. levies, and bringing that down also discouraged companies from shifting those abroad.

Mr. EDWARDS. As any CEO would do, they are trying to generate income for their shareholders, their owners, and so, I appreciate

you calling attention to the fact that if we want more American jobs, if we want more investment in the United States, as opposed to places like China, then we need to create the environment for them to do that. Thank you very much.

Mr. Kuhlman, what did the Tax Cuts and Jobs Act of 2017 do for small businesses?

Mr. KUHLMAN. I think from an overall environment, the passage of the Tax Cuts and Jobs Act combined with some of the emphasis on reducing regulations, we saw small business optimism at or near all-time highs right before the pandemic. Of course, the pandemic turned everything upside down, but business owners took the benefits and just reinvested it back in the business. According to a survey we did in 2019, one in four increased compensation, nearly identical number increased business investment, 16 percent hired new employees, 20 percent paid down debt. Overall, they plowed it back into the business so their obligations for the overall economic benefit of the small business to have.

Mr. EDWARDS. Thank you. One more question I would like to get to before I run out of time. 32 percent of small business owners reported raising their selling prices. Would raising taxes help the inflation that Americans are already experiencing today?

Mr. KUHLMAN. Short answer, no.

Mr. EDWARDS. Okay, all right. Mr. Chair, I see I am out of time. I yield back.

Chairman ARRINGTON. I thank the gentleman from North Carolina. I yield five minutes to my friend Lloyd Smucker from the Commonwealth of Pennsylvania.

Mr. SMUCKER. Thank you to the Chairman. Dr. Mazur—Mazur—Mazur, sorry about that. In response to a question earlier, you said we could make the tax system more fair by making it progressive.

Dr. MAZUR. It already is progressive, making it more progressive.

Mr. SMUCKER. Yeah, okay. That is the point I wanted to clarify, and in fact, I would like to enter into the record a report from the Joint Committee on Taxation, Mr. Chairman.

Chairman ARRINGTON. So ordered.

[The information follows:]

**PRESENT LAW AND BACKGROUND ON THE TAXATION
OF HIGH INCOME AND HIGH WEALTH TAXPAYERS**

Scheduled for a Public Hearing
Before the
SUBCOMMITTEE ON SELECT REVENUE MEASURES
of the
HOUSE COMMITTEE ON WAYS AND MEANS
on May 12, 2021

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION



May 10, 2021
JCX-24-21

CONTENTS

	<u>Page</u>
INTRODUCTION.....	1
I. BACKGROUND DATA.....	4
A. Data on Income.....	4
B. Data on the Income Taxation of Estates and Trusts.....	15
C. Data on Wealth Transfer Taxes.....	17
D. Data on Wealth.....	21
II. THE PRESENT LAW TAXATION OF HIGH INCOME AND HIGH WEALTH TAXPAYERS.....	29
A. In general.....	29
B. Income Taxation of Individuals, Estates, and Trusts.....	31
1. Income taxation of individuals.....	31
2. Income taxation of estates and trusts.....	36
C. Taxation of Business and Investment Income of Individuals.....	40
1. Income tax treatment of gains and losses from the disposition of property.....	40
2. Overview of mark-to-market taxation.....	44
3. Taxation of domestic business income of individuals.....	49
4. All-in tax rates on income of individuals.....	54
D. The Estate, Gift, and Generation-Skipping Transfer Taxes.....	58
1. Common features of the estate, gift and generation-skipping transfer taxes.....	58
2. The estate tax.....	60
3. The gift tax.....	64
4. The generation-skipping transfer tax.....	65
III. DISCUSSION.....	67
A. Income Tax Proposals.....	67
B. Wealth Taxation.....	78
C. Wealth Transfer Tax Proposals.....	82
APPENDIX.....	89

INTRODUCTION

The Subcommittee on Select Revenue Measures of the House Committee on Ways and Means has scheduled a public hearing for May 12, 2021, called, “Funding Our Nation’s Priorities: Reforming the Tax Code’s Advantageous Treatment of the Wealthy.” This document,¹ prepared by the staff of the Joint Committee on Taxation, describes empirical information, legal background, and policy considerations related to topics to be considered in the hearing.

The primary purpose of a tax system is to raise revenue to fund government expenditures. The economic crisis brought on by the ongoing COVID-19 pandemic has led Congress to respond by passing several bills that will substantially increase the U.S. debt.² As the debate over further responses and other priorities continues, several fundamental decisions arise. If Congress desires to increase government expenditures further, funding options include increasing government debt or raising more revenue. If Congress decides to raise more revenue, one of the questions is how.

Several factors may be used to assess how well a tax system raises revenue, including whether the tax system promotes or hinders economic efficiency and growth, how fair the tax system is (including both horizontal and vertical equity),³ and how simple and administrable the tax system is. The disparate effects of the COVID-19 pandemic across industry,⁴ educational attainment,⁵ and income group⁶ have drawn focus to the continuing debate about the fairness of the U.S. tax system. One salient question in that debate is the degree to which the U.S. tax system should impose taxes according to a taxpayer’s ability to pay; in other words, what is the appropriate level of progressivity for the overall U.S. tax system.

¹ This document may be cited as follows: Joint Committee on Taxation, *Present Law and Background on the Taxation of High Income and High Wealth Taxpayers* (JCX-24-21), May 10, 2021. This document can be found on the Joint Committee on Taxation website, www.jct.gov.

² The Congressional Budget Office projects that by 2031, debt as a percent of gross domestic product will exceed the historical highs of Federal spending resulting from World War II. Congressional Budget Office, *The 2021 Long-Term Budget Outlook*, March 2021, Figure 1.

³ The concept of horizontal equity asks whether taxpayers who otherwise are similarly situated bear the same tax burden. The concept of vertical equity asks how the tax burdens of low-ability-to-pay taxpayers compare to tax burdens of high-ability-to-pay taxpayers.

⁴ Michael Dalton, “Geographic Impact of COVID-19 in BLS Surveys by Industry,” *Monthly Labor Review*, U.S. Bureau of Labor Statistics, August 2020, <https://doi.org/10.21916/mlr.2020.17>.

⁵ Daly et al., “The Unequal Impact of COVID-19: Why Education Matters,” *FRBSF Economic Letter*, Federal Reserve Board of San Francisco, June 2020.

⁶ Julianne Horowitz, Anna Brown, and Rachel Minkin, “A Year Into the Pandemic, Long-Term Financial Impact Weighs Heavily on Many Americans,” Pew Research Center, March 5, 2021 examined survey responses from January 2021 and found that 41 percent of upper-income adults reported that their family’s financial situation had improved since February 2020 compared to 11 percent who reported finances had worsened. In contrast, 22 percent of lower-income adults reported financial improvement while 31 percent reported worsening finances.

Answering this question involves considering how ability to pay should be measured. Important concepts for the consideration of this question include income and wealth. A general concept of income is the change in an individual's net wealth plus an individual's consumption over a certain timeframe. Wealth can be defined as an individual's assets minus the individual's debts.⁷

One option for measuring ability to pay is to measure it by income. Income could be argued to be a more appropriate measure of ability to pay than wealth because not all wealth is held in liquid assets. A progressive tax system using income as a base would impose a relatively higher rate of tax on those with more income. However, there are administrability concerns under a broad income tax, including: how should changes in the value of an asset be measured; should income be measured annually;⁸ and should certain sources of income be excluded? There are also efficiency concerns: what do high marginal income tax rates do to incentives to work, and compared to other taxes how distortionary is such a tax?

Another possibility is to use a taxpayer's wealth as an indicator of ability to pay. Arguably, a taxpayer with more wealth has more capacity to pay taxes. A progressive tax system using wealth as a base would impose a relatively higher rate of tax on those with more wealth. However, such a tax may treat otherwise similarly situated taxpayers differently depending on saving and consumption patterns. Additionally, the fairness of a tax system is one factor that is balanced against other priorities. If attempting to tax wealth directly, there may be administrability concerns, such as: how should wealth be measured; should certain kinds of assets be excluded; how should nontradable or illiquid assets be valued; and what if any new reporting might be necessary? There are also efficiency concerns: what would a broad tax on wealth do to incentives to save and invest, and compared to other taxes how distortionary is such a tax?

The inquiry is not only how to determine the appropriate base for taxation (wealth, income, some combination, or something else entirely) but also how broad the base should be. Implementing and administering a tax on a broad measure of wealth or income means knowing the relevant composition of wealth and sources of income so that they can be measured. Alternatively, a progressive wealth or income tax could target certain components of wealth or income that are held in higher proportion by high-wealth or high-income taxpayers. Such a tax would also require identifying which components of wealth or income fit these criteria. Section I presents and discusses the available data on sources of income and composition of wealth.

The present U.S. tax system can be viewed as progressively taxing certain components of income and wealth. The individual income tax applies progressive rates to a set of sources of

⁷ This measure would exclude the education or skills of a taxpayer (sometimes referred to as human capital).

⁸ Franco Modigliani and Richard H. Brumberg, "Utility Analysis and the Consumption Function: An Interpretation of Cross-Section Data," in Kenneth K. Kurihara, (ed.), *Post-Keynesian Economics*, Rutgers University Press, 1954, pp. 388-436.

income.⁹ The donor of a gift or decedent making a bequest are subject to the estate and gift tax system, with certain annual and lifetime exemptions which may be present for reasons of administrability (not having to account for relatively small transfers) and fairness (progressivity can be achieved with exemptions for smaller transfers). Section II provides a more detailed description of relevant present law tax provisions that relate to income taxation and wealth transfer taxation.

Given the complexity of the issues and our current system, there are ongoing debates about which components of income and wealth our system should tax and the degree to which such components should be taxed to balance fairness, efficiency, and administrability concerns. Section III concludes with a discussion of some proposals that share an aim to increase the progressivity of the Federal tax system.

⁹ These sources include compensation for services, interest, dividends, capital gains, rents, royalties, 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, income allocated from S corporations and partnerships, and income distributed from estates or trusts.

I. BACKGROUND DATA

The following discussion reviews data about and provides a summary of analyses of sources of income and composition of wealth by income and wealth groups, respectively.

A. Data on Income

The economics literature discusses the distribution of national income, the total amount of money earned within a country. Specifically, discussion has focused on how best to measure income composition and shares. Income measures used to estimate inequality are critical for estimating average tax rates and tax progressivity. In the early 1900s, researchers first observed that a larger share of national income went to labor than to capital.¹⁰ Initial survey data about wages, dividends, and interest from different industries revealed that the share of income going to the top one percent of the income distribution was 14 percent and the share going to the top 10 percent was 35 percent.¹¹ However, there were disagreements about the assumptions made and data used to measure the distribution of income.¹² Soon after the introduction of the modern Federal income tax, researchers used the income reported on tax returns to estimate income shares.¹³ In general, revised estimates and trends using tax return information were similar to prior measures, although industry survey data may have underestimated the volatility of national income.¹⁴ Even after the introduction of tax return reporting, concerns remained as to how to best measure the distribution of national income.¹⁵

Work on the measurement of income compositions and shares has continued.¹⁶ The Congressional Budget Office estimated income share using tax return data and found that between 1979 and 2015, the top one percent's share of income before taxes and transfers increased by more than seven percentage points.¹⁷ Between 1979 and 2006, Census data show

¹⁰ Willford I. King, *The Wealth and Income of the People of the United States*, Macmillan, 1915; Scott Nearing, *Income; an Examination of the Returns for Services Rendered and from Property Owned in the United States*, Macmillan, 1915.

¹¹ *Ibid.*

¹² Arthur L. Bowley, "Income in the United States," *The Quarterly Journal of Economics*, 37(3): 510-517, 1923.

¹³ Wesley C. Mitchell, Willford I. King, Frederick R. Macaulay, and Oswald W. Knauth, "Income in the United States, Its Amount and Distribution, 1909-1919," *General Series National Bureau of Economic Research*, no. 1-2, 1921. For a summary of this early literature, see Hugh Rockoff, "Off to a Good Start: The NBER and the Measurement of National Income," *NBER Working Paper No. 26895*, 2020.

¹⁴ *Ibid.*

¹⁵ Morgan Reynolds and Eugene Smolensky, *Public Expenditures, Taxes, and the Distribution of Income: The United States, 1959, 1961, 1971*, W. W. Norton & Company, 1977.

¹⁶ Thomas Piketty and Emmanuel Saez, "Income Inequality in the United States, 1913-1998," *NBER Working Paper No. 8467*, 2001.

¹⁷ Congressional Budget Office, *The Distribution of Household Income, 2015*, November 2018 (supplemental data).

that the top one percent's pre-tax/pre-transfer income shares increased by about three percentage points, when corrected for survey changes and top-coding issues.¹⁸

Another question that arises is how to measure total income. For example, the Congressional Budget Office estimates above use a narrower income definition than national income.¹⁹ The Census data also look at pre-tax/pre-transfer income shares. In general, national income may be measured pre-tax/pre-transfer, pre-tax/after-transfer, or after-tax/after-transfer.

Other recent work shows results that indicate the share of national income (before taxes, but after Social Security and unemployment benefits) earned by the top one percent of American adults rose by eight percentage points from 1979 to 2019.²⁰ Subsequent work by other economists has estimated smaller increases in income concentration. Other economists report that the top one percent's pre-tax national income rose less than five percentage points from 1979 to 2015.²¹ However, pre-tax national income does not account for taxes or government transfers. When an income measure is computed that includes taxes and transfers, those same economists found that the top one percent's share rose by approximately one percentage point from 1979 to 2015.²² In general, there is uncertainty in how to measure income and interpret available data. There is a range of results due to different data sources, different income definitions, and different assumptions used to allocate missing income.

In the following tables, the Joint Committee staff has calculated several alternative measures of income categorized by percentiles of the income distribution.²³ The income group thresholds are set such that each percentile has the same number of individual U.S. residents (including adults, dependents, and non-filers). For example, the number of individuals in the 27th percentile is the same as the number of individuals in the 61st percentile. The income

¹⁸ Richard V. Burkhauser, Shuaizhang Feng, Stephen P. Jenkins, and Jeff Larrimore, "Recent Trends in Top Income Shares in the United States: Reconciling Estimates from March CPS and IRS Tax Return Data," *Review of Economics and Statistics* 44(2): 371–388, 2012.

¹⁹ Congressional Budget Office estimates do not correct for effects from the Tax Reform Act of 1986, causing an upward bias in the estimated increases. Differences between the CBO income definition and national income are discussed in Gerald Auten and David Splinter, "Top 1% Income Shares: Comparing Estimates Using Tax Data," *AEA Papers & Proceedings* 109, 307–311, 2019.

²⁰ Thomas Piketty, Emmanuel Saez, and Gabriel Zucman, "Distributional National Accounts: Methods and Estimates for the United States," *Quarterly Journal of Economics* 133(2): 553–609, 2018.

²¹ See Gerald Auten and David Splinter, "Income Inequality in the United States: Using Tax Data to Measure Long-Term Trends," *Working Paper*, December 20, 2019, available at http://davidsplinter.com/AutenSplinter-Tax_Data_and_Inequality.pdf.

²² *Ibid.*

²³ The data on income presented here are compiled by generally following the methodology described in Gerald Auten and David Splinter, "Income Inequality in the United States: Using Tax Data to Measure Long-Term Trends," *Working Paper*, December 20, 2019, available at http://davidsplinter.com/AutenSplinter-Tax_Data_and_Inequality.pdf.

estimates use tax return data²⁴ and are ranked using tax-unit size-adjusted incomes if a taxpayer reports a spouse and/or dependents.²⁵ The unit of observation for the income estimates is a tax unit.²⁶ In order to be more consistent with recent income distribution studies, the tables in this subsection (Tables 1 through 4) differ from standard distributional tables produced by the Joint Committee staff.²⁷

In Table 1, the Joint Committee staff ranks tax filing units by the unit's income before taxes and after the receipt of transfers (pre-tax/after-transfer income). Pre-tax income is income before taxes paid, including any indirect taxes paid that are allocable to the group (e.g., the employer portion of payroll taxes are added to taxable wages). Pre-tax/after-transfer income also includes government transfers, including government cash and non-cash transfers such as Medicare, Social Security benefits, unemployment benefits, workers' compensation benefits, Medicaid, Supplemental Nutrition Assistance Program ("SNAP"), and Supplemental Security Income ("SSI") benefits. The income groups in Table 1 range from the bottom 50 percent to the top 0.01 percent of the income distribution. Table 1 shows the distribution of pre-tax/after-transfer national income amounts, shares, and averages by income group for the year 2018. For example, the bottom 50 percent had a total combined income amount of \$4.4 trillion, which was 20.7 percent of total national income reported in the year 2018. The average per capita income amount was \$27,000. The 50-90 percentile had a total combined income amount of \$8.9 trillion, which was 43.4 percent of total national income reported in the year 2018. The average per capita income amount was \$71,000. In 2018, there are about 15,000 tax units in the top 0.01 percent. The top 0.01 percent had a total income amount of \$447 billion, which was approximately 2.2 percent of total national income in the year 2018. The top 0.01 percent average income amount was \$14,259,000.

²⁴ These data are the annual Individual and Sole proprietor ("INSOLE") samples that the IRS Statistics of Income Division produces to be representative of all returns filed each year.

²⁵ The Joint Committee staff follows the Congressional Budget Office (see Congressional Budget Office, *The Distribution of Household Income, 2017*, October 2020) in defining income groups based on all individuals (including primary and secondary taxpayers and dependents). This helps control for the bias introduced from falling marriage rates as compared to groups set by tax units. When ranking tax units, the Joint Committee staff accounts for size differences—which accounts for the costs of supporting dependents and the economics of scale from shared resources—by dividing tax unit income by the square-root of the number of individuals in the unit. This is the same equivalence scale used by the Congressional Budget Office. Income shares are calculated using total tax unit incomes, such that they sum to national income.

²⁶ Tax units include all individuals claimed on the same tax returns, or who would file together in the case of non-filers. Certain returns are excluded: dependent filers, individuals under the age of 20, non-U.S. residents, and residents of the U.S. territories.

²⁷ See the Appendix for a comparison of the Joint Committee staff's standard methodology compared to that used for Tables 1 through 4.

Table 1.—Distribution of Pre-Tax/After-Transfer National Income Amounts, Shares, and Averages by Income Group for 2018

Income Group (Percentile)	Amount (\$ Billions)	Share (Percent)	Average Per Capita (Dollars)
Bottom 50	4,252	20.7	27,000
50-90	8,889	43.4	71,000
90-95	2,106	10.3	134,000
95-99	2,709	13.2	216,000
99-99.5	617	3.0	394,000
99.5-99.9	874	4.3	697,000
99.9-99.99	610	3.0	2,163,000
Top 0.01	447	2.2	14,259,000

Note: Average incomes are on a per capita basis: total income divided by the number of adults and dependents in each group.

Source: Joint Committee staff calculations.

In Table 2, the Joint Committee staff measures income on a pre-tax/pre-transfer basis. This is a different measure of income than that used in Table 1. Pre-tax/pre-transfer income is pre-tax income excluding government transfers. That is, unlike Table 1, the income measure does not include such items as Social Security, unemployment benefits, and SNAP benefits. The income groups in Table 2 range from the bottom 50 percent to the top 0.01 percent of the income distribution. Table 2 shows the income composition by source of income and by income group of pre-tax/pre-transfer national income for the year 2018. In the first row, the income share of the bottom 50 percent is largely composed of wage income (67 percent) and retirement income (12 percent) and is minimally composed of passthrough business income (eight percent), corporate income (four percent), interest income (one percent), and other income (seven percent). In other words, this group derives most of its income from employment (*i.e.*, wage and retirement income) and a small share of its income from investment (*i.e.*, returns on debt and equity, whether in private businesses or public companies) and other income (*i.e.*, imputed rents and property taxes paid that may be attributable to ownership of a primary residence). In general, as one moves up the income distribution, the relative share of income from investment increases, while the relative share of income from employment decreases. For example, in the last row, the income share of the top 0.01 percent is 21 percent wages, 28 percent passthrough business income, 28 percent corporate income, six percent interest, two percent retirement income, and 16 percent other income.

Table 2.—Income Composition by Source of Income and by Income Group of Pre-Tax/Pre-Transfer National Income, 2018 (Percent)

Income Group (Percentile)	Wage	Passthrough	Corporate	Interest	Retirement	Other	Total
Bottom 50	67	8	4	1	12	7	100
50-90	66	7	5	1	12	10	100
90-95	51	10	6	1	11	21	100
95-99	46	17	8	1	9	19	100
99-99.5	40	26	9	2	6	16	100
99.5-99.9	32	31	12	3	4	18	100
99.9-99.99	28	32	16	4	3	17	100
Top 0.01	21	28	28	6	2	16	100

Notes: Pre-tax/pre-transfer national income is divided into six categories: (1) wages include employer payroll taxes paid, employer provided health insurance, and underreported wages; (2) passthrough income is gross income net of deductions from partnerships, S corporations, sole proprietorships, farming, and rental activities; (3) corporate income includes taxable dividends (but excludes dividends attributable to retirement accounts, government accounts, and non-profits), retained earnings (taxable income less dividends and corporate taxes paid), and corporate taxes paid; (4) interest income includes taxable interest and tax-exempt interest; (5) private retirement income includes income from tax-exempt retirement accounts, including 401(k)s and IRAs; and (6) other income includes imputed rents (but only from owner-occupied housing) and property and other taxes paid. Mutual fund income is reported in different categories (e.g., corporate income or retirement) depending on how it is earned or reported in the tax return data. Details may not add due to rounding.

Source: Joint Committee staff calculations.

In Table 3, the Joint Committee staff measures income on a pre-tax/pre-transfer basis; this is the same measure used in Table 2. The income groups remain the same. Table 3 shows the distribution of different sources of income across income groups for the year 2018. In each column, the denominator changes to reflect the source of income. For example, in the first column, the denominator is all wage income reported in the year 2018. The 50-90 percentile reported more than one-half of wage income (52 percent) and retirement income (51 percent) and between one-quarter and one-third of passthrough business income (25 percent), corporate income (31 percent), interest income (21 percent), and other income (33 percent). In total, the groups representing the top ten percent reported more than half of passthrough business income (61 percent), corporate income (65 percent), interest income (63 percent), and other income (59 percent).

**Table 3.—Shares of Source of Pre-Tax/Pre-Transfer National Income
By Income Group, 2018 (Percent)**

Income Group (Percentile)	Wage	Passthrough	Corporate	Interest	Retirement	Other
Bottom 50	18	9	10	15	18	9
50-90	52	25	31	21	51	33
90-95	10	9	10	7	12	18
95-99	12	21	17	14	13	22
99-99.5	2	7	5	5	2	4
99.5-99.9	3	13	9	12	2	7
99.9-99.99	2	9	8	12	1	5
Top 0.01	1	6	11	13	0.4	3
Total	100	100	100	100	100	100

Notes: Pre-tax/pre-transfer national income is divided into six categories: (1) wages include employer payroll taxes paid, employer provided health insurance, and underreported wages; (2) passthrough income is gross income net of deductions from partnerships, S corporations, sole proprietorships, farming, and rental activities; (3) corporate income includes taxable dividends (but excludes dividends attributable to retirement accounts, government accounts, and non-profits), retained earnings (taxable income less dividends and corporate taxes paid), and corporate taxes paid; (4) interest income includes taxable interest and tax-exempt interest; (5) private retirement income includes income from tax-exempt retirement accounts, including 401(k)s and IRAs; and (6) other income includes imputed rents (but only from owner-occupied housing) and property and other taxes paid. Mutual fund income is reported in different categories (e.g., corporate income or retirement) depending on how it is earned or reported in the tax return data. Details may not add due to rounding.

Source: Joint Committee staff calculations.

Table 4 shows average Federal tax rates by income group for the year 2018. The Joint Committee staff defines average Federal tax rates on a pre-tax/after-transfer income basis.²⁸ When moving up the income distribution from the bottom 50 percent to the top 0.01 percent, the average rate of all applicable Federal taxes increases from 6.3 percent to 32.9 percent. When excluding payroll taxes, the average Federal tax rate increases from -0.6 percent to 32.1 percent. This implies a progressive tax system using income as a base (*i.e.*, there is a relatively higher

²⁸ For the calculation of average tax rates, the Joint Committee staff assumes the following for incidence: (1) corporate taxes are borne by labor 25 percent, (2) business property taxes are borne by business income, (3) employer payroll taxes are borne by labor, and (4) other taxes are allocated by disposable income less savings. For further information, see the Appendix and Gerald Auten and David Splinter, “Income Inequality in the United States: Using Tax Data to Measure Long-Term Trends,” *Working Paper*, December 20, 2019, available at http://davidsplinter.com/AutenSplinter-Tax_Data_and_Inequality.pdf.

average rate of tax imposed on taxpayers with more income).²⁹ In general, this increasing trend along the income distribution is similar across the following different types of taxes: Federal income tax, Federal corporate tax, and Federal estate and gift tax. The progressivity of the Federal income tax and Federal corporate tax are greater than that of the other taxes. When moving up the income distribution from the bottom 50 percent to the top 0.01 percent, the average rate of payroll tax³⁰ and the average rate of other Federal tax decrease from 6.8 percent to 0.8 percent and 1.0 percent to 0.2 percent, respectively. In other words, these taxes are regressive. Despite this regressivity, the overall Federal tax system, on average, remains progressive. In addition, when excluding payroll taxes or considering the progressive spending that regressive payroll taxes fund (*i.e.*, Social Security, Disability, and Medicare benefits), the system becomes more progressive.³¹ Since 1985, the progressivity of the Federal tax system has increased every decade.³²

²⁹ Breaking out the bottom 20 percent also emphasizes this progressivity. For example, the Congressional Budget Office estimates that this bottom income group had a -10.9 Federal income tax rate in 2017, much lower than the bottom 50 percent rates seen in Table 4. Congressional Budget Office, *The Distribution of Household Income, 2017*, October 2020. For a comparison of recent tax progressivity estimates, see David Splinter, “U.S. Tax Progressivity and Redistribution,” *National Tax Journal* 73(4): 1005–1024, 2020.

Alternative tax rate estimates appear in other publications. See, *e.g.*, Emmanuel Saez and Gabriel Zucman, *The Triumph of Injustice*, W.W. Norton & Co., Inc., October 15, 2019. However, unlike the average tax rates presented in this pamphlet, these estimates differ because the tax numerator excludes refundable tax credits and the income denominator excludes payroll taxes and all non-Social Security transfers. The estimates therefore use a partial after-tax/pre-transfer income denominator rather than a conventional pre-tax/after-transfer income denominator. Under this approach, the bottom decile has less income than in conventional estimates, causing exaggerated tax rates. For that reason, Saez-Zucman drop the bottom of the distribution from their results.

³⁰ Three factors lower the average payroll tax rates relative to statutory rates: (1) non-wage income, (2) tax-excluded compensation included in wages, and (3) transfers.

³¹ The Congressional Budget Office finds that from a lifetime perspective the Social Security system is progressive. They estimate that “for people in the bottom fifth of the earnings distribution, the ratio of benefits to taxes is almost three times as high as it is for those in the top fifth.” Congressional Budget Office, *Is Social Security Progressive?*, December 2006.

³² Congressional Budget Office estimates of average Federal tax rates decreased more for lower-income groups. Between 1985 and 2017, bottom-quintile tax rates decreased 10.5 percentage points, middle-three-quintile tax rates decreased 3.7 percentage points, and top one percent rates increased 5.5 percentage points. See Congressional Budget Office, *The Distribution of Household Income, 2017*, October 2020. Various measures of tax progressivity show similar increases. See, *e.g.*, David Splinter, “U.S. Tax Progressivity and Redistribution,” *National Tax Journal* 73(4):1005–1024, 2020.

**Table 4.—Average Federal Tax Rates by Income Group, 2018
(Percent)**

Income Group (Percentile)	Average Rate of All Federal Taxes	Average Rate of All Federal Taxes Excluding Payroll Taxes	Federal Income Tax ¹	Federal Corporate Tax	Payroll Tax ²	Federal Estate and Gift Tax ³	Other Federal Tax ⁴
Bottom 50	6.3	-0.6	-2.0	0.5	6.8	*	1.0
50-90	14.1	6.9	5.0	0.7	7.2	*	1.2
90-95	17.6	11.1	9.1	0.9	6.5	0.1	1.0
95-99	18.6	13.9	12.0	1.0	4.7	0.1	0.8
99-99.5	22.6	19.4	17.4	1.0	3.2	0.3	0.6
99.5-99.9	26.0	23.8	21.7	1.0	2.3	0.5	0.5
99.9-99.99	30.8	29.5	27.0	1.3	1.4	0.7	0.4
Top 0.01	32.9	32.1	29.5	1.9	0.8	0.5	0.2

[1] The Federal income tax rate is negative on average for the bottom 50 percent because of refundable credits.

[2] Payroll tax includes both employer and employee portions as well as all unemployment insurance contributions.

[3] The estate tax is allocated based on the decedent's income in the last ten fully years of life.

[4] Other Federal tax is mostly excise taxes and customs duties.

Note: The average rate is the amount of tax for that income group divided by the pre-tax/after-transfer income of that income group, hence, the denominator is the same for all types of taxes. “*” denotes negligible tax rate.

Source: Joint Committee staff calculations.

The following figures present information about pre-tax/pre-transfer (as with Tables 2 and 3), pre-tax/after-transfer (as with Table 1), and after-tax/after-transfer national income. After-tax/after-transfer income is income after all taxes (Federal, State, and, local) are paid and includes government transfers.³³ After-tax/after-transfer income represents the annual amount a tax unit has available to allocate between current consumption and savings. Figure 1 shows the pre-tax/pre-transfer, pre-tax/after-transfer, and after-tax/after-transfer income share trends from 1960 to 2018 for the following income groups: bottom 50 percent (Figure 1a), the 50-90 percentile (Figure 1b), the 90-99 percentile (Figure 1c), and top one percent (Figure 1d). Pre-tax/pre-transfer income and pre-tax/after-transfer income are as described above.³⁴

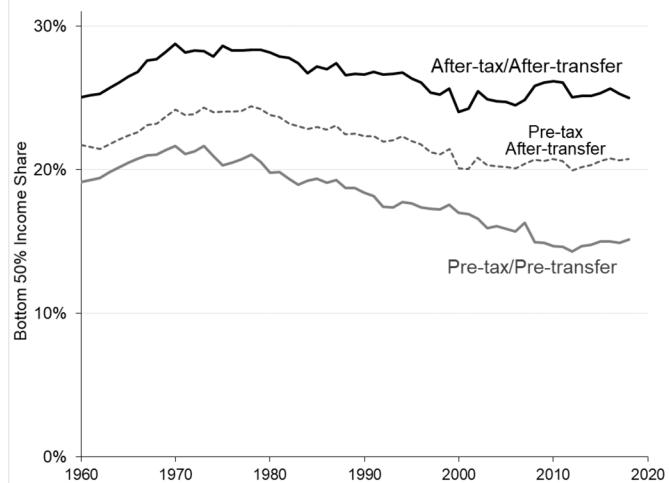
The shares of the bottom 50 percent increase after transfers and taxes are taken into account. This is the result of the concentration of transfers in the bottom half of the income distribution as well as the effects of refundable tax credits and the lower tax rates imposed on lower-income individuals. In Figure 1b, the tax and transfer system has, on average, little effect on the shares of incomes for the 50-90 percentile. This suggests that the tax and transfer system in the aggregate has little effect on the relative share of income of individuals in the 50-90 percentile relative to its effect on individuals in the bottom 50 percent and top ten percent. Finally, in Figures 1c and 1d, the shares of income for the 90-99 percentile and the top one percent fall when accounting for transfers and taxes. This is the opposite pattern to that seen for the bottom 50 percent and occurs because this higher-income group receives fewer transfers and pays tax at relatively higher rates than lower income groups.

Trends over time are also apparent. In Figure 1a, all three share of income measures for the bottom 50 percent, after rising in the 1960s, have been declining since the 1970s. In Figure 1b, all three share of income measures for the 50-90 percentile have been relatively flat since 1960. In Figure 1c, all three of income measures for the 90-99 percentile have also been relatively flat. In Figure 1d, all three share of income measures for the top one percent declined in the late 1960s, rose between the early 1990s and late 2000s, and have been relatively stable in recent years.³⁵ When accounting for taxes and transfers, however, the increase between the early 1990s and late 2000s is less pronounced.

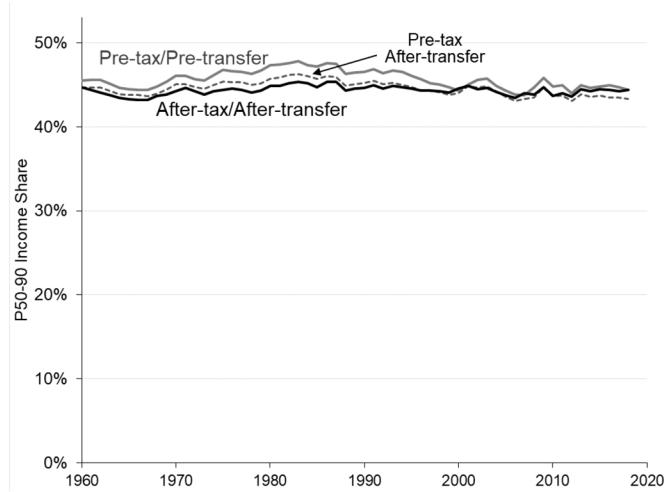
³³ The after-tax/after-transfer income estimates include an allocation for government consumption (e.g., spending on schools) half per capita and half by after-tax income and an allocation of deficits by Federal payroll and income taxes.

³⁴ See descriptions for Tables 1 and 2 for the definitions of pre-tax/pre-transfer income and pre-tax/after-transfer income.

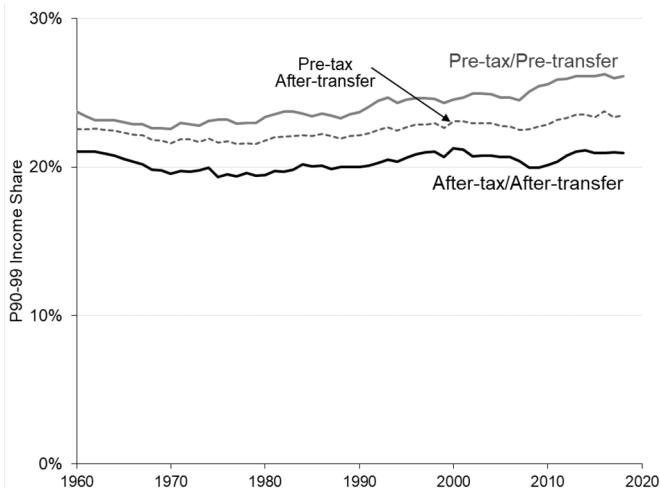
³⁵ The estimated jump in top income shares between 1986 and 1988 is related to the Tax Reform Act of 1986, which changed how income was reported on tax returns. These changes make it difficult to precisely identify when top income shares began increasing. Top income shares generally tend to increase with economic expansions and decrease with recessions.

Figure 1a.—Bottom 50 Percent Income Shares, 1960-2018

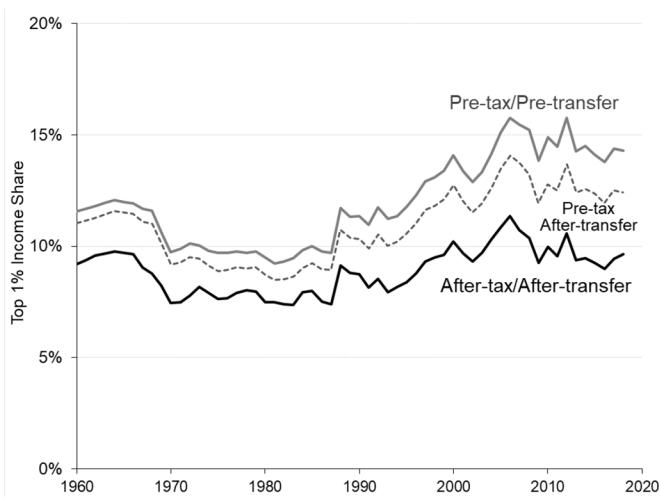
Source: Joint Committee staff calculations.

Figure 1b.—50-90 Percentile Income Shares, 1960-2018

Source: Joint Committee staff calculations.

Figure 1c.—90-99 Percentile Income Shares, 1960-2018

Source: Joint Committee staff calculations.

Figure 1d.—Top 1% Income Shares, 1960-2018

Source: Joint Committee staff calculations.

B. Data on the Income Taxation of Estates and Trusts

This section provides income tax data for estates and trusts. Estates and trusts are generally taxed in the same manner as individuals. However, they are allowed a deduction for amounts distributed to beneficiaries. By use of this deduction, estates and trusts may eliminate their income tax liability if they distribute (rather than retain) income; beneficiaries are taxed on distributions. Income distributed by an estate or trust to a beneficiary retains its character.

In 2017, 3.2 million Form 1041 trust and estate income tax returns were filed. In the year 2017, based on income distributions reported on Form K1-1041 by U.S. taxpayers, beneficiaries received on net \$56.0 billion of distributions from estates and trusts. The \$56.0 billion consists of income allocable to estates' and trusts' interest (5.0 percent), dividends (33.7 percent), business income (7.7 percent), short-term capital gains (0.7 percent), long-term capital gains (20.8 percent), rent (17.6 percent), and other/unknown sources (14.7 percent).

Estates and trusts are subject to tax on income that is not distributed but instead retained. For 2017, 1.1 million estate and trust income tax returns reported net taxable income. Total estate and trust income was \$178 billion, and total net taxable income (*i.e.*, income after exemptions and deductions including the deduction for income distributed to beneficiaries) was \$90 billion.

Table 5 provides information about estate and trust distributions for 2017. The Joint Committee staff calculated an income distribution table of total net income from estates and trusts. The income groups are based on beneficiary adjusted gross income ("AGI") exclusive of distributions received from trusts or estates.³⁶ Because of this, there is a "negative" AGI category of taxpayers who absent distributions do not have positive AGI.

Table 5 shows the number of individual returns that report trust distributions received, the amount of distributions, the group's percentage share of total distributions, the average distribution received, and average AGI excluding distributions. The last six columns, for each income group, represent the percentage of returns for which the distributions are less than a certain percent of total AGI. The \$100,000-\$200,000 income group reported the largest number of returns (318) totaling \$8.3 billion, which represents 14.8 percent of the total amount reported in the year 2017. However, the less than \$0 income group reported the largest amount of \$10.0 billion, which represents 17.9 percent of the total amount reported in the year 2017. The less than \$0 income group had an average distribution of \$129,348 and an average AGI of -\$141,493. The \$1 million and over income group had the largest average distribution and average AGI of \$303,373 and \$4,271,561, respectively. As shown in the table, taxpayers across income groups receive distributions from estates and trusts, as measured by both the total distributions received and the percentage shares. However, individuals in higher income groups receive on average higher distributions, while, at the same time, those distributions are more likely to account for a smaller percentage of AGI.

³⁶ The income groups are not subject to the modifications described above for the tables relating to the income taxation of individuals.

Table 5.—Distribution from Estates and Trusts by Distribution-Exclusive AGI Group, 2017

Income Group	Number of Returns (Thousands)	Total Distributions Received (\$ Millions)	Share (%)	Average Distribution Received (\$)	Average AGI Excluding Distributions (\$)	Distributions as Percentage of AGI (Percent)					
						<10% (Percent)	10%-25% (Percent)	25%-50% (Percent)	50%-75% (Percent)	75%-90% (Percent)	>90% (Percent)
Less than \$0	77	10,000	17.9	129,348	-141,493	24.9	9.5	18.2	21.4	13.7	*
\$0-\$15,000	231	3,026	5.4	13,075	18,577	35.8	18.0	18.2	16.4	9.9	12.3
\$15,000-\$30,000	139	3,724	6.7	26,875	49,357	40.2	24.4	17.2	14.0	3.8	1.7
\$30,000-\$50,000	144	3,812	6.8	26,391	66,846	50.4	20.7	20.7	10.2	0.5	0.5
\$50,000-\$75,000	180	4,153	7.4	23,070	81,949	59.3	20.3	16.0	6.6	1.4	0.2
\$75,000-\$100,000	147	3,235	5.8	22,056	108,733	65.9	30.3	3.5	0.9	0.1	*
\$100,000-\$200,000	318	8,224	14.8	26,101	168,166	65.9	21.0	10.2	2.5	0.3	0.1
\$200,000-\$500,000	174	7,238	12.9	41,533	338,992	73.3	16.4	8.3	1.4	0.3	0.0
\$500,000-\$1,000,000	44	3,604	6.4	82,048	770,099	64	13.4	1.7	0.3	0.0	*
\$1,000,000 and Over	29	8,899	15.9	303,373	4,271,361	83.6	9.9	4.8	1.5	0.2	0.1
Total	1,484	\$5,987	100	\$7,755	210,854	53.3	14.4	8.2	3.8	2.0	*

Note: ** Distribution as a percentage of AGI is not calculated for returns with negative AGI. Details may not add due to rounding.

[1] 740 less than 0.5 percent

Source: Joint Committee staff calculations

C. Data on Wealth Transfer Taxes

In Table 6, below, the Joint Committee staff draws on tax return data to show the burden of the estate tax, a tax on the transfer of wealth, for taxpayers across the income distribution.³⁷ Table 6 shows estate tax returns and estate tax liability by average real (inflation adjusted) modified adjusted gross income from 2011 to 2015. The estate tax returns and estate tax liability are for 2016 decedents; decedents must generally file estate tax returns with 15 months (including extension) from date of death.³⁸

While comparing estate tax liabilities by income group presents conceptual challenges,³⁹ the following method provides some information on the distribution of the estate tax by the income of the decedent. The Joint Committee staff constructed a dataset consisting of a match of the income tax returns for years 2011 to 2016 to the estate tax returns of decedents dying in calendar year 2016. The Joint Committee staff then computed modified adjusted gross income by adding tax-exempt interest and nontaxable Social Security benefits to those decedents' adjusted gross incomes to produce measures of income for each taxable year from 2011 to 2016. These income values were then adjusted for inflation so that the values represent 2016 dollars. The Joint Committee staff then averaged the 2016 values of the decedents' incomes for the last five full calendar years of the decedents' lives to produce measures of average income. The original sample contained 7,875 estate tax returns representing the 13,429 decedents dying in 2016 with estate tax filing requirements. The Joint Committee staff computed an average real income measure for 7,711 observations representing 13,191 decedents.⁴⁰ The matched returns represent more than 93 percent of the total estate tax liability reported on the estate tax returns of 2016 decedents.

³⁷ As discussed more below, the income distribution is calculated differently for purposes of Table 6 than for tables in the prior subsections.

³⁸ Thus, the estate tax returns for 2016 decedents will generally be filed in 2016, 2017, and 2018. Every three years, IRS Statistics of Income ("SOI") compiles for all decedents of the year a file of estate tax returns. This "year of death" file was used to generate Table 6. 2016 is the latest year for which this file is available.

³⁹ For example, the decedent may not bear the burden of estate tax. If, for example, the decedent did not alter his or her behavior because of the tax, then the burden would be borne by the decedent's heirs. In that case, comparing by the heirs' income may be more appropriate than by the decedent's income.

⁴⁰ The Joint Committee staff dropped observations with losses or without reported income.

Table 6.—All Estate Tax Returns from 2016 Decedents by Average Real Modified Adjusted Gross Income from 2011-2015

Income Group	Estate				
	Returns	Total Estate Tax Liability ¹ (\$ Millions)	Average Estate Tax Liability (\$ Millions)	Percent of Estate Tax Liability (Percent)	Average Estate Tax Rate
Less than \$100,000	591	268	0.5	1.4	5.7
\$100,000 to \$200,000	1,486	463	0.3	2.4	4.4
\$200,000 to \$500,000	5,137	2,910	0.6	15.1	7.1
\$500,000 to \$1,000,000	3,177	3,419	1.1	17.8	9.7
\$1,000,000 and Over	2,800	12,171	4.3	63.3	12.1
Total, All Returns	13,191	19,236	1.5	100.0	10.0

[1] This includes only estate tax liability and excludes generation-skipping transfer tax liability.

Note: Details may not add due to rounding.

Source: Joint Committee staff calculations.

Table 6 shows, by income group for the year 2016, the number of returns filed, the total estate tax liability reported on those returns, the average estate tax liability reported on those returns, income groups' percent share of total estate tax liability reported, and the average estate tax rate. The income groups, which range from less than \$100,000 to \$1,000,000 and over, are based on average real modified adjusted gross income. In general, income groups toward the bottom of the income distribution file fewer estate tax returns, pay less estate tax, and are subject to a lower average estate tax rate. In the first column, the \$200,000 to \$500,000 income group filed the largest number of returns. However, the \$1,000,000 and over income group reported the largest total estate tax liability (\$12,171 million), representing 63.3 percent of estate tax liability reported in 2016, while the \$200,000 to \$500,000 income group reported a total estate tax liability of \$2,910 million (15.1 percent of estate tax). The average estate tax liability paid for the \$1,000,000 and over income group (\$4.3 million) was significantly greater than the average value of lower income groups. Similarly, in the last column, the \$1,000,000 and over income group paid a relatively higher average estate tax rate of 12.1 percent compared to the average estate tax rate of lower income groups.

As shown in Table 6, a decedent with estate tax liability may have relatively low income. This could be for several reasons. In general, wealthy taxpayers have more control over the timing and forms of their incomes. Some taxpayers may have made large lifetime gifts. Because the estate tax takes into account gifts made during life, these taxpayers may finish life with few assets (and income from those assets) relative to other estate tax filers but may have an estate tax

liability.⁴¹ As another example, some taxpayers may have significant assets and income, but also may have large business losses that reduce their income. The years covered by the analysis includes the aftermath of the 2008 financial crisis, which may have generated business losses for some taxpayers. Third, some taxpayers with large estates may hold significant assets that do not produce taxable income, such as cash, a home, or a Roth IRA or other similar retirement account. Alternatively, a thrifty individual may have saved a large portion of modest income over her lifetime and accumulated enough wealth to have estate tax liability. Taxpayers following these (and potentially other) patterns may have low income in the final years of life, but also have (or have gifted) assets worth enough to trigger the estate tax.

Table 7 shows the estate tax returns filed for 2016 decedents, distributed by gross estate size. A decedent's gross estate is reduced by a lifetime exemption and certain deductions to determine estate tax liability. As mentioned above, the estate tax also takes into account gifts during life. The table separately lists taxable and nontaxable returns. Nontaxable returns are largely returns subject to a filing requirement that claimed a deduction for transfers to charity, a deduction for a bequest to a surviving spouse, or both, which reduced the taxable estate below the exemption amount. The gross estate size categories range from less than \$5 million to \$50 million or more. The table shows the number of estate tax returns filed and the total amount of gross estate for each group. It also shows the number of returns claiming a deduction for a bequest to a surviving spouse, and the total amount of that deduction for each group, as well as the number of returns claiming a charitable deduction, and the total amount of the deduction for each group. Finally, for returns subject to tax, the table shows the amount of estate tax. Most returns are filed by taxpayers in the lower end of the gross estate distribution, with the less than \$5 million group and \$5 million to \$10 million group collectively filing 9,036 returns. However, the total gross estate (when grouping taxable and nontaxable returns), marital deduction, charitable deduction, and estate tax are all highest for taxpayers in the highest gross estate group.

Public Law 115-97 generally doubled the estate and gift tax exemption for decedents dying and gifts made during the years 2018 through 2025, with the exemption reverting to the exemption levels that otherwise would have been in effect for decedents dying and gifts made after 2025. This change may affect the number of individuals subject to estate tax. There is currently incomplete information about decedents in years after 2016. However, a look at individuals who filed estate tax returns in 2019 (who may have died in 2017, 2018, 2019, or other years), shows that 6,409 returns were filed, of which 2,570 were taxable.

⁴¹ The estate tax calculation imposes tax on adjusted taxable gifts previously made by the decedent but provides a reduction based on prior-year gifts. In this way, the estate tax system takes into account prior gifts.

Table 7.—Estate Tax Returns Filed for 2016 Decedents by Size of Total Gross Estate and Estate Tax Return Status Group

Size of Total Gross Estate	Gross Estate, Tax Purposes Number	Amount (\$ Millions)	Bequests to Surviving Spouse Number	Amount (\$ Millions)	Charitable Deduction Number	Amount (\$ Millions)	Estate Tax Number	Amount (\$ Millions)
All Taxable Returns								
Less than \$5 Million	5,467	105,412	740	13,373	1,550	11,602	5,467	20,485
\$5 Million to \$10 Million	568	1,821	57	27	102	36	568	298
\$10 Million to \$20 Million	1,446	18,390	211	390	546	264	2,556	2,021
\$20 Million to \$50 Million	614	18,658	144	1,975	261	1,409	1,446	4,125
\$50 Million or More	282	46,925	116	10,029	152	9,104	282	4,652
All Nontaxable Returns								
Less than \$5 Million	597	2,142	389	780	80	59	--	--
\$5 Million to \$10 Million	5,315	36,965	3,743	14,393	934	2,268	--	--
\$10 Million to \$20 Million	1,390	18,500	1,202	11,162	308	1,722	--	--
\$20 Million to \$50 Million	502	14,624	444	10,567	130	1,804	--	--
\$50 Million or More	159	19,451	145	15,058	43	2,605	--	--

Note: Details may not add due to rounding.

Source: Joint Committee staff calculations.

D. Data on Wealth

As with income, there are many ways to measure wealth. The following discussion uses a measure of annual net financial wealth, which deducts current private debts from current private financial assets. When using this measure for wealth, the share of wealth held by the top wealth groups has increased over the last three decades; the share of wealth owned by the top one percent has especially increased. However, recent work argues that when also including expected Social Security benefits, the increase in wealth levels held by the top wealth groups is less pronounced, with top wealth shares remaining relatively flat over the last three decades.⁴² Including expected Social Security benefits in a measure of wealth is similar to including government transfers in income measure, as done in Table 1 and Figures 1. Because of data limitations, however, the following discussion uses measures of wealth that do not include Social Security benefits.

The following tables use the Distributional Financial Accounts (“DFA”) dataset to present the distribution and composition trend of financial wealth, as well as trends over time. The DFA, compiled by the Federal Reserve Board, provides quarterly estimates of the distribution of a comprehensive measure of U.S. household⁴³ financial wealth⁴⁴ from the third quarter of the year 1989 to the fourth quarter of the year 2020. The DFA presents data on the level, composition, and share of U.S. household financial wealth held by four percentile groups of financial wealth: the top one percent, the next nine percent (*i.e.*, the 90-99 percentile), the next 40 percent (*i.e.*, the 50-90 percentile), and the bottom 50 percent.⁴⁵ The DFA integrates two datasets produced by the Federal Reserve Board: the Financial Accounts of the United States, which provide quarterly data on aggregate balance sheets of various sectors of the U.S. economy, and the Survey of Consumer Finances (“SCF”), which provides comprehensive triennial microdata on the assets and liabilities of a representative sample of U.S. households.⁴⁶ The DFA is constructed in three steps: (1) a balance sheet from the SCF is generated that is conceptually consistent with the components of aggregate household net worth in the Financial Accounts; (2) the reconciled SCF balance sheet is interpolated and forecasted for quarters where the SCF is not

⁴² See Sylvain Catherine, Max Miller, and Natasha Sarin, “Social Security and Trends in Wealth Inequality,” *Jacobs Levy Equity Management Center for Quantitative Financial Research Paper*, February 29, 2020, available at <https://ssrn.com/abstract=3546668>. The authors also argue that wealth estimated on a lifetime (rather than annual) basis further reduces observed wealth shares by the top wealth groups.

⁴³ The unit of observation is the primary economic unit (“PEU”), which for simplicity is referred to here as “household”. The PEU follows the Survey of Consumer Finance unit of observations and is defined as the “economically dominant single individual or couple (married or living as partners) in a household and all other individuals in the household who are financially interdependent with that individual or couple.”

⁴⁴ For the meanings of consumer durable goods and real estate, see the note accompanying the table.

⁴⁵ Board of Governors of the Federal Reserve System, *DFA: Distributional Financial Accounts*, <https://www.federalreserve.gov/releases/z1/dataviz/dfa/>.

⁴⁶ Michael Batty, Jess Bricker, Joseph Briggs, Eliza beth Holmquist, Susan McIntosh, Kevin Moore, Eric Nielsen, Sarah Reber, Molly Shatto, Kamila Sommer, Tom Sweeney, and Alice Henriques Volz, “Introducing the Distributional Financial Accounts of the United States,” *Finance and Economics Discussion Series 2019-017*, Washington: Board of Governors of the Federal Reserve System, <https://www.federalreserve.gov/econres/feds/files/2019017pap.pdf>.

observed based on information in the Financial Accounts and other sources; and (3) the distribution observed is applied in the reconciled SCF to the Financial Accounts' aggregates.

This dataset is different from that used in the prior section to show different measures of income and therefore the results may not be strictly comparable. For example, the income distributions presented in the prior section are determined based on groups of equal number of individuals and tax units, while here wealth groups are determined based on the number of households, which ignores differences in household size.⁴⁷ The distribution of tax units by income, while positively correlated, is not the same as the distribution of households by wealth because income and wealth are different measures. For example, there may be individuals with income less than \$50,000 and wealth over \$1 million, which would place such an individual in the bottom 90 percent of the income distribution and the top ten percent of the wealth distribution, based on measures in Table 1 and Figure 2c.⁴⁸

Table 8 shows the distribution of net financial wealth levels and shares by wealth group for the year 2020. Net financial wealth is gross financial wealth less debt. The wealth groups in Table 8 range from the bottom 50 percent to the top one percent of the financial wealth distribution. The bottom 50 percent has a net financial wealth level of \$2.2 trillion, which was approximately two percent of total net financial wealth in the year 2020. The 90-99 percentile has a net financial wealth level of \$43.8 trillion, which represents 38.4 percent of total net financial wealth in the year 2020. The top one percent has a net financial wealth level of \$35.1 trillion, which was approximately 30.8 percent of total net financial wealth in the year 2020.

⁴⁷ Tax units and household or PEU units can diverge for several reasons. First, unmarried individuals who are in the same household and classified in the SCF as "living with partner" would file separate tax returns. In addition, there can be other members of a household who would file their own tax returns if their incomes were high enough. In both cases, one household is associated with multiple tax units.

⁴⁸ Also, wealth share measures may differ not only based on how broadly one defines wealth, but also based on how percentile groups are determined. For example, when using the DFA data and changing from setting percentiles by wealth to setting them by income, the year 2020 fourth quarter top one percent financial wealth shares fall from 31 percent to 26 percent.

Table 8.—Distribution of Net Financial Wealth Levels and Shares¹ by Wealth Group, 2020

Wealth Group (Percentile)	Level (\$ Trillions)	Share (Percent)
Bottom 50	2.2	2.0
50-90	33.0	29.0
90-99	43.8	38.4
Top 1	35.1	30.8

[1] Net average financial wealth is not shown in Table 8 because of the lack of data on the number of households for the year 2020 from the SCF and Current Population Survey.

Source: Distributional Financial Accounts data.

Table 9 shows the financial wealth composition by source of financial wealth and by wealth group for the year 2020. The wealth groups remain the same, ranging from the bottom 50 percent to the top one percent of the financial wealth distribution. Summing across both assets and liabilities, each wealth group's shares of total financial wealth sum to 100 percent. In the first row, for assets, the financial wealth of the bottom 50 percent is largely composed of real estate (52 percent), consumer durable goods (19 percent), pension entitlements (11 percent), and other wealth (13 percent), while the financial wealth share of the bottom 50 percent is minimally composed of corporate equities and mutual fund shares (two percent) and private businesses (two percent). This group derives most of its financial wealth from assets held for a noninvestment consumption purpose (e.g., owning a home or a vehicle and owning whole life insurance), while this group derives minimal financial wealth from public companies and private businesses. However, moving up the wealth distribution, the relative share of financial wealth from investment increases, along with an increase in other assets, while the relative share of financial wealth from assets held for a noninvestment consumption purpose decreases. In the last row, the financial wealth share of the top one percent is composed of 13 percent real estate, two percent consumer durable goods, 41 percent corporate equities and mutual fund shares, four percent pension entitlements, and 21 percent other.

For liabilities, home mortgages represent the largest share of debt for each wealth group. However, consumer credit (e.g., credit card debt and student loans) is a much greater share of liabilities for the two groups at the bottom of the financial wealth distribution, especially for the bottom 50 percent, where the share of consumer credit is almost as large as the share of home mortgages. While home mortgages are a way to build financial wealth (in the form of real estate equity), consumer credit is less likely to build financial wealth (although it may when incurred to purchase durable goods). However, that comparison is incomplete because real estate and durable goods are not equal forms of financial wealth: real estate tends to increase in nominal value over time, while durable goods generally depreciate. Among other liabilities are loans against insurance policies and trading on margin, which are debts incurred for specific benefits or for convenience.

**Table 9.—Financial Wealth Composition by Source of Financial Wealth and by Wealth Group, 2020
(Percent)**

Wealth Group (Percentile)	Assets						Liabilities				
	Real Estate	Consumer Durable Goods	Corporate Equities and Mutual Funds	Pension Entitlements	Private Businesses	Other	Total	Home Mortgage	Consumer Credit	Other	Total
Bottom 50	52	19	2	11	2	13	100	48	47	5	100
50-90	34	6	8	30	4	17	100	75	21	4	100
90-99	20	3	21	29	9	18	100	86	9	6	100
Top 1	13	2	41	4	19	21	100	71	9	20	100

Note: Real estate includes all types of owner-occupied housing including farmhouses and mobile homes as well as second homes that are not rented, vacant homes for sale, and vacant land (at market value). Consumer durable goods includes automobiles, trucks/motor vehicles, furniture, car interiors, light fixtures, household appliances, audio/video/photo equipment, computers, boats, books, jewelry/watches, health and therapeutic equipment, and luggage. Corporate equities and mutual funds shares include directly held stocks and mutual funds, as well as the portion of other investment vehicles that are invested in equities (IRAs, trusts, managed investment accounts, 529 plans, and Health Savings Accounts) and held indirectly through IRAs, trusts, and managed investment accounts (checkable deposits, securities, and bonds). Pension entitlements include the balances of defined contribution pension plans (such as 401(k) and 403(b) plans), accrued benefits to be paid in the future from defined benefit plans (including those for which life insurance companies have assumed the payment obligation) and annuities sold by life insurers directly to individuals, but does not include Social Security, Private businesses, include equity in private businesses (including rental real estate). Other assets include receivables due from property-casualty insurance companies, the value of other policies from life insurance companies (excluding reserves for life insurance coverage and annuities), and government-sponsored retiree health care funds/retirees. Home mortgages are derived from measures of residential home mortgage loans as reported by lenders and households. Consumer credit includes credit card, student loan, and vehicle loan balances. Other liabilities include margin accounts at brokers-dealers, loans taken against the value of life insurance policies, and loans to households from a variety of government programs. Details may not add due to rounding.

Source: Distributional Financial Accounts data.

Table 10 shows the distribution of different sources of financial wealth across wealth groups for the year 2020. The wealth groups remain the same. In each column, the denominator changes to reflect the type of asset or liability. For example, in the first column, the denominator is all real estate owned by U.S. households in the year 2020. In total, groups representing the bottom 90 percent own more than one-half of real estate (55 percent) and about two-thirds of consumer durable goods. In total, groups representing the top ten percent own about one-third (35 percent) of consumer durable goods and less than half (44 percent) of real estate, more than four times its proportionate share. These groups own more than half (54 percent) of pension entitlements. By contrast, the 50-90 percentile hold roughly their proportionate share of pension entitlements (43 percent), while the bottom 50 percent owns only three percent. The ownership of corporate equities and mutual fund shares and private businesses is even more concentrated: the top one percent owns 52 percent of the former and 54 percent of the latter. Finally, other income (which is largely rights to insurance) is concentrated at the top, with the 90-99 percentile owning 36 percent and the top one percent owning 31 percent.

For liabilities, home mortgages are disproportionately held by the wealthiest groups. The 50-90 percentile has 48 percent (20 percent more than their proportionate share), while the 90-99 percentile has 25 percent (more than double their proportionate share), and the top one percent has five percent. Consumer credit, however, which generally does not build financial wealth, is disproportionately incurred by the bottom 50 percent.⁴⁹ Finally, other liabilities, generally business debt, are disproportionately incurred by groups representing the top ten percent, with almost half the total share (18 percent) being incurred by the top one percent.

⁴⁹ The distributions of home mortgage and consumer credit liabilities cannot be compared to the distributions of real estate and consumer durable goods. Liabilities represent smaller total dollar amounts.

Table 10.—Shares of Source of Financial Wealth and by Wealth Group, 2020
(Percent)

Wealth Group (Percentile)	Assets					Liabilities			
	Real Estate	Consumer Durable Goods	Corporate Equities and Mutual Funds	Pension Entitlements	Private Businesses	Other	Home Mortgage	Consumer Credit	Other
Bottom 50	12	24	1	3	1	4	22	57	31
50-90	43	42	11	43	13	29	48	35	32
90-99	30	22	36	48	32	36	25	7	20
Top 1	14	13	52	6	54	31	5	2	18
Total	100	100	100	100	100	100	100	100	100

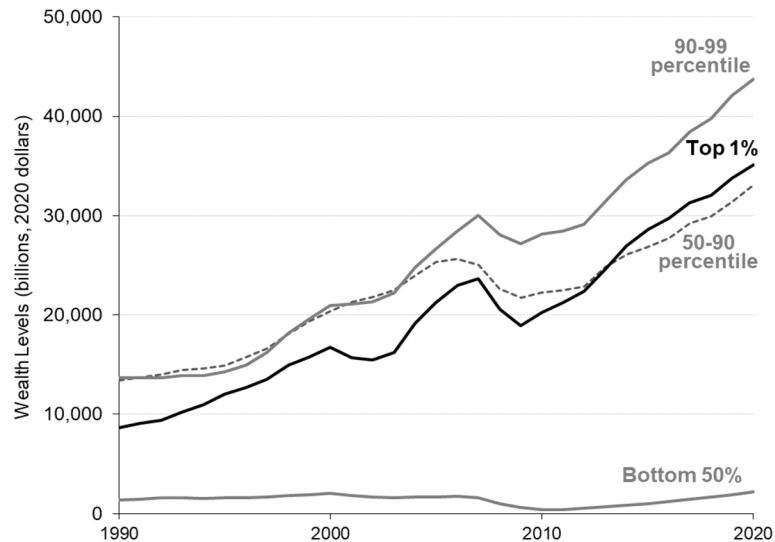
Note: Real estate includes all types of owner-occupied housing including farmhouses and mobile homes, as well as second homes that are not rented, vacant homes for sale, and vacant land (at market value). Consumer durable goods includes automobiles, trucks/other vehicles, furniture, carpets/rugs, light fixtures, household appliances, audio/video/photo equipment, computers, boats, books, jewelry/watches, health and therapeutic equipment, and luggage. Corporate equities and mutual fund shares include directly held stocks and mutual funds, as well as the portion of other investment vehicles that are invested in equities (IRAs, trusts, managed investment accounts, 529 plans, and Health Savings Accounts) and held indirectly through IRAs, trusts, and managed investment plans (such as 401(k) and 403(b) plans). Accrued benefits to be paid in the future from defined benefit plans (including those for which life insurance companies have assumed the payment obligation), and annuities sold by life insurers directly to individuals, but does not include Social Security. Private businesses include equity in private businesses (including rental real estate). Other assets include receivables due from property-casualty insurance companies, the value of other policies from life insurance companies (excluding reserves for life insurance coverage and annuities), and government-sponsored retiree health care fund reserves. Home mortgages are derived from measures of residential home mortgage loans as reported by lenders and households. Consumer credit includes credit card, student loan, and vehicle loan balances. Other liabilities include margin accounts at broker-dealers, loans taken against the value of life insurance policies, and loans to households from a variety of government. Details may not add due to rounding.

Sources: Distributional Financial Accounts data.

The following figures show the trends of net financial wealth levels (Figure 2a) and net financial wealth shares (Figure 2b) by wealth group from 1990 to 2020. These trends do not take into account wealth from Social Security benefits due to data limitations. The wealth groups are the same in each figure, ranging from the bottom 50 percent to the top one percent of the financial wealth distribution.

Figure 2a shows the relative stability of the trends in net financial wealth levels before the financial crisis in 2007. While the net financial wealth level for the top 50 percent steadily increases, the net financial wealth level for the bottom 50 percent is relatively steady. All groups saw a decline in net financial wealth levels during the 2008 financial crisis. While the top 50 percent reached its pre-crisis financial wealth level in a few years, the bottom 50 percent reached its pre-crisis financial wealth level only recently.⁵⁰

Figure 2a.—Trends in Real Net Financial Wealth Levels by Wealth Group, 1990-2020



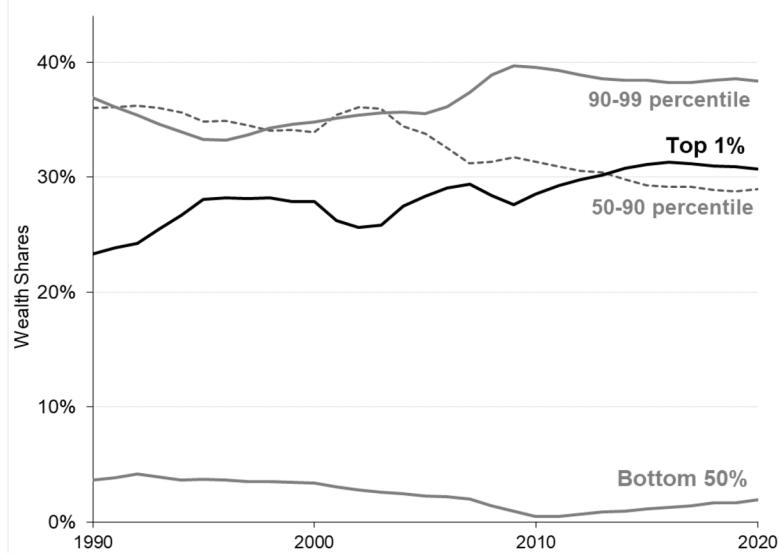
Note: Wealth is indexed for inflation using the PCEPI.

Source: Distributional Financial Accounts data.

⁵⁰ When combining the DFA data with the Current Population Survey for the approximate number of households, average wealth per household by wealth group generally shows the same story: relative to other wealth groups, the bottom 50 percent had a larger proportional shock to their wealth during the financial crisis and only recently returned to their pre-crisis average wealth.

Figure 2b shows divergent trends in net financial wealth shares. While the top ten percentile groups trend upward over time, the bottom 90 percent trends down. Since the financial crisis, the 90-99 percentile has owned a relatively constant share of wealth, and the 50-90 percentile has owned a declining share of wealth. The offsetting increase has gone to the bottom 50 percent and top one percent.

Figure 2b.—Trends in Net Financial Wealth Shares by Wealth Group, 1990-2020



Source: Distributional Financial Accounts data.

II. THE PRESENT LAW TAXATION OF HIGH INCOME AND HIGH WEALTH TAXPAYERS

A. In general

There is no Federal tax on wealth or property owned⁵¹ by an individual.⁵² However, the income tax imposes tax on income derived from property, such as dividends from stock or gain from the sale of property. The income tax system also, in some cases, taxes estates and trusts as separate taxpayers, capturing income on property held by an estate or in trust on behalf of individual beneficiaries.

In general, individuals and other taxpayers are only subject to tax on property when there has been a disposition of the property, *i.e.*, a sale or exchange.⁵³ However, in certain cases, the taxpayer may be subject to tax on income from property even where a disposition has not occurred.⁵⁴

Capital gains rules permit owners of capital assets, generally including interests in business entities like partnerships and corporations to claim capital gain treatment on the sale or exchange of such assets. In many cases, there are other rules that affect the tax treatment of income derived through business entities, affecting the tax that is either directly or indirectly borne by the owners.

The income tax system generally does not tax property received by an individual from transfers by gift or at death.⁵⁵ However, a separate wealth transfer tax system—comprised of the

⁵¹ In contrast, many local and some State governments impose a wealth tax in the form of taxes on the value of real property. See 50-State Property Tax Comparison Study for Taxes Paid in 2019, Lincoln Institute of Land Policy and Minnesota Center for Fiscal Excellence, June 2020, available at https://www.lincolinst.org/sites/default/files/pubfiles/50-state-property-tax-comparison-for-2019_full.pdf (last visited April 30, 2021); 2018 State & Local Government Finance Historical Datasets and Tables, United States Census, available at <https://www.census.gov/data/datasets/2018/econ/local/public-use-datasets.html> (last visited April 30, 2021).

Separately, for a short period of time, the Code imposed tax on the acquisition of certain luxury goods including aircrafts, boats, passenger vehicles, furs, and jewelry valued at over a certain threshold, but these laws were repealed within a few years of enactment. See Pub. L. No. 101-508, January 23, 1990 (enacting the luxury excise tax); Pub. L. No. 103-66, August 10, 1993 (repealing the luxury excise tax for all items except passenger vehicles); Pub. L. No. 104-188, August 20, 1996 (repealing the luxury excise tax on passenger vehicles). For a more detailed description of these taxes see Joint Committee on Taxation, *Description Of A Proposal To Extend Certain Expiring Tax Provisions, Repeal The Luxury Excise Tax On Certain Items, And Adopt Revenue-Raising Provisions Scheduled for Markup by the Senate Committee on Finance on June 16, 1992* (JCX-23-92), June 19, 1992.

⁵² The Code generally uses the term “individual” to refer to natural persons.

⁵³ Sec. 1001. Unless otherwise stated, all references to the Code are to the Internal Revenue Code of 1986, as amended.

⁵⁴ See, *e.g.*, secs. 475, 877A, 1256, 1259, 1272, and 1296.

⁵⁵ Sec. 102; see also sec. 101.

estate tax, gift tax, and generation-skipping transfer tax—may impose tax on the donor who transfers assets by gift or the estate of the decedent who transfers assets at death.⁵⁶

These rules are discussed in more detail in section II.D.

⁵⁶ Chapters 11-13 of the Internal Revenue Code. The wealth transfer tax system has a large lifetime exemption that excludes most donors and decedents from transfer tax.

B. Income Taxation of Individuals, Estates, and Trusts

1. Income taxation of individuals

In general

Individual taxpayers are subject to income taxation under the Internal Revenue Code (“Code”).⁵⁷ United States citizens and resident aliens are generally subject to taxation on worldwide income.⁵⁸ A nonresident alien generally is subject to the U.S. individual income tax only on income with a sufficient nexus to the United States.⁵⁹

Taxable income equals the taxpayer’s gross income less certain exclusions, exemptions, and deductions. Income tax liability is determined by applying graduated tax rates to a taxpayer’s taxable income. A taxpayer may face additional liability if the alternative minimum tax applies. Income tax liability may be reduced by applicable tax credits.

The tax rate brackets and amount of certain deductions and limitations vary depending on the individual’s filing status.⁶⁰ Individuals may file as (1) married filing jointly, (2) a surviving spouse,⁶¹ (3) a head of household,⁶² (4) married filing separately, or (5) an unmarried individual (other than a surviving spouse or head of household).

Gross income

Under the Code, gross income means “income from whatever source derived” except for certain items specifically exempt or excluded.⁶³ Sources of income include compensation for services, annuities, income from life insurance and endowment contracts (other than certain

⁵⁷ Sec. 1. For a more detailed overview on the taxation of individuals, see Joint Committee on Taxation, *Overview of the Federal Tax System As In Effect for 2021* (JCX-18-20), April 15, 2021.

⁵⁸ 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 U.S. citizen or resident who satisfies certain requirements for presence in a foreign country also is allowed a limited exclusion (\$108,700 in 2021) for foreign earned income and a limited exclusion for employer-provided housing. Sec. 911. For a more detailed discussion of international tax rules that affect individual taxpayers, see *General Explanation of Public Law 115-97* (JCS-1-18), December 2018, p.331-338.

⁵⁹ See sec. 871.

⁶⁰ See sec. 1(a)-(d), (j)(2).

⁶¹ A surviving spouse is generally a taxpayer whose spouse died in either of the two taxable years preceding the current taxable year who maintains a household with a qualifying child. Sec. 2(a). Surviving spouses are often but not always treated the same as married filing jointly taxpayers.

⁶² A head of household taxpayer is generally an unmarried taxpayer (who is not a surviving spouse) who maintains a household with a qualifying child or dependent. Sec. 2(b).

⁶³ Sec. 61. Part III of Subchapter B of Chapter 1 of the Code contains provisions excluding certain items from gross income. In addition, exclusions may be a matter of common law. See, e.g., Rev. Rul. 74-74, 1974-1 C.B. 18 (discussing common law general welfare doctrine).

death benefits), pensions, gross profits from a trade or business, and income in respect of a decedent.⁶⁴ They also include income derived from property such as interest, dividends, capital gains, rents, and royalties. Contributions to qualified retirement plans, along with any attributable earnings, generally are included in gross income upon distribution.

Gross income is not limited to income earned directly by the individual. It also includes income distributed from trusts or estates⁶⁵ and income allocated from S corporations or partnerships.⁶⁶

Statutory exclusions from gross income include property received by gift or inheritance,⁶⁷ for which the transferor may be subject to tax under the wealth transfer tax system.⁶⁸ Other exclusions include death benefits payable under a life insurance contract,⁶⁹ interest on certain State and local bonds,⁷⁰ employer-provided health insurance,⁷¹ and certain other employer-provided benefits.⁷²

Adjusted gross income

An individual's adjusted gross income ("AGI") is determined by subtracting certain "above-the-line" deductions from gross income. These deductions⁷³ include trade or business expenses of trades or businesses that do not consist of the performance of services as an employee, as well as limited trade or business expenses of employees such as certain moving expenses for members of the Armed Forces and certain expenses of elementary and secondary school teachers.⁷⁴ Such deductions also include contributions to a qualified retirement plan by a self-employed individual, contributions to certain individual retirement accounts ("IRAs"), losses from the sale or exchange of property, and deductions attributable to rent or royalties.

⁶⁴ Alimony and separate maintenance payments received generally are includable as income for divorce or separation instruments executed before January 1, 2019.

⁶⁵ The rules for the income taxation of estates and trusts are discussed at Section II.B.2, below.

⁶⁶ These rules for partnerships and S corporations are discussed at Section II.C.3, below.

⁶⁷ Sec. 102.

⁶⁸ The wealth transfer tax rules are discussed at Section II.D, below.

⁶⁹ Sec. 101.

⁷⁰ Sec. 103.

⁷¹ Secs. 105 and 106.

⁷² See, e.g., secs. 119, 127, and 129.

⁷³ Sec. 62. Alimony and separate maintenance payments generally are deductible by the payor spouse for divorce and separation instruments executed before January 1, 2019.

⁷⁴ Sec. 62(a)(1).

Taxable income

To determine taxable income, an individual reduces AGI by (1) the applicable standard deduction⁷⁵ or applicable itemized deductions⁷⁶ and (2) the deduction for qualified business income.⁷⁷

The standard deduction is the sum of the basic standard deduction and the additional standard deduction. The amount of the basic standard deduction depends on a taxpayer's filing status.⁷⁸ The additional standard deduction is allowed with respect to any individual who is elderly (*i.e.*, above age 64) and/or blind.⁷⁹ The amounts of the basic standard deduction and the additional standard deductions are indexed annually for inflation.

In lieu of taking the applicable standard deductions, an individual may elect to itemize deductions. The deductions that may be itemized include⁸⁰ certain State and local income, property, and sales taxes;⁸¹ home mortgage interest (on mortgages up to certain specified dollar amounts);⁸² charitable contributions;⁸³ certain investment interest;⁸⁴ medical expenses (in excess of 7.5 percent of AGI);⁸⁵ and casualty and theft losses attributable to Federally declared disasters (in excess of 10 percent of AGI and in excess of \$100 per loss).⁸⁶

⁷⁵ In the case of any taxable year beginning in 2021, if the taxpayer elects not to itemize, up to \$300 (\$600 in the case of a joint return) in certain charitable contributions may be deducted in addition to the standard deduction. See sec. 170(p).

⁷⁶ Sec. 63.

⁷⁷ Sec. 199A. The deduction for qualified business income, which has the effect of a tax rate reduction for certain business income, is discussed in more detail at Section II.C.4, below.

⁷⁸ For 2021, the amount of the standard deduction is \$12,550 for a single individual and for a married individual filing separately, \$18,800 for a head of household, and \$25,100 for married individuals filing jointly and for a surviving spouse.

⁷⁹ For 2021, the additional amount is \$1,350 for married taxpayers (for each spouse meeting the applicable criterion) and surviving spouses. The additional amount for single individuals and heads of households is \$1,700. If an individual is both elderly and blind, the individual is entitled to two additional standard deductions, for a total additional amount (for 2021) of \$2,700 or \$3,400, as applicable.

⁸⁰ See also Part VI and Part VII of Subchapter B of Chapter 1 of the Code.

⁸¹ Sec. 164. This deduction is limited to \$10,000 annually (\$5,000 for married taxpayers filing separately).

⁸² See sec. 163(h).

⁸³ Sec. 170.

⁸⁴ See sec. 163(d).

⁸⁵ Sec. 213.

⁸⁶ Sec. 165.

Tax liability

In general

A taxpayer's net income tax liability is the greater of (1) regular individual income tax liability reduced by credits allowed against the regular tax or (2) tentative minimum tax reduced by credits allowed against the minimum tax. The amount of income subject to tax is determined differently under the regular tax and the alternative minimum tax, and separate rate schedules apply.

Regular tax liability

To determine regular tax liability, the tax rate schedules (or the tax tables) are applied to a taxpayer's 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.⁸⁷ Separate rate schedules apply based on an individual's filing status. The current highest marginal tax rate for individuals is 37 percent.⁸⁸

Effective marginal tax rates may be altered by the phase-in and phaseout of certain exemptions or credits.⁸⁹

Credits against tax

An individual's income tax liability may be reduced by using available tax credits. Certain credits may only be taken by individuals,⁹⁰ such as the credit for certain child or dependent care expenditures⁹¹ or the credit for adoption expenses.⁹² Individuals may also be

⁸⁷ The term "marginal tax rate" generally refers to the additional, or incremental, increase in tax liability from a \$1.00 increase in the taxpayer's income. The marginal tax rates for individuals prescribed in section 1 of the Code and described in Table 1 are referred to as "statutory marginal tax rates."

⁸⁸ Sec. 1(j).

⁸⁹ The term "effective marginal tax rate" refers to the additional, or incremental, increase in tax liability *under the income tax* from a \$1.00 increase in the taxpayer's income. For example, a credit that is phased out, or incrementally reduced, by \$.05 for every \$1.00 above a certain threshold would cause the effective marginal tax rate to be 5 percentage points higher than the statutory marginal tax rate in the phaseout range. The Code contains many provisions that may cause effective marginal tax rates to differ from statutory marginal rates. For a discussion of such provisions that have an effect on effective marginal tax rates as applied to a prior version of the Code, see Joint Committee on Taxation, *Present Law and Analysis Relating to Individual Effective Marginal Tax Rates* (JCS-3-98), February 3, 1998.

⁹⁰ See Subpart A of Part IV of Chapter 1 of the Code; see also, e.g., secs. 32, 35, and 36B.

⁹¹ Sec. 21.

⁹² Sec. 23.

eligible to claim other credits that are generally applicable to taxpayers such as the foreign tax credit⁹³ or credits under the general business credit.⁹⁴

In some instances, a credit is wholly or partially “refundable,” that is, if the amount of these credits exceeds tax liability (net of other nonrefundable credits), such credits create an overpayment, which may generate a refund. Three of the largest refundable credits in terms of cost are the child tax credit,⁹⁵ the earned income tax credit,⁹⁶ and the recovery rebate credits.⁹⁷

Alternative minimum tax liability

Individuals may also be subject to the alternative minimum tax (“AMT”), in an amount by which the tentative minimum tax exceeds the regular income tax for the taxable year.⁹⁸ The tentative minimum tax is determined by reference to an alternative minimum taxable income (“AMTI”), which 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.⁹⁹ This amount is compared to an exemption amount that varies by filing status.¹⁰⁰

Among the tax preferences and adjustments included in AMTI are an inclusion of certain tax-exempt interest¹⁰¹ and the disallowance of the deduction for State and local taxes, the standard deduction, and certain itemized deductions.¹⁰²

An individual may generally use credits against both regular tax liability and tentative minimum tax liability.¹⁰³

⁹³ Sec. 901.

⁹⁴ See subpart D of Subchapter A of Chapter 1 of the Code.

⁹⁵ Sec. 24.

⁹⁶ Sec. 32.

⁹⁷ Secs. 6428, 6428A, and 6428B. Other refundable credits include the American opportunity tax credit, the premium tax credit, the health coverage tax credit, and (for 2021) the child and dependent care tax credit.

⁹⁸ Sec. 55.

⁹⁹ Secs. 56, 57 and 58.

¹⁰⁰ For taxable years beginning in 2021, the exemption amount is \$114,600 for married individuals filing jointly and surviving spouses, \$73,600 for other unmarried individuals, and \$57,300 for married individuals filing separately.

¹⁰¹ Sec. 57(a)(5).

¹⁰² Sec. 56(b).

¹⁰³ See secs. 26(a) and 38(c).

Tax rates on capital gains and qualified dividends, and the net investment income tax

Individuals are subject to lower rates on certain capital gains and certain dividends.¹⁰⁴ These lower rates apply for both the regular tax and the alternative minimum tax.¹⁰⁵

The deduction for qualified business income¹⁰⁶ applies to certain business income. This deduction has the effect of reducing the effective marginal tax rate on such income.

In addition to the income tax, individuals are subject to a 3.8-percent net investment income tax on certain income.¹⁰⁷ The deduction for qualified business income and the net investment income tax are discussed in more detail in section II.C.4, below.

2. Income taxation of estates and trusts

Estates and trusts in general

Estates and trusts are legal arrangements that may be created upon the transfer of wealth.¹⁰⁸

A trust is a three-party legal arrangement for the ownership of property arranged as follows: (1) A settlor or grantor transfers legal title to the property to (2) one or more trustees, who hold title on behalf of (3) one or more beneficiaries. The trustee has a fiduciary duty to protect the beneficial or equitable rights of the beneficiaries with respect to the property; the trustee may be subject to certain requirements with respect to both the corpus (*i.e.*, the property held) by the trust and the income earned by the trust. The three parties to the trust need not be different; a grantor may also be a trustee or a beneficiary, and a trustee may be a beneficiary. The beneficiaries of a trust are generally individuals but may also include charitable organizations, business entities, or other persons.

An estate is a similar arrangement that may arise upon the death of an individual as follows: (1) A decedent's property is held (2) by an executor who controls the property (3) on behalf of one or more beneficiaries, the heirs of the estate, until the affairs of the estate are wound up and the property is distributed to the heirs.

Trusts are generally governed by a trust agreement. An estate may be governed by a will but may also arise even if the decedent does not have a will. Both estates and trusts are also subject to State statutory and common law.

¹⁰⁴ Sec. 1(h), (j)(5).

¹⁰⁵ Sec. 55(b)(3).

¹⁰⁶ Sec. 199A.

¹⁰⁷ Sec. 1411.

¹⁰⁸ See generally Lane and Zaritzky, *Federal Income Taxation of Estates and Trusts*, 3d. edition, Chapter 1; see also Treas. Reg. sec. 301.7701-4(a)(trusts). *Commissioner v. Beebe*, 67 F.2d 662, 664 (1933) (estates).

Tax treatment of estates and trusts

Estates and trusts are generally subject to Federal income tax.¹⁰⁹ Domestic estates and trusts are generally subject to tax on worldwide income.¹¹⁰

The taxable income of estates and trusts is generally computed in the same manner as the taxable income of individuals, with modifications:¹¹¹ (1) no standard deduction is allowed;¹¹² (2) a small personal exemption is allowed;¹¹³ (3) an unlimited charitable deduction is allowed for amounts paid to (or in the case of an estate or certain trusts, amounts permanently set aside for) charity;¹¹⁴ and (4) estates and trusts may deduct estate or trust administration costs.¹¹⁵

Estates and trusts are allowed a deduction for amounts distributed to beneficiaries during the taxable year.¹¹⁶ The amount of the deduction is limited by distributable net income, a measure of income to be distributed.¹¹⁷ Because of this deduction, the beneficiary, not the estate or trust, is generally subject to income tax on the distributed amount. By use of this deduction, trusts and estates may eliminate income tax liability to the extent they distribute (rather than retain) income.

If an estate or trust retains income and has taxable income, the rate brackets¹¹⁸ that apply are more compressed than the individual tax brackets, meaning that an estate or trust is more

¹⁰⁹ Sec. 1(e), Part I of Subchapter J of Chapter 1. The term "trust" may also refer to a number of other types of arrangements or entities. Certain trusts may be classified as business entities. See Treas. Reg. sec. 301.7701-4(a). Trust may also be pensions, sec. 401, or charitable entities, sec. 501. These types of trusts are all outside the scope of the document.

In addition, many trusts are subject to special rules beyond the ones discussed herein. See, e.g., sec. 641(c) (small business trusts), sec. 642(b) (qualified disability trusts), sec. 644 (charitable remainder trusts), and sec. 646 (Alaska Native Settlement Trusts).

¹¹⁰ Foreign estates and foreign trusts are generally taxed similarly to nonresident aliens. See sec. 7701(a)(31) (definition of foreign estate and foreign trust); see also sec. 7701(a)(30). Taxation will depend on the source of income, whether the income is retained or distributed, the residence of the beneficiaries, and, in the case of trusts, whether the trust is a grantor trust or a nongrantor trust.

¹¹¹ Sec. 641(b).

¹¹² Sec. 63(c)(6)(D).

¹¹³ Sec. 642(b). For estates, the amount of the exemption is \$600. For trusts required to currently distribute all income, the amount is \$300, while for other trusts, the amount is \$100.

¹¹⁴ Sec. 642(c).

¹¹⁵ Sec. 67(e).

¹¹⁶ See secs. 651 and 661.

¹¹⁷ Sec. 643(a).

¹¹⁸ Sec. 1(e), (j)(2).

quickly subject to tax at the highest marginal rate.¹¹⁹ If an estate or trust is subject to tax, it generally pays the tax using income or assets of the estate or trust. Thus, for example, the trust grantor does not pay the tax. This reduces the funds of the estate or trust held for the beneficiaries.

Like individuals, estates and trusts may claim the foreign tax credit¹²⁰ or credits under the general business credit.¹²¹ However, these credits may in some cases instead be allocated to the beneficiaries of the estate or trust.¹²² Similarly, estates and trusts are subject to the AMT.

Estates and trusts are subject to lower rates on certain capital gains and certain dividends.¹²³ Estates and trusts may claim a deduction for qualified business income.¹²⁴ Estates and trusts are also subject to a separate net investment income tax on certain income.¹²⁵

Tax treatment of beneficiaries and grantors

Beneficiaries

The transfer of property to an estate or a trust is not a taxable event for the beneficiary or beneficiaries.¹²⁶

If a beneficiary or beneficiaries receives a distribution from an estate or trust, the amount of the distribution, limited by distributable net income, is included in the beneficiary's gross income.¹²⁷ An item of income retains its character when received by the beneficiary.

¹¹⁹ For example, for taxable years beginning in 2021, estates and trusts are subject to the highest marginal rate of 37 percent on taxable income above \$13,050, while married filing separately taxpayers (the next most "compressed" bracket) are subject to the highest marginal rate on taxable income above \$314,150.

¹²⁰ Sec. 642(a).

¹²¹ Subpart D of Subchapter A of Chapter 1 of the Code.

¹²² See, e.g., secs. 52(d) and 901(b)(5).

¹²³ Sec. 1(h), (j)(5). These lower rates apply for both the regular tax and the AMT. Sec. 55(b)(3).

¹²⁴ Sec. 199A. This provision is discussed in more detail at Section II.C.4, below.

¹²⁵ Sec. 1411. This provision is discussed in more detail at Section II.C.4, below.

¹²⁶ The transfer may be a gift or bequest to the beneficiary, excluded from gross income under section 102. Alternatively, if the transfer is to a grantor trust (discussed more below), the Secretary generally has held that the transaction has no effect for income tax purposes.

¹²⁷ Secs. 652 and 662.

Grantors

A grantor or settlor generally cannot take a deduction for a transfer to an estate or a trust. However, a grantor may be able to claim a charitable deduction if the transfer is to a trust with a charitable organization as a beneficiary.¹²⁸

Different rules (discussed below) apply to transactions between grantors and grantor trusts.

Grantor trusts

Under the grantor trust rules, if the grantor or settlor of a trust retains certain rights or powers with respect to a trust, the grantor of the trust is treated as the owner of the trust.¹²⁹ A grantor may own only a portion of a trust. Additionally, these rules may apply to an individual other than the grantor who possesses the requisite rights or powers.

If a trust is a grantor trust, the grantor (and not the trust) is taxed on the income of the trust. The grantor may pay the tax out of funds not owned by the trust. If the grantor does so, the funds of the trust available to the beneficiaries are undiminished by the tax payment. Additionally, IRS guidance provides that transactions between the grantor and the grantor trust are disregarded.¹³⁰ Thus, for income tax purposes, a transfer of property to a grantor trust is not a gift, and a sale to a grantor trust is not a sale for tax purposes and does not give rise to gain or loss. The wealth transfer tax consequences of a transfer to a grantor trust may be different.

Just as grantor trusts are not separate income tax taxpayers, they are not separately subject to the net investment income tax.¹³¹

¹²⁸ Sec. 170(f)(2). The charitable organization, exempt from tax, will not have to pay tax on the income received.

¹²⁹ Sec. 671-679. A grantor is treated as the owner of any portion of a trust if: (1) the grantor has a reversionary interest in either the corpus or the income from the corpus, if certain conditions are satisfied; (2) the grantor has a power of disposition without the approval or consent of any adverse party; (3) the grantor can exercise certain administrative powers of over the trust; (4) the grantor or a nonadverse party has the power to revoke, *i.e.*, revest in the grantor title of a portion of the trust; and (5) without prior approval of an adverse party, the income from the trust may be distributed to or for the benefit of the grantor or the grantor's spouse.

¹³⁰ Rev. Rul. 85-13, 1985-1 C.B. 184, 1985-71 R.B. 28.

¹³¹ Treas. Reg. sec. 1.1411-3(b)(1)(v).

C. Taxation of Business and Investment Income of Individuals

1. Income tax treatment of gains and losses from the disposition of property

In general

In general, a taxpayer is not required to include the economic appreciation (or depreciation) that has accrued on an asset in gross income before the sale or other disposition of the asset.¹³² There are, however, exceptions (discussed below) where the Code either requires or permits taxpayers to include income, gain, or loss that has accrued on an asset before the asset has been disposed of.

A taxpayer's gain or loss on disposition of an asset is generally the difference between the amount realized as a result of the disposition and the taxpayer's adjusted basis in the asset.¹³³ The amount realized is the sum of any money received plus the fair market value of the property (other than money) received by the taxpayer as a result of the disposition.¹³⁴ A taxpayer's basis in property is generally the cost paid in acquiring the property.¹³⁵ The taxpayer's adjusted basis is basis subject to certain adjustments.¹³⁶ For example, a taxpayer must increase basis by certain capital expenditures made or carrying costs incurred with respect to the asset.¹³⁷ If the property is depreciable, basis is reduced by depreciation allowed or allowable.¹³⁸ If the property is corporate stock, basis is reduced by the amount of a distribution made by the corporation in excess of corporate earnings and profit.¹³⁹

Among other nonrecognition events, an individual's transfer of property by gift or bequest is not a taxable event under the income tax system.¹⁴⁰ Thus, the donor or decedent does not recognize gain or loss upon these dispositions.

In many cases, gains or losses are subject to the capital gains rules. Under these rules, long-term gains are taxed at reduced rates while losses are subject to certain limitations.¹⁴¹

¹³² See secs. 61(a)(3) and 1001(a).

¹³³ Sec. 1001(a).

¹³⁴ Sec. 1001(b).

¹³⁵ Sec. 1012.

¹³⁶ Secs. 1011 and 1016.

¹³⁷ Secs. 265 and 266.

¹³⁸ Sec. 1016(a)(2).

¹³⁹ Sec. 301(c)(2).

¹⁴⁰ See secs. 1001(c), 1014, and 1015.

¹⁴¹ Secs. 1(h), (j)(5), and 1211.

Capital gains rules

Definition of a capital asset

Capital assets are all property held by the taxpayer other than certain enumerated types of property.¹⁴² The enumerated exceptions are: (1) stock in trade or inventory of a business or property held primarily for sale to customers in the ordinary course of a trade or business; (2) depreciable, amortizable, or real property used in a trade or business; (3) a specified patent, invention, model or design (whether or not patented), and a secret formula or process, copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property;¹⁴³ (4) accounts or notes receivable acquired in the ordinary course of business for services or from the sale of property described in the first exception; (5) certain publications of the United States government; (6) certain commodities derivative financial instruments held by commodities dealers; (7) certain business hedging transactions; and (8) business supplies.

In addition, under section 1231, the net gain from the sale, exchange, or involuntary conversion of certain property used in the taxpayer's trade or business is treated as long-term capital gain.¹⁴⁴ Under section 1245, gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances.¹⁴⁵ If the depreciable asset is sold for more than its adjusted basis, any gain exceeding the total depreciation recapture is generally treated as section 1231 gain.

Mechanics of capital gains

The capital gains rules look to whether the gain or loss from the sale or exchange of a capital asset is long-term or short-term. Generally, gain or loss is treated as long-term if the asset is held for more than one year and treated as short-term if held for one year or less.¹⁴⁶ Rules apply for the determination of the taxpayer's holding period.¹⁴⁷

Capital losses whether short-term or long-term are generally deductible in full against capital gains. In addition, individual taxpayers may deduct capital losses against up to \$3,000 of

¹⁴² Sec. 1221.

¹⁴³ The rule applies to such property held either by the taxpayer who created the property or a taxpayer with a substituted or transferred basis from the taxpayer who created the property (or for whom the property was created).

¹⁴⁴ However, net gain from such property is treated as ordinary income to the extent that losses from such property in the previous five years were treated as ordinary losses.

¹⁴⁵ Sec. 1245. In certain cases, section 1250 may apply to depreciable real property. For a detailed discussion of the recapture rules under sections 1245 and 1250, see Joint Committee on Taxation, *Tax Incentives for Domestic Manufacturing* (JCX-15-21), March 12, 2021.

¹⁴⁶ Sec. 1222.

¹⁴⁷ Sec. 1223.

ordinary income in each year.¹⁴⁸ Any remaining unused capital losses may be carried forward indefinitely.¹⁴⁹

Tax rates on capital gains

The applicable tax rate for an individual's net capital gain is determined based on a progressive rate structure with thresholds based on taxable income.¹⁵⁰ The thresholds vary depending on filing status. There are three rate brackets: 0 percent, 15 percent, and 20 percent.¹⁵¹ Qualified dividends are also subject to tax at these rates.¹⁵²

In two cases, there are additional higher rate brackets. A maximum 25 percent rate applies to unrecaptured section 1250 gain. Unrecaptured section 1250 gain arises upon the sale of depreciable real property, gain from which may be treated as long-term gain under section 1231 (for property used in a trade or business). Upon the sale of such property, a portion of the gain attributable to depreciation recapture is treated as capital gain but taxed at a higher rate.¹⁵³ A maximum 28 percent rate applies to gain from the sale of collectibles.¹⁵⁴

Exclusion and deferral

Several rules apply to capital gains that allow taxpayers to exclude or defer gain from income. For example, under section 1202, a taxpayer generally may exclude 100 percent of the gain from the sale of certain small business stock. Under section 1031, a taxpayer who realizes gain from the sale of certain real property may defer recognition by reinvestment of the proceeds in another real property investment. Under the qualified opportunity zone rules, a taxpayer who realizes capital gain may defer recognition by reinvestment of the gain in a qualified opportunity fund that, in turn, makes certain investments in low-income areas.

Income tax treatment of transfers of property by gift or bequest

Transfers by a donor by gift or by a decedent at death are treated differently than sales or other dispositions of property. These transfers are generally not taxable events for either the transferor or transferee under the income tax system, and basis rules specific to the transactions apply. In addition, these transfers may give rise to consequences under the wealth transfer tax

¹⁴⁸ Sec. 1211(b). The limitation is \$1,500 in the case of married filing separately taxpayers.

¹⁴⁹ Sec. 1212(b).

¹⁵⁰ Sec. 1(h) and (j)(5).

¹⁵¹ Sec. 1(h)

¹⁵² Sec. 1(h)(11).

¹⁵³ Sec. 1(h)(6). This should be compared to the section 1245 recapture for depreciable personal property, which may also give rise to long-term capital gain under section 1231. Under that section, the gain attributable to prior depreciation or amortization allowances is treated as ordinary income (not capital gain) and taxed at ordinary rates.

¹⁵⁴ The term collectible is defined in section 408(m).

system compromising the estate, gift, and generation-skipping transfer tax. The wealth transfer tax system is discussed in more detail below¹⁵⁵ but mentioned as relevant here.

Transfers by gift

A transfer by gift is not a taxable event to the donor,¹⁵⁶ while the asset transferred is not included in the gross income of the donee.¹⁵⁷ However, the donor may be subject to gift tax on the transfer. The donee's basis is generally the donor's basis increased by any gift tax paid by the donor.¹⁵⁸ However, if the fair market value at the time of transfer is less than the basis, the donee's basis is limited to the fair market value.¹⁵⁹

Slightly different rules apply to transfers between spouses. A transfer by gift between spouses is not a taxable event,¹⁶⁰ while the asset transferred is not included in the gross income of the donee.¹⁶¹ In addition, the transfer is generally not subject to gift tax.¹⁶² The donee spouse's basis is the donor spouse's adjusted basis, and the fair-market-value limitation does not apply.¹⁶³

For purposes of the capital gains rules, a donee's holding period includes the donor's holding period.¹⁶⁴

Transfers at death

A transfer at death is also not a taxable event to the decedent,¹⁶⁵ while the asset transferred is not included in the gross income of the heir.¹⁶⁶ However, the decedent's estate

¹⁵⁵ See section II.D.

¹⁵⁶ See secs. 1001(c) and 1015.

¹⁵⁷ Sec. 102.

¹⁵⁸ Sec. 1015.

¹⁵⁹ *Ibid.* The increase for gift tax paid also cannot result in basis above fair market value.

¹⁶⁰ Sec. 1041. This rule also applies to transfers incident to divorce.

¹⁶¹ Sec. 102.

¹⁶² Sec. 2523.

¹⁶³ See also sec. 1015(c).

¹⁶⁴ Sec. 1223(2).

¹⁶⁵ See secs. 1001(c) and 1014.

¹⁶⁶ Sec. 102.

may be subject to estate tax on the transfer; transfers to a surviving spouse are generally not subject to estate tax.¹⁶⁷

The heir's basis in the asset is generally the fair market value of the asset on the date of the decedent's death,¹⁶⁸ despite the fact that untaxed appreciation (or depreciation) is not taken into account by either the decedent or the heir. This "step up" or "step down" in basis removes the built-in gain or loss on the asset at the time of the decedent's death from the income tax system. The income tax system therefore only takes into account gain or loss that arises during the heir's ownership of the asset.

For purposes of the capital gains rules, the heir is treated as holding the inherited asset for more than one year, such that it is eligible for long-term capital gains treatment, regardless of the actual period of ownership.¹⁶⁹

Transfers by gift or at death to charitable transferees

Gifts and bequests to charitable organizations, like other gifts and bequests, are not taxable events for income tax purposes and so do not cause the transferor to realize or recognize gain or loss on a transfer of property. The transferor may claim a deduction for income tax purposes, subject to certain limits, generally equally to the fair market value of the property transferred.¹⁷⁰ In the case of appreciated property, this allows the taxpayer to claim a benefit with respect to untaxed appreciation.

Transfers by gift or at death are also generally not subject to tax under the transfer tax system.

2. Overview of mark-to-market taxation

In general, a taxpayer is not required to include an item of gain or loss in the calculation of gross income until the gain or loss has been realized. According to the Supreme Court, realization occurs when the taxpayer "obtains the fruition of the economic gain which has already accrued to him."¹⁷¹ In the context of property (as distinct from services), realization generally occurs when the taxpayer sells, exchanges, or otherwise disposes of the asset on which the gain or loss has accrued.¹⁷²

¹⁶⁷ Sec. 2056.

¹⁶⁸ Sec. 1014(a). In certain cases, different valuation rules apply.

¹⁶⁹ Sec. 1223(9).

¹⁷⁰ Sec. 170. In certain cases, the deduction is limited to a lower amount, such as the taxpayer's basis in the contributed property. Sec. 170(e).

¹⁷¹ *Helvering v. Horst*, 311 U.S. 112, 115 (1940).

¹⁷² See sec. 1001.

In certain circumstances, however, the Code either requires or permits taxpayers to include gain or loss that has accrued on an asset before the asset has been disposed of.¹⁷³ Some of these rules employ a concept called “mark to market,” where the taxpayer is treated as if it sold the asset subject to these rules (*i.e.*, the asset being “marked”) for the asset’s fair market value as of the date of the mark prescribed by the statute. In many cases, the date of the mark is the last business day of the taxpayer’s taxable year, but it could also be the date of a particular event (*e.g.*, the day before the taxpayer relinquishes U.S. citizenship).

Any gain or loss included in gross income as a result of an asset being marked to market generally is taken into account in calculating future gain or loss (including gain or loss on a future mark to market) on the asset.¹⁷⁴ So, for example, if a taxpayer purchases a security that is subject to the mark-to-market rules of section 475 for \$20, and at the end of the taxpayer’s taxable year, the security is worth \$40, the taxpayer would be required to include \$20 in income for that year. If at the end of the taxpayer’s next taxable year, the security is worth \$30, the taxpayer would have a \$10 loss. And if, in the middle of the taxable year following the year of the loss, the taxpayer sells the security for \$30, the taxpayer would have no gain on the sale.

As this example demonstrates, the cumulative effect of a mark-to-market regime that applies to an asset over time is for the fluctuation in value of the asset across each relevant period to be included in the taxpayer’s income for each such period. The net amount of the overall inclusions across all periods equals the amount that would have been included if gain or loss were calculated only upon sale or other disposition.¹⁷⁵ But a mark-to-market regime that applies to an asset over time takes account of the gain and loss regularly across the holding period of the asset, rather than merely upon disposition.

What follows is a brief description of four mark-to-market rules in the Code: section 475 (applying mark to market to certain securities and commodities dealers and traders); section 877A (marking to market the assets of individuals who terminate U.S. citizenship or long-term permanent resident status); section 1256 (mark to market of certain financial derivatives); and section 1296 (elective mark to market for marketable stock in a passive foreign investment company).

¹⁷³ See, *e.g.*, secs. 475, 877A, 1256, 1259, 1272, and 1296.

¹⁷⁴ See, *e.g.*, sec. 475(a) (flush language).

¹⁷⁵ In the above example, the net gain or loss is a \$10 gain, which equals the difference between the purchase price of \$20 and the sale price of \$30. This is equal to the gain or loss across all periods of (1) year 1 gain of \$20, (2) year 2 loss of \$10, and (3) year 3 gain or loss of \$0.

Mark to market for dealers and traders in securities and commodities

Section 475(a) generally requires dealers¹⁷⁶ in securities¹⁷⁷ to mark to market securities held by the dealer at the end of each year. That is, the securities are treated as sold on the last business day of the taxable year at their fair market value.¹⁷⁸ The mark-to-market requirement does not apply to securities held for investment, certain debt securities, and certain hedges.¹⁷⁹ Section 475(e) permits dealers in commodities¹⁸⁰ to elect similar treatment with respect to commodities held by the dealer. Section 475(f) permits traders¹⁸¹ in securities and commodities to elect mark-to-market treatment with respect to securities and commodities held in connection with the trader's trade or business. Such elections, once made, are irrevocable without the consent of the Secretary.

The character of gain or loss from the mark to market or the disposition of a security or commodity under section 475 is ordinary income or loss.¹⁸²

Before the enactment of section 475 in 1993, dealers in securities could elect to account for their inventories according to (1) the lower of cost or market ("LCM"), (2) cost, or (3) fair market value. With section 475, Congress provided a uniform mark-to-market rule for the taxation of securities held by securities dealers of all types. Explaining Congress's reasons for adopting section 475, the House Budget Committee report accompanying the legislation states that "[i]nventories of securities generally are easily valued at year end, and, in fact, are currently valued at market by securities dealers in determining their income for financial statement

¹⁷⁶ Section 475(c)(1) defines a dealer in securities as a taxpayer who either (1) regularly purchases securities from or sells securities to customers in the ordinary course of business, or (2), regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of business.

¹⁷⁷ Security is defined to include stocks, interests in widely held or publicly traded partnerships and trusts, debt instruments, interest rate swaps, currency swaps, and equity swaps, as well as options, forwards, and short positions on any of the above-mentioned financial instruments, and other positions identified as hedges with respect to any of the above-mentioned instruments. Section 1256 contracts are excluded. See sec. 475(c)(2).

¹⁷⁸ Sec. 475(a).

¹⁷⁹ Sec. 475(b)(1). To meet these exceptions, the eligible securities must be clearly identified as such in the dealer's records. Sec. 475(b)(2).

¹⁸⁰ Commodity is defined to include actively traded commodities within the meaning of section 1092(d)(1), notional principal contracts with respect to actively traded commodities, derivatives on actively traded commodities, and certain hedges with respect to the aforementioned categories of commodity. See sec. 475(e)(2).

¹⁸¹ The Tax Court has defined a trader as someone that does not provide the services of acting as a middleman (earning compensation from the attendant fees), but rather "depend[s] upon such circumstances as a rise in value or an advantageous purchase to enable them to sell at a price in excess of cost." See *Kemon v. Commissioner*, 16 T.C. 1026, 1032-33 (1951).

¹⁸² Sec. 475(d)(3) and (f)(1)(D).

purposes.”¹⁸³ The report adds, “the cost method and the LCM method generally understate the income of securities dealers and . . . the mark-to-market method most clearly reflects their income.”¹⁸⁴

Mark to market of property of expatriating persons

Individual taxpayers who expatriate from the United States (*i.e.*, either relinquish U.S. citizenship or cease to be lawful permanent residents of the United States¹⁸⁵) after June 16, 2008 are subject to tax on the net unrealized gain in their property immediately prior to expatriation under the mark-to-market rules of section 877A.¹⁸⁶ Section 877A treats a taxpayer who expatriates as having sold all of their property on the day before the expatriation date for its fair market value.¹⁸⁷ The taxpayer may elect to defer payment of any additional tax attributable to gain on the deemed sale until the taxpayer actually disposes of property deemed sold, if the taxpayer elects to do so and irrevocably waives any right under any U.S. treaty that would preclude assessment or collection of the tax deferred by reason of the election.¹⁸⁸ Nonetheless, the amount of such gain is fixed as of the date of the mark.

Mark to market of certain financial derivatives

Section 1256 was enacted in 1981 as part of a set of rules addressing so-called straddle shelters.¹⁸⁹ A straddle shelter was a transaction whereby a taxpayer could use combinations of financial instruments (potentially including both securities and derivatives) to limit or eliminate risk of loss on an existing financial position while at the same time deferring gain recognition and potentially converting short term capital gain into long term capital gain.¹⁹⁰ Section 1256 applies to certain derivatives that could be used as part of a straddle shelter.

To address the deferral and character conversion opportunities presented by straddle shelters, section 1256 requires derivatives to which it applies (referred to in the statute as “section 1256 contracts”) to be marked to market on the last business day of the taxpayer’s

¹⁸³ Report of the Committee on the Budget, House of Representatives, to accompany H.R. 2264, A Bill to Provide for Reconciliation Pursuant to Section 7 of the Concurrent Resolution on the Budget for Fiscal Year 1994, H.R. Rep. No. 103-111, May 25, 1993, p. 661.

¹⁸⁴ *Ibid.*

¹⁸⁵ Lawful permanent resident is defined in section 7701(b)(6).

¹⁸⁶ See Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 110th Congress* (JCS-1-09), January 2009, p. 197.

¹⁸⁷ Sec. 877A(a)(1). Section 877A provides for a one-time mark, rather than periodic marks as in sections 475, 1256, and 1296.

¹⁸⁸ Sec. 877A(b)(1) and (5).

¹⁸⁹ See generally Joint Committee on Taxation, *General Explanation of the Economic Recovery Act of 1981* (JCS-71-81), December 29, 1981, pp. 279-316.

¹⁹⁰ An example of the mechanics of a straddle shelter is provided by Joint Committee on Taxation, *General Explanation of the Economic Recovery Act of 1981* (JCS-71-81), December 29, 1981, p. 295.

taxable year, and prescribes that any resultant gain or loss is treated as 40 percent short term gain or loss and 60 percent long term gain or loss. Originally, section 1256 applied only to regulated futures contracts, but it has since been expanded to apply to foreign currency contracts, nonequity options, dealer equity options, and dealer securities futures contracts.¹⁹¹ Any securities futures contract (or option on such a contract) other than a dealer securities futures contract is explicitly excluded from the application of section 1256, as is any interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement.¹⁹²

Mark to market of marketable PFIC stock

The passive foreign investment company (“PFIC”) regime of sections 1291 through 1298 addresses the use of foreign companies to defer U.S. tax on passive income in part by permitting taxpayers to elect to mark certain PFIC stock to market.

A PFIC is generally defined as any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income or if 50 percent or more of its assets produce, or are held for the production of, passive income.¹⁹³ The regime provides three alternative sets of rules for current inclusion of PFIC income, one of which permits a taxpayer holding marketable stock¹⁹⁴ in a PFIC to elect to include (or deduct) income (or loss) each year equal to the difference between the fair market value of the marketable PFIC stock as of the close of the taxable year and the taxpayer’s adjusted basis in such stock (*i.e.*, marking the marketable PFIC stock to market).¹⁹⁵ The resulting gain or loss is treated as ordinary income or loss.¹⁹⁶

Taxpayers making the election are exempted from a different set of rules under the PFIC regime under which U.S. shareholders pay tax on certain income or gain realized through the company, plus an interest charge that is attributable to the value of deferral.¹⁹⁷ The same exemption applies to PFIC stock that is required to be marked to market under any other provision of the Code.¹⁹⁸

¹⁹¹ Sec. 1256(b)(1). For definitions of these terms, see section 1256(g).

¹⁹² Sec. 1256(b)(2).

¹⁹³ Sec. 1297.

¹⁹⁴ Marketable stock is defined in Treas. Reg. sec. 1.1296-2. Generally, the term comprises stock that is regularly traded on a qualified exchange, certain stock that is redeemable at its net asset value, and options on the previous two categories of marketable stock. Treas. Reg. sec. 1.1296-2(a)(1).

¹⁹⁵ Sec. 1296.

¹⁹⁶ Sec. 1296(c)(1).

¹⁹⁷ Sec. 1291(d)(1).

¹⁹⁸ Sec. 1296(d)(1).

3. Taxation of domestic business income of individuals

Income from a business

For Federal tax purposes, business income is taxed under rules relating to the form in which the business is conducted. The business may take the form of an entity or may be conducted as a sole proprietorship.¹⁹⁹ The principal business entities for Federal income tax purposes are C corporations, partnerships, and S corporations. Partnerships and S corporations are often referred to as passthrough entities because their income is included in the gross income of the owners of the entities rather than in the income of the entities themselves. In the case of individuals, the tax rate on income from passthrough entities and sole proprietorships depends on the individual's filing status and income. A large portion of business income is derived by C corporations and is taxed under the corporate income tax. Distributed C corporation income (generally, dividend income) is also subject to income tax in the hands of the recipient shareholders.

Choice of business entity

Taxpayers may choose among forms of doing business. Differences in the way business income is taxed affect this choice.

C corporations are considered to have good access to capital markets, though distributed corporate income is subject to two levels of income tax.²⁰⁰ As for passthrough entities, partnerships have no limit on the number of partners, whereas S corporations are limited to 100 shareholders.²⁰¹ Partnership agreements may provide for allocations of income, gain, deduction, loss and credit to reflect the business arrangement provided the allocations have substantial economic effect, whereas S corporation income, gain, deduction, loss and credit must be allocated to shareholders on a pro rata per share, per day basis.²⁰² Some differences involve the availability of partnership or S corporation status to existing businesses. For example, a C corporation may convert to an S corporation, but not to a partnership, without immediate recognition of gain at either the corporate or the shareholder level.²⁰³ There are a number of

¹⁹⁹ A sole proprietorship is generally not treated as an entity separate from its owner, as discussed below. More complex or specialized arrangements involving, for example, affiliated corporations, tiered entities, special purpose entities, real estate investment trusts ("REITs"), regulated investment companies (mutual funds or "RICs") or foreign entities or investments are beyond the scope of this discussion.

²⁰⁰ Publicly traded partnerships provide access to public capital markets without two levels of income tax, but with additional complexity. Partnerships more commonly are not publicly traded.

²⁰¹ Sec. 1361(b). Certain related shareholders are treated as one for this purpose.

²⁰² Sec. 704(b) and sec. 1366(a).

²⁰³ The liquidation of a C corporation generally requires the corporation to recognize gain on its assets. Secs. 336-338 (providing some exceptions to this treatment). A conversion of a C corporation to a partnership is treated as a liquidation of the C corporation. However, the conversion of a C corporation to an S corporation (achieved through electing S corporation status) is not treated as a liquidation of the C corporation. (Certain built-in gain of a C corporation that elects S corporation status remains subject to C corporation tax if recognized within five years after the conversion.) Thus, if a C corporation can satisfy the limits on the number and types of shareholders,

other differences.²⁰⁴ In general, a partnership offers more flexibility as well as greater complexity in application, while an S corporation imposes a variety of restrictions but may be simpler to implement in common situations.

In 2018, there were approximately 1.6 million C corporations, 4.0 million partnerships, 4.9 million S corporations, 27.1 million nonfarm sole proprietorships, and 1.8 million farm sole proprietorships. Before 1987, there were more C corporations than S corporations and partnerships combined. In 1987, the number of S corporations and partnerships exceeded the number of C corporations. Since 1987, the combined number of passthrough entities has more than tripled. The growth has been led by large increases in the number of small S corporations (those with less than \$100,000 in assets) and limited liability companies (“LLCs”) taxed as partnerships.²⁰⁵

Individuals who are shareholders in a C corporation

In general

An individual who is a shareholder in a C corporation²⁰⁶ is generally subject to tax on dividends distributed to the individual by the corporation. A distribution by a corporation to its shareholders²⁰⁷ generally is taxable as a dividend to the extent of the corporation’s current and accumulated earnings and profits.²⁰⁸ Qualified dividends are subject to tax generally at the same preferential rates that apply to capital gains for individual taxpayers.²⁰⁹

the single class of stock requirement, and other applicable requirements, a conversion of a C corporation to an S corporation is not taxable, and post-conversion income and appreciation of assets in the entity are subject only to shareholder-level tax.

²⁰⁴ For a chart summarizing tax differences among C corporations, partnerships, S corporations, and sole proprietorships, see Joint Committee on Taxation, *Present Law and Data Related to the Taxation of Business Income* (JCX-42-17), September 15, 2017, pp. 11-16, at www.jct.gov.

²⁰⁵ Joint Committee on Taxation staff calculations; for more background and data, see Joint Committee on Taxation, *Present Law and Data Related to the Taxation of Business Income* (JCX-42-17), September 15, 2017, available at www.jct.gov.

²⁰⁶ A C corporation is any corporation that is not an S corporation. The letter “C” appears to reflect that subchapter C of chapter 1 of the Code is entitled “corporate distributions and adjustments.”

²⁰⁷ A corporate shareholder (*i.e.*, a corporation that owns shares of another corporation) that receives a dividend generally is eligible for a dividends-received deduction that results in the recipient corporation being taxed on at most 30 percent and possibly on none of the dividend received by the shareholder. Sec. 243. Special rules apply in certain cases and with respect to certain amounts received by corporate shareholders. Secs. 245-250.

²⁰⁸ 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. Sec. 301(c). 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. Sec. 311. A distribution of stock of the corporation generally is not a taxable event to either the corporation or the shareholder. Secs. 311(a) and 305.

²⁰⁹ Sec. 1(h)(11).

In addition, the C corporation is subject to the 21-percent corporate income tax as an entity separate from its shareholders.²¹⁰ As a result, a corporation's distributed income generally is taxed once at the corporate level when earned and then again to individual shareholders when distributed as dividends. Corporate deductions and credits reduce only corporate income (and corporate income taxes) and are not passed through to shareholders. Corporate income that is not distributed to shareholders generally is subject to tax at the corporate level only. Dividends paid to individuals generally are not deductible by the corporation.²¹¹

Shareholders in a C corporation are taxed at capital gains rates upon sale or exchange (including certain redemptions²¹²) of the stock. Amounts received by a shareholder in complete liquidation of a corporation generally are treated as full payment in exchange for the shareholder's stock.²¹³

Income retained at the corporate level (not distributed to shareholders²¹⁴) generally is reflected in an increased stock price, relevant for purposes of determining shareholder-level capital gain on sale or exchange of the stock. If the C corporation distributes property to shareholders, the gain on appreciated corporate property generally is subject to corporate-level tax upon distribution to the shareholders, yielding the same tax result as if the assets had been sold by the corporation and the proceeds distributed to the shareholders. No separate rate structure exists for corporate capital gains.

In contrast to dividends on stock, some amounts paid as interest to holders of corporate debt may be subject to only one level of tax (at the recipient level) since the corporation is allowed a deduction for part or all of the amount of interest expense paid or accrued.²¹⁵

²¹⁰ Sec. 11. This double taxation is mitigated by a reduced tax rate generally applicable to the qualified dividend income of individuals.

²¹¹ Foreign investors are subject to withholding tax on dividends paid by domestic corporations, and generally are exempt from U.S. income tax on capital gains from the sale of corporate stock (irrespective of whether the corporation is domestic or foreign). Tax-exempt investors generally are not subject to tax on either dividends or on sales or exchanges of corporate stock.

²¹² Sec. 302.

²¹³ A liquidating corporation recognizes gain or loss on the distributed property as if such property were sold to the shareholders for its fair market value. Sec. 311. However, if a corporation liquidates a subsidiary corporation of which it has 80 percent or more control, no gain or loss generally is recognized by either the parent corporation or the subsidiary corporation. Sec. 332.

²¹⁴ The accumulated earnings tax (generally at a 20 percent rate) may be imposed on a corporation if it 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. Secs. 531 and 541. These rules, when applicable, in effect impose the shareholder-level tax in addition to the corporate-level tax on accumulated earnings or undistributed personal holding company income.

²¹⁵ Sec. 163.

Individuals who are partners in a partnership

Partners in a partnership are subject to tax on their distributive shares of partnership income. Partnerships generally are treated for Federal income tax purposes as passthrough entities not subject to tax at the entity level.²¹⁶ The character of partnership items, such as ordinary income or loss, capital gain, or capital loss, passes through to partners.²¹⁷ Partners must take into account these partnership items based on the partnership's method of accounting and regardless of whether income is distributed to the partners.²¹⁸

A partner's deduction for partnership losses is limited to the partner's adjusted basis in its partnership interest.²¹⁹ Losses not allowed as a result of that limitation generally are carried forward to the next year.

Partners generally may receive distributions of partnership property without recognition of gain or loss, subject to some exceptions.²²⁰

Partnerships may allocate items of income, gain, loss, deduction, and credit among the partners, provided the allocations have substantial economic effect.²²¹ In general, an allocation has substantial economic effect to the extent the partner to which the allocation is made receives the economic benefit or bears the economic burden of such allocation and the allocation substantially affects the dollar amounts to be received by the partners from the partnership independent of tax consequences.²²²

State laws of every State provide for the establishment of limited liability companies ("LLCs"), which are neither partnerships nor corporations under applicable State law, but which

²¹⁶ Sec. 701.

²¹⁷ Sec. 702(b).

²¹⁸ Sec. 702(a).

²¹⁹ Sec. 704(d). A partner's adjusted basis in a partnership interest generally equals (1) the sum of (a) the amount of money and the adjusted basis of property contributed to the partnership, or the amount paid for the partnership interest, (b) the partner's distributive share of partnership income, and (c) the partner's share of partnership liabilities, reduced by (2) the sum of (a) the partner's distributive share of losses allowed as a deduction and certain nondeductible expenditures, and (b) any partnership distributions to the partner. Sec. 705. In addition, passive loss and at-risk limitations limit the extent to which certain types of income can be offset by a partner's share of partnership deductions (secs. 469 and 465). These limitations do not apply to corporate partners, except certain closely-held corporations.

²²⁰ Sec. 731. Gain or loss may nevertheless be recognized, for example, on the distribution of money or marketable securities in excess of basis, distributions with respect to contributed property, or in the case of disproportionate distributions (which can result in ordinary income). Sec. 751.

²²¹ Sec. 704(b)(2).

²²² Treas. Reg. sec. 1.704-1(b)(2).

are generally treated as partnerships for Federal tax purposes.²²³ An individual who holds an interest in an LLC that is treated as a partnership is a partner for Federal tax purposes.

A partner in a publicly traded partnership that meets the applicable requirements²²⁴ generally is subject to the same tax treatment applicable to a partner in a partnership that is not publicly traded. To meet the applicable requirements, 90 percent or more of a publicly traded partnership's gross income must comprise one or more types of qualifying income.²²⁵

Individuals who are shareholders in an S corporation

S corporation shareholders are subject to tax on their pro rata shares of S corporation income.²²⁶ An S corporation²²⁷ generally is not subject to Federal income tax at the corporate level.²²⁸ The character of S corporation items, such as ordinary income or loss, capital gain, or capital loss, passes through to S corporation shareholders. The shareholder's pro rata shares are determined based on the S corporation's method of accounting and regardless of whether income is distributed to the shareholders.

A shareholder's deduction for corporate losses is limited to the sum of the shareholder's adjusted basis in its S corporation stock and the indebtedness of the S corporation to the shareholder. Losses not allowed as a result of that limitation generally are carried forward to the next year.²²⁹

²²³ Any domestic nonpublicly traded unincorporated entity with two or more members generally is treated as a partnership for Federal income tax purposes, while any single-member domestic unincorporated entity generally is treated as disregarded for Federal income tax purposes (*i.e.*, treated as not separate from its owner). Treas. Reg. sec. 301.7701-3 (known as the "check-the-box" regulations). Instead of the applicable default treatment, however, an LLC may elect to be treated as a corporation for Federal income tax purposes.

²²⁴ For this purpose, a publicly traded partnership means any partnership if interests in the partnership are traded on an established securities market or interests in the partnership are readily tradable on a secondary market (or the substantial equivalent thereof). Sec. 7704(b). If the publicly traded partnership does not meet the applicable requirements, however, it is treated as a corporation for Federal tax purposes. Sec. 7704(a).

²²⁵ Sec. 7704(c)(2). Qualifying income is defined to include interest, dividends, and gains from the disposition of a capital asset (or of property described in section 1231(b)) that is held for the production of income that is qualifying income. Qualifying income also includes rents from real property, gains from the sale or other disposition of real property, and certain other income and gains specified by statute. Sec. 7704(d).

²²⁶ Sec. 1366(b).

²²⁷ An S corporation is so named because its Federal tax treatment is governed by subchapter S of the Code.

²²⁸ Secs. 1363 and 1366.

²²⁹ A shareholder's adjusted basis in the S corporation stock generally equals (1) the sum of (a) the shareholder's capital contributions to the S corporation and (b) the shareholder's pro rata share of S corporation income, reduced by (2) the sum of (a) the shareholder's pro rata share of losses allowed as a deduction and certain nondeductible expenditures, and (b) any S corporation distributions to the shareholder. Sec. 1367. If any amount that would reduce the adjusted basis of a shareholder's S corporation stock exceeds the amount that would reduce that basis to zero, the excess is applied to reduce (but not below zero) the shareholder's basis in any indebtedness of

In general, an S corporation shareholder is not subject to tax on corporate distributions unless the distributions exceed the shareholder's basis in the stock of the corporation.

To be eligible to elect S corporation status, a corporation may not have more than 100 shareholders and may not have more than one class of stock.²³⁰ Only individuals (other than nonresident aliens), certain tax-exempt organizations, and certain trusts and estates are permitted shareholders of an S corporation. Although there are limitations on the types of shareholders and stock structure an S corporation may have, businesses organized as S corporations may be as large as those organized as C corporations or partnerships.

Individuals conducting a business as a sole proprietorship

An individual who conducts a business in the form of a sole proprietorship is taxed directly on business income. The individual files Schedule C (sole proprietorships generally), Schedule E (rental real estate and royalties), or Schedule F (farms) with his or her individual tax return. The transfer of a business conducted as a sole proprietorship is treated as a transfer of each individual asset of the business.

Unlike a C corporation, partnership, or S corporation, a business conducted as a sole proprietorship generally is not treated as an entity distinct from its owner for Federal income tax purposes.²³¹ Nonetheless, a sole proprietorship is treated as an entity separate from its owner for employment tax purposes,²³² for certain excise taxes,²³³ and certain information reporting requirements.²³⁴

4. All-in tax rates on income of individuals

Tax rates on income of individuals are described in section II.B.1, above, relating to income taxation of individuals. An individual's income from a business may be taxed at ordinary rates up to 37 percent in 2021, or at the rates applicable to capital gains and qualified dividends, generally at a top rate of 20 percent, as described there.

the S corporation to the shareholder. If, after a reduction in the basis of such indebtedness, there is an event that would increase the adjusted basis of the shareholder's S corporation stock, such increase is instead first applied to restore the reduction in the basis of the shareholder's indebtedness. Sec. 1367(b)(2).

²³⁰ Sec. 1361. For this purpose, a husband and wife and all members of a family are treated as one shareholder. Sec. 1361(c)(1).

²³¹ A single-member unincorporated entity is disregarded for Federal income tax purposes, unless its owner elects to be treated as a C corporation. Treas. Reg. sec. 301.7701-3(b)(1)(ii). Sole proprietorships often are conducted through legal entities for nontax reasons. While sole proprietorships generally may have no more than one owner, a married couple that files a joint return and jointly owns and operates a business may elect to have that business treated as a sole proprietorship under section 761(f).

²³² Treas. Reg. sec. 301.7701-2(c)(2)(iv).

²³³ Treas. Reg. sec. 301.7701-2(c)(2)(v).

²³⁴ Treas. Reg. sec. 301.7701-2(c)(2)(vi).

Income received by individuals from a corporation is subject to two levels of tax, that is, both the 21-percent corporate income tax and the income tax imposed on the shareholder (generally, at a 20-percent rate for qualified dividends).²³⁵ Income received by individuals through a passthrough entity (a partnership or an S corporation) or a sole proprietorship may have a reduced effective rate of tax due to the qualified business income deduction of up to 20 percent. Some business income of an individual is subject to the net investment income tax ("NIIT") or the tax on net earnings from self-employment ("SECA") as well as to the income tax. Taking these other tax rates and the qualified business income deduction into account as well as the individual's income tax rate gives the "all-in" tax rate.

Deduction for qualified business income

An individual taxpayer generally may deduct 20 percent of qualified business income from a partnership, S corporation, or sole proprietorship, as well as 20 percent of aggregate qualified real estate investment trust ("REIT") dividends and qualified publicly traded partnership income.²³⁶ A specified agricultural or horticulture cooperative generally may deduct nine percent of qualified production activities income.²³⁷

For taxpayers with taxable income²³⁸ in excess of the threshold amount (for 2021, \$329,800 for married taxpayers filing jointly, \$164,925 for married taxpayers filing separately, and \$164,900 for all other taxpayers),²³⁹ the deduction with respect to qualified business income is limited based on (1) the taxpayer's allocable share of W-2 wages paid by the trade or business and the taxpayer's allocable share of capital investment with respect to the trade or business²⁴⁰ and (2) the type of trade or business in which the income is earned.²⁴¹ These limitations begin to

²³⁵ Mitigating factors with respect to the two-level taxation of distributed corporate income include the availability of corporate-level deductions and credits that may lower the overall rate of the corporation's tax; use of corporate debt, payments of interest on which are deductible by the corporation; and retention rather than distribution of corporate income, among other factors.

²³⁶ Sec. 199A.

²³⁷ The deduction is limited by the cooperative's taxable income for the year (computed without regard to the 199A deduction and reduced by certain payments or allocations to patrons). The deduction may instead be allocated to and deducted by the cooperative's patrons, limited to each patron's taxable income for the year (computed without regard to any section 199A deduction under the general rule and after taking into account the cooperative's section 199A deduction).

²³⁸ Taxable income is computed without regard to the deduction allowable under section 199A with respect to the threshold amount.

²³⁹ These threshold amounts are indexed for inflation.

²⁴⁰ The deduction is limited to the greater of (a) 50 percent of the W-2 wages paid with respect to the qualified trade or business, or (b) the sum of 25 percent of the W-2 wages with respect to the qualified trade or business plus 2.5 percent of the unadjusted basis, immediately after acquisition, of all qualified property. Sec. 199A(b)(2)(B).

²⁴¹ Qualified business income generally excludes income from a specified service trade or business when taxable income is in excess of the threshold amount and always excludes income from the trade or business of performing services as an employee. A specified service trade or business means any trade or business involving the

phase in above the threshold amount of taxable income.²⁴² In addition, the deduction calculated with respect to qualified business income, qualified REIT dividends, and qualified publicly traded partnership income may not exceed 20 percent of the taxpayer's taxable income for the tax year.²⁴³

NIIT

The net investment income tax applies at a 3.8 percent rate to certain investment income of individuals.²⁴⁴ The tax is imposed in addition to the income tax. Thus, for taxpayers subject to the NIIT, the maximum rate on certain capital gains and dividends is 23.8 percent (that is, 20 percent plus 3.8 percent), while the maximum rate on other investment income that is subject to ordinary rates, including interest, annuities, royalties, and rents, is 40.8 percent (that is, 37 percent plus 3.8 percent). The NIIT generally applies to certain capital gains and dividends, partnership income of a partner that is not subject to SECA tax, and income of an S corporation shareholder not active in the S corporation business.

SECA

SECA tax is imposed generally at a 3.8 percent rate on amounts above \$142,800 for 2021. (For amounts below or equal to \$142,800, the SECA tax rate is generally 3.8 percent plus 12.4 percent, or 16.2 percent²⁴⁵). The SECA tax applies to net earnings from self-employment,

performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners, or which involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities. Sec. 199A(d).

²⁴² Taxable income is computed without regard to the deduction allowable under section 199A with respect to the threshold amount.

²⁴³ Taxable income is computed without regard to the deduction allowable under section 199A and is reduced by net capital gain with respect to this limitation.

²⁴⁴ Sec. 1411. The NIIT generally applies to an individual partner's distributive share of partnership income and gains to which SECA does not apply (see sec. 1402(a)(1)-(17)) and to S corporation shareholders who are not active in the S corporation's business (as well as to certain other investment income). For individuals, the tax is imposed on the lesser of (i) net investment income or (ii) the excess of modified adjusted gross income ("AGI") over a threshold amount. Modified AGI is AGI 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). 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. Net investment income is the excess of (i) the sum of (a) gross income from interest, dividends, annuities, royalties, and rents (other than income derived in the ordinary course of any inapplicable trade or business), (b) other gross income derived from any applicable trade or business, and (c) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in an inapplicable trade or business over (2) deductions properly allocable to such gross income or net gain. The tax also applies to estates and certain trusts.

²⁴⁵ Sec. 1401. The SECA tax applies at a rate of 12.4 percent on net earnings from self-employment up to the FICA wage base (\$142,800 for 2021), plus an additional hospital insurance ("HI") tax at 3.8 percent (i.e., the sum of 2.9 percent plus 0.9 percent). The HI tax is not limited to the FICA wage base, but applies to any amount of

taking into account allowable deductions, derived from any trade or business carried on by an individual, including as a sole proprietor.²⁴⁶ A partner in a partnership is subject to SECA tax on the distributive share of income or loss from the partnership's trade or business, subject to enumerated exceptions.²⁴⁷ The SECA tax generally does not apply to an S corporation's pro rata share of S corporation income.²⁴⁸

All-in rates on distributed corporate income and on passthrough income

The all-in rate on distributed corporate income can be higher than the 20-percent top marginal income tax rate applicable to the individual shareholder receiving a qualified dividend, due to the imposition of the 21-percent corporate income tax in addition to shareholder-level tax. The all-in rate on passthrough income taxed to an individual can be lower than the 37-percent top marginal income tax rate on ordinary income of individuals, due to the 20-percent deduction for qualified business income. For distributed corporate income and for passthrough income, the NIIT or the SECA tax, generally at a 3.8 percent rate, may also apply to increase the all-in Federal tax rate.

net earnings from self-employment. Secs. 1401 and 1402(b). For purposes of calculating an all-in rate for income subject to SECA, it is assumed that the relevant income exceeds \$142,800, and therefore the rate of 3.8 percent is used in this discussion.

²⁴⁶ Sec. 1402(a).

²⁴⁷ Sec. 1402(a)(1)-(5), (10), and (13). The SECA exceptions for partners generally relate to certain rent, dividends, interest, gain from the sale or exchange of a capital asset or other property that is not stock in trade nor held for sale to customers, certain retirement income of a partner, and the distributive share of a limited partner that is not a guaranteed payment for services.

²⁴⁸ An S corporation shareholder is, however, subject to employment tax on wages received from the S corporation. Secs. 3101, 3102, and 3121.

D. The Estate, Gift, and Generation-Skipping Transfer Taxes

This section describes the Federal wealth transfer taxes, which include the gift tax, the estate tax and the generation-skipping transfer tax. These taxes are imposed on individual taxpayers.²⁴⁹ A gift tax is imposed on certain lifetime transfers, and an estate tax is imposed on certain transfers at death. A generation-skipping transfer tax generally is imposed on transfers, either directly or in trust or through similar arrangement, to a “skip person” (*i.e.*, a beneficiary in a generation more than one generation younger than that of the transferor).

The first subsection below describes several common features of the estate, gift, and generation-skipping transfer taxes. The subsections that follow describe each of the three taxes in greater detail.

1. Common features of the estate, gift and generation-skipping transfer taxes

Unified credit (exemption) and tax rates

The gift and estate taxes are unified such that a single graduated rate schedule and exemption apply to an individual’s cumulative taxable gifts and bequests. The unified estate and gift tax rates begin at 18 percent on the first \$10,000 in cumulative taxable transfers and reach 40 percent on cumulative taxable transfers over \$1,000,000. A unified credit of \$4,625,800 (for 2021) is available with respect to taxable transfers by gift or at death. This credit effectively exempts a total of \$11.7 million (for 2021)²⁵⁰ in cumulative taxable transfers from the gift tax or the estate tax. The unified credit thus also has the effect of rendering the marginal rates below 40 percent inapplicable. Any unused exemption amount 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. Table 11, below, summarizes the estate and gift tax rates and exemption amounts in effect for 1977 through 2021.²⁵¹

The generation-skipping transfer tax is imposed using a flat rate equal to the highest estate tax rate (40 percent). Tax is imposed on cumulative generation-skipping transfers in excess of the generation-skipping transfer tax exemption amount in effect for the year of the transfer. The generation-skipping transfer tax exemption is equal to the estate tax exemption amount in effect for the year (currently \$11.7 million).

²⁴⁹ A transfer to a corporation is sometimes treated as a gift to the shareholders of the corporation. A transfer from a corporation is sometimes treated as a gift made by the shareholders of the corporation. Treas. Reg. sec. 25.2511-1(h)(1).

²⁵⁰ Rev. Proc. 2020-45, I.R.B. 2020-46, p. 1024. Section 2010(c)(3) sets the basic exclusion amount at \$5 million and indexes this amount for inflation for calendar years after 2011. For decedents dying and gifts made after December 31, 2017, and before January 1, 2026, the \$5 million base-year figure is temporarily increased to \$10 million. For decedents dying and gifts made in 2021, the inflation-indexed exemption is \$11.7 million.

²⁵¹ In 2004 through 2009, although the estate tax exemption exceeded \$1 million, the gift tax exemption remained at \$1 million.

Table 11.—Estate and Gift Tax Rates and Exemption Amounts, 1977-2021

Year	Annual gift exclusion per donee single/joint	Exemption value of unified credit	Threshold of highest statutory tax rate ¹	Highest statutory tax rate (percent)
1977	\$3,000/\$6,000	\$120,667	\$5 million	70
1982	\$10,000/\$20,000	\$225,000	\$4 million	65
1983	\$10,000/\$20,000	\$275,000	\$3.5 million	60
1984	\$10,000/\$20,000	\$325,000	\$3 million	55
1985	\$10,000/\$20,000	\$400,000	\$3 million	55
1986	\$10,000/\$20,000	\$500,000	\$3 million	55
1987	\$10,000/\$20,000	\$600,000	\$3 million	55 ²
1998	\$10,000/\$20,000	\$625,000	\$3 million	55 ²
1999	\$10,000/\$20,000	\$650,000	\$3 million	55 ²
2000	\$10,000/\$20,000	\$675,000	\$3 million	55 ²
2002	\$11,000/\$22,000	\$1 million	\$2.5 million	50
2003	\$11,000/\$22,000	\$1 million	\$2 million	49
2004	\$11,000/\$22,000	\$1.5 million	\$2 million	48
2005	\$11,000/\$22,000	\$1.5 million	\$2 million	47
2006	\$12,000/\$24,000	\$2 million	\$2 million ¹	46
2007	\$12,000/\$24,000	\$2 million	\$1.5 million ¹	45
2009	\$13,000/\$26,000	\$3.5 million	\$1.5 million ¹	45
2010	\$13,000/\$26,000	\$5 million	\$500,000 ¹	35 ³
2012	\$13,000/\$26,000	\$5.12 million	\$500,000 ¹	35
2013	\$14,000/\$28,000	\$5.25 million	\$1 million ¹	40
2014	\$14,000/\$28,000	\$5.34 million	\$1 million ¹	40
2015	\$14,000/\$28,000	\$5.43 million	\$1 million ¹	40
2016	\$14,000/\$28,000	\$5.45 million	\$1 million ¹	40
2017	\$14,000/\$28,000	\$5.49 million	\$1 million ¹	40
2018	\$15,000/\$30,000	\$11.18 million	\$1 million ¹	40
2019	\$15,000/\$30,000	\$11.4 million	\$1 million ¹	40
2020	\$15,000/\$30,000	\$11.58 million	\$1 million ¹	40
2021	\$15,000/\$30,000	\$11.7 million	\$1 million ¹	40

¹ Because the exemption amount in later years equals or exceeds the threshold for the highest tax rate, transfers that equal or are in excess of the exemption amount generally are subject to a flat tax at the highest marginal rate.

² From 1987 through 1997, the benefits of the graduated rate structure and unified credit were phased out at a 5-percent rate for estates between \$10,000,000 and \$21,040,000, creating an effective marginal tax rate of 60 percent for affected estates (with a \$600,000 unified credit). The Taxpayer Relief Act of 1997 provided for gradual increases in the unified credit from \$625,000 in 1998 to \$1 million in 2006 and thereafter. A conforming amendment made to the 5-percent surtax continued to phase out the benefit of the graduated rates, but the benefit of the unified credit was no longer phased out.

³ For decedents dying in 2010, executors were permitted to elect not to have the estate subject to estate tax. Heirs who acquire assets from an electing decedent's estate, however, took a modified carry over basis determined under then-section 1022 of the Code, instead of a stepped-up basis determined under section 1014 of the Code.

Transfers between spouses

A 100-percent marital deduction generally is permitted for the value of property transferred between spouses.²⁵² In addition, transfers of “qualified terminable interest property” are eligible for the marital deduction. Qualified terminable interest property is property: (1) that passes from the decedent, (2) in which the surviving spouse has a “qualifying income interest for life,” and (3) to which an election under these rules applies. A qualifying income interest for life exists if: (1) the surviving spouse is entitled to all the income from the property (payable annually or at more frequent intervals) or has the right to use the property during the spouse’s life, and (2) no person has the power to appoint any part of the property to any person other than the surviving spouse.

Transfers to charity

Contributions to charitable and certain other organizations may be deducted from the value of a gift or from the value of the assets in an estate for Federal gift or estate tax purposes.²⁵³ For estate tax purposes, the charitable deduction is limited to the value of the transferred property that is required to be included in the gross estate.²⁵⁴ A charitable contribution of a partial interest in property, such as a remainder or future interest, generally is not deductible for gift or estate tax purposes.²⁵⁵ Unlike the income tax charitable deduction, there are no percentage limits on deductible charitable contributions for gift or estate tax purposes.²⁵⁶

2. The estate tax

Overview

The Code imposes a tax on the transfer of the taxable estate of a decedent who is 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.²⁵⁷ The taxable estate is determined by deducting from the value of the decedent’s gross estate any

²⁵² Secs. 2056 and 2523. A marital deduction generally is denied for property passing to a surviving spouse who is not a U.S. citizen. A marital deduction is permitted, however, for property passing to a qualified domestic trust of which the noncitizen surviving spouse is a beneficiary. A qualified domestic trust is a trust that has as its trustee at least one U.S. citizen or U.S. corporation. No corpus may be distributed from a qualified domestic trust unless the U.S. trustee has the right to withhold any estate tax imposed on the distribution. Tax is imposed on (1) any distribution from a qualified domestic trust before the date of the death of the noncitizen surviving spouse and (2) the value of the property remaining in a qualified domestic trust on the date of death of the noncitizen surviving spouse. The tax is computed as an additional estate tax on the estate of the first spouse to die.

²⁵³ Secs. 2055 and 2522.

²⁵⁴ Sec. 2055(d).

²⁵⁵ Secs. 2055(e)(2) and 2522(c)(2).

²⁵⁶ Sec. 170(b).

²⁵⁷ Secs. 2001(a) and 2101(a).

deductions provided for in the Code. After applying tax rates to determine a tentative amount of estate tax, certain credits are subtracted to determine the final estate tax liability.

Gross estate

A decedent's gross estate includes, to the extent provided for in the Code, the date-of-death value of all of a decedent's property, real or personal, tangible or intangible, wherever the property is situated.²⁵⁸ In general, the value of property for this purpose is the fair market value of the property as of the date of the decedent's death, although an executor may elect to value certain property as of an alternate valuation date.²⁵⁹

The gross estate includes property directly owned by the decedent and other property in which the decedent had a beneficial interest at the time of his or her death.²⁶⁰ The gross estate also includes certain property transferred by the decedent prior to his or her death, including: (1) certain gifts made within three years prior to the decedent's death;²⁶¹ (2) certain transfers of property in which the decedent retained a life estate;²⁶² (3) certain transfers taking effect at death;²⁶³ and (4) revocable transfers.²⁶⁴ In addition, the gross estate includes property with respect to which the decedent had, at the time of death, a general power of appointment (generally, the right to determine who will have beneficial ownership).²⁶⁵ The value of a life insurance policy on the decedent's life is included in the gross estate if the proceeds are payable to the decedent's estate or if the decedent had incidents of ownership with respect to the policy at the time of his or her death.²⁶⁶

The rules for determining whether an asset is included in a taxpayer's gross estate differ in some respects from the rules for determining whether a taxpayer is treated as the owner of an asset for income tax purposes. Thus, for example, a taxpayer may be treated as owning an asset for income tax purposes that is not included in the grantor's gross estate for estate tax purposes.

²⁵⁸ Sec. 2031(a).

²⁵⁹ Sec. 2032. In general, the alternate valuation date is the date that is six months after the decedent's death, except that property distributed, sold, exchanged, or otherwise disposed of within six months after the decedent's death is valued as of the date of the distribution, sale, exchange, or other disposition.

²⁶⁰ Sec. 2033.

²⁶¹ Sec. 2035.

²⁶² Sec. 2036.

²⁶³ Sec. 2037.

²⁶⁴ Sec. 2038.

²⁶⁵ Sec. 2041.

²⁶⁶ Sec. 2042.

Deductions from the gross estate

A decedent's taxable estate is determined by subtracting from the value of the gross estate any deductions provided for in the Code. As described above, the value of property transferred to a surviving spouse or to charity generally is deducted from the gross estate in arriving at the taxable estate; as a result, bequests to a surviving spouse or to charity generally are permitted without imposition of an estate tax. An estate tax deduction also is permitted for death taxes (e.g., any estate, inheritance, legacy, or succession taxes) actually paid to any State or the District of Columbia, in respect of property included in the gross estate of the decedent.²⁶⁷ A deduction is available for any funeral expenses, estate administration expenses, and claims against the estate, including certain taxes.²⁶⁸ Finally, a deduction is available for uninsured casualty and theft losses incurred during the settlement of the estate.²⁶⁹

Credits against tax

After accounting for allowable deductions, a gross amount of estate tax is computed. Estate tax liability is then determined by subtracting allowable credits from the gross estate tax.

The most significant credit allowed for estate tax purposes is the unified credit, which is discussed in greater detail above.²⁷⁰ For 2021, the value of the unified credit is \$4,625,800, which has the effect of exempting \$11.7 million in transfers from tax. The unified credit available at death is reduced by the amount of unified credit used to offset gift tax on gifts made during the decedent's life.

Estate tax credits also are allowed for: (1) gift tax paid on certain pre-1977 gifts (before the estate and gift tax computations were integrated);²⁷¹ (2) estate tax paid on certain prior transfers (to limit the estate tax burden when estate tax is imposed on transfers of the same property in two estates by reason of deaths in rapid succession);²⁷² and (3) certain foreign death taxes paid (generally, where the property is situated in a foreign country but included in the decedent's U.S. gross estate).²⁷³

²⁶⁷ Sec. 2058. Such State taxes must have been paid and claimed before the later of: (1) four years after the filing of the estate tax return; or (2) (a) 60 days after a decision of the U.S. Tax Court determining the estate tax liability becomes final, (b) the expiration of the period of extension to pay estate taxes over time under section 6166, or (c) the expiration of the period of limitations in which to file a claim for refund or 60 days after a decision of a court in which such refund suit has become final.

²⁶⁸ Sec. 2053.

²⁶⁹ Sec. 2054.

²⁷⁰ Sec. 2010.

²⁷¹ Sec. 2012.

²⁷² Sec. 2013.

²⁷³ Sec. 2014. In certain cases, an election may be made to deduct foreign death taxes. See sec. 2053(d).

Rules for small and family-owned businesses and farms

Special-use valuation

An executor may elect to value for estate tax purposes certain “qualified real property” used in farming or another qualifying closely-held trade or business at its current-use value rather than its fair market value.²⁷⁴ The maximum reduction in value for such real property is \$750,000 (adjusted for inflation occurring after 1997; the inflation-adjusted amount for 2021 is \$1,190,000²⁷⁵). In general, real property qualifies for special-use valuation only if (1) at least 50 percent of the adjusted value of the decedent’s gross estate (including both real and personal property) consists of a farm or closely-held business property in the decedent’s estate and (2) at least 25 percent of the adjusted value of the gross estate consists of farm or closely held business real property. In addition, the property must be used in a qualified use (*e.g.*, farming) by the decedent or a member of the decedent’s family for five of the eight years before the decedent’s death.

If, after a special-use valuation election is made, the heir who acquired the real property ceases to use it in its qualified use within 10 years of the decedent’s death, an additional estate tax is imposed to recapture the entire estate-tax benefit of the special-use valuation.

Installment payment of estate tax for closely held businesses

Under present law, the estate tax generally is due within nine months of a decedent’s death. However, an executor generally may elect to pay estate tax attributable to an interest in a closely held business in two or more installments (but no more than 10).²⁷⁶ An estate is eligible for payment of estate tax in installments if the value of the decedent’s interest in a closely held business exceeds 35 percent of the decedent’s adjusted gross estate (*i.e.*, the gross estate less certain deductions). If the election is made, the estate may defer payment of principal and pay only interest for the first five years, followed by up to 10 annual installments of principal and interest. This provision effectively extends the time for paying estate tax by 14 years from the original due date of the estate tax.²⁷⁷

²⁷⁴ Sec. 2032A.

²⁷⁵ Rev. Proc. 2020-45, I.R.B. 2020-46, p. 1024.

²⁷⁶ Sec. 6166.

²⁷⁷ A special two-percent interest rate applies to the amount of deferred estate tax attributable to the first \$1 million (adjusted annually for inflation occurring after 1998; the inflation-adjusted amount for 2021 is \$1,590,000) in taxable value of a closely held business. Rev. Proc. 2020-45, I.R.B. 2020-46, p. 1024. The interest rate applicable to the amount of estate tax attributable to the taxable value of the closely held business in excess of \$1 million (adjusted for inflation) is equal to 45 percent of the rate applicable to underpayments of tax under section 6621 of the Code (*i.e.*, 45 percent of the Federal short-term rate plus three percentage points). The interest rate on this portion adjusts with the Federal short-term rate. Interest paid on deferred estate taxes is not deductible for estate or income tax purposes.

3. The gift tax

Overview

The Code imposes a tax for each calendar year on the transfer of property by gift during such year by any individual, whether a resident or nonresident of the United States.²⁷⁸ The gift tax is imposed on the donor. As with the estate tax, the gift tax generally applies to citizens and residents of the United States and applies to nonresident aliens in certain limited cases.

The amount of an individual's taxable gifts for a calendar year is determined by subtracting from the total amount of gifts made during the year: (1) the gift tax annual exclusion (described below); and (2) allowable deductions. The gift tax for the current taxable year is then determined by: (1) computing a tentative tax on the combined amount of all taxable gifts for the current and all prior calendar years using the common gift tax and estate tax rate table; (2) computing a tentative tax only on all prior-year gifts; (3) subtracting the tentative tax on prior-year gifts from the tentative tax computed for all years to arrive at the portion of the total tentative tax attributable to current-year gifts; and (4) subtracting the amount of unified credit not consumed by prior-year gifts.

Transfers by gift

The gift tax applies to a transfer by gift regardless of whether: (1) the transfer is made outright or in trust; (2) the gift is direct or indirect; or (3) the property is real or personal, tangible or intangible.²⁷⁹ For gift tax purposes, the value of a gift of property is the fair market value of the property at the time of the gift.²⁸⁰ Where property is transferred for less than full consideration, the amount by which the value of the property exceeds the value of the consideration is considered a gift and is included in computing the total amount of a taxpayer's gifts for a calendar year.²⁸¹

For a gift to occur, a donor generally must relinquish dominion and control over donated property. For example, if a taxpayer transfers assets to a trust established for the benefit of his or her children, but retains the right to revoke the trust, the taxpayer may not have made a completed gift, because the taxpayer has retained dominion and control over the transferred assets. A completed gift made in trust generally is treated as a gift to the trust beneficiaries.

Certain transfers for medical and education purposes are not treated as transfers by gift for gift tax purposes.²⁸² In addition, the gift tax does not apply transfers to section 527 political

²⁷⁸ Sec. 2501(a). Nonresident aliens are subject to the gift tax with respect to transfers of tangible real or personal property if the property is located in the United States at the time of the gift.

²⁷⁹ Sec. 2511(a).

²⁸⁰ Sec. 2512(a).

²⁸¹ Sec. 2512(b); Rev. Proc. 2020-45, I.R.B. 2020-46, p. 1024.

²⁸² Sec. 2503(e).

organizations or to tax-exempt organizations described in section 501(c)(4), (5), or (6) of the Code.²⁸³

Taxable gifts

As stated above, the amount of a taxpayer's taxable gifts for the year is determined by subtracting from the total amount of the taxpayer's gifts for the year the gift tax annual exclusion and any available deductions.

Gift tax annual exclusion

Under present law, donors of lifetime gifts are provided an annual exclusion of \$15,000 per donee in 2021 (indexed for inflation from the 1997 annual exclusion amount of \$10,000) for gifts of present interests in property during the taxable year.²⁸⁴ If the non-donor spouse consents to split the gift with the donor spouse, then the annual exclusion is \$30,000 per donee in 2021.

Marital and charitable deductions

As described above, transfers to a spouse or to charity generally are deductible for gift tax purposes. As a result, transfers between spouses or to charity generally are permitted without imposition of a gift tax.

4. The generation-skipping transfer tax

A generation-skipping transfer tax generally is imposed (in addition to the gift tax or the estate tax) on certain transfers, either directly or in trust or similar arrangement, to a "skip person" (e.g., a beneficiary in a generation more than one generation below that of the transferor).²⁸⁵ As with the estate and gift taxes, it generally applies to citizens and residents of the United States and may apply to nonresident aliens in certain limited cases.

Exemption and tax rate

A lifetime exemption generally equal to the estate tax exemption (\$11.7 million for 2021) is provided for each person making generation-skipping transfers.²⁸⁶ The exemption may be allocated by the taxpayer (or his or her executor) to transferred property, and in some cases is automatically allocated. Allocation of the generation-skipping transfer tax exemption effectively reduces the tax rate on a generation-skipping transfer.

The tax rate on generation-skipping transfers is a flat rate of tax equal to the maximum estate tax rate (40 percent) multiplied by the "inclusion ratio." The inclusion ratio is one minus

²⁸³ Sec. 2501(a)(4) & (6).

²⁸⁴ Sec. 2503(b).

²⁸⁵ Sec. 2601, *et seq.*

²⁸⁶ Sec. 2631.

the applicable fraction. The applicable fraction is the amount of exemption allocated to a trust (or to a direct skip) divided by the value of assets transferred.²⁸⁷

If, for example, a taxpayer transfers \$5 million in property to a trust and allocates \$5 million of exemption to the transfer, the inclusion ratio is zero (1 minus (\$5 million/\$5 million)), and the applicable tax rate on any subsequent generation-skipping transfers from the trust is zero percent (40 percent multiplied by the inclusion ratio of zero). If the taxpayer instead allocates \$2.5 million of exemption to the \$5 million transfer, the inclusion ratio is 0.5 (1 minus (\$2.5 million/\$5 million)), and the applicable tax rate on any subsequent generation-skipping transfers from the trust is 20 percent (40 percent multiplied by the inclusion ratio of 0.5). If the taxpayer allocates no exemption to a transfer in trust, the inclusion ratio is one, and the applicable tax rate on any subsequent generation-skipping transfers from the trust is 40 percent (40 percent multiplied by the inclusion ratio of one).

Generation-skipping transfers

The generation-skipping transfer tax generally is imposed at the time of a generation-skipping transfer – a direct skip, a taxable termination, or a taxable distribution.²⁸⁸

A direct skip is any transfer subject to estate or gift tax of an interest in property to a skip person.²⁸⁹ A skip person may be a natural person or may be certain trusts. All persons assigned to the second or more remote generation below the transferor's generation are skip persons (e.g., grandchildren and great-grandchildren). Trusts are skip persons if (1) all interests in the trust are held by skip persons, or (2) no person holds an interest in the trust and at no time after the transfer may a distribution (including distributions and terminations) be made to a non-skip person.²⁹⁰

A taxable termination is a termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, immediately after such termination, a non-skip person has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person.²⁹¹

A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination or direct skip). If a transferor allocates generation-skipping transfer tax exemption to a trust prior to the taxable distribution, generation-skipping transfer tax may be avoided.²⁹²

²⁸⁷ Sec. 2642(a).

²⁸⁸ Sec. 2611.

²⁸⁹ Sec. 2612(c).

²⁹⁰ Sec. 2613.

²⁹¹ Sec. 2612(a).

²⁹² Sec. 2612(b).

III. DISCUSSION

Potential changes to the taxation of individuals' income or wealth could range from changes to rates and rules within the current system to broader overhauls that fundamentally change how certain activities are taxed or introduce a new base on which to impose a tax. Consistent with this document's focus on taxation of high income and high wealth taxpayers, this discussion describes and analyzes proposals that may affect the progressivity of the Code. This section organizes these proposals into three broad categories of the types of taxes they propose, (1) income tax, (2) wealth tax, and (3) wealth transfer tax, and describes the proposals, explores the various trade-offs between them, and discusses their potential efficiency and administrative consequences.

A. Income Tax Proposals

Individual income tax rates

The individual income tax system can be made more progressive by making changes to the tax rates and the rate brackets.²⁹³ Under present law, the highest marginal tax rate is 37 percent, which for 2021 applies to income above a range for individuals from \$314,150 (for married filing separately taxpayers) to \$628,300 (for married filing jointly taxpayers), and for income above \$13,050 for trusts and estates. Some have proposed to increase the highest marginal rate, either at the same income thresholds or for specified higher thresholds to increase progressivity. Alternatively, or in conjunction, rate thresholds could be lowered so that more income is subject to tax at the highest rates.

Administratively, these changes are relatively straightforward and would mostly require changes in forms and calculations of income tax (using the same base). An issue with this approach is that not everything included in a broad income measure is subject to income taxation and certain categories of income may be subject to preferential rates as under present law.²⁹⁴

Increasing tax on income may also affect labor supply and growth in the economy by reducing the after-tax return to labor. A reduction in the after-tax return to labor may reduce the incentive for individuals to work. Partially offsetting this effect, increases in taxes reduce after-tax income and provide an incentive to work more to replace the lost income. This can have two effects on economic output. First, reductions in labor supply lead to reductions in economic output (holding average labor productivity constant). Second, a tax on labor may reduce economic output indirectly by distorting work effort and occupational choice (lowering average

²⁹³ Expansions in refundable credits also increase progressivity as they function as negative income tax rates. David Splinter, "Who Pays No Tax? The Declining Fraction Paying Income Taxes and Increasing Tax Progressivity," *Contemporary Economic Policy*, vol. 37, July 2019, pp. 413-426.

²⁹⁴ For example, for discussion of whether carried interests are a form of compensation for services or income or gain from capital see Joint Committee on Taxation, *Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests* (JCX-41-07), July 10, 2007 or Joint Committee on Taxation, *Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part I* (JCX-62-07), September 4, 2007. For some other deviations from a broad concept of income in present law see Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2020-2024* (JCX-23-20), November 5, 2020.

labor productivity). A large economics literature has studied the effect of taxes on hours worked,²⁹⁵ while fewer studies have been conducted on the effect of taxes on work effort and occupational choice.²⁹⁶ A number of studies separately identify the effect of taxes on the hours worked by those individuals who are already employed (the “intensive margin” or “hours margin”), and the effect of taxes on the decision to work or not (the “extensive margin” or “participation margin”). Responses on both the intensive and extensive margins affect the amount of labor supplied in the economy.

Most empirical studies find that the labor supply decisions of low-income individuals are generally more responsive to taxes than the labor supply decisions of high-income individuals.²⁹⁷ Additionally, as tax rates vary across geographic location, individuals may decide not to alter the amount of labor supplied, but rather may alter the location of that labor. Some research has empirically explored migration, both within and across countries, as another response of high-income individuals to individual taxation.²⁹⁸

Taxation of capital income

Under present law, the corporate income tax rate is a 21 percent flat rate. Some have proposed to raise this rate, either for all income or income above a certain threshold using a progressive rate structure.

As shown in the data section above, a large share of corporate ownership and income from corporate stock accrues to those with high wealth and high income respectively. If a

²⁹⁵ See Joint Committee on Taxation, *Economic Growth and Tax Policy* (JCX-19-17), May 16, 2017 for a summary.

²⁹⁶ Research on the responsiveness of taxable income to changes in tax rates partly accounts for the possible distortions of tax on work effort and occupational choice, to the extent that taxable income is determined by work effort and occupational choice. For example, if individual income tax rates are lowered, and work effort increases without any change in hours worked, that may increase the amount of income a worker receives (e.g., bonuses) but does not affect hours worked (i.e., labor supply). However, observed changes in taxable income as a result of changes in tax rates are not solely attributable to changes in work effort. An additional behavioral response is often for taxpayers to shift income into a form that is taxed more favorably. For a discussion of the literature on responsiveness of taxable income to changes in tax rates, as well as the limitations in this line of research, see Emmanuel Saez, Joel Slemrod, and Seth H. Giertz, “The Elasticity of Taxable Income with Respect to Marginal Tax Rates: A Critical Review,” *Journal of Economic Literature*, vol. 50, March 2012, pp. 3-50, and Gerald Auten, David Splinter, and Susan Nelson, “Reactions of High-Income Taxpayers to Major Tax Legislation,” *National Tax Journal*, vol. 69, December 2016, pp. 935-964.

²⁹⁷ Robert McClelland and Shannon Mok, “A Review of Recent Research on Labor Supply Elasticities,” *Congressional Budget Office Working Paper* 2012-12, October 2012.

²⁹⁸ These studies generally pertain to specific groups, such as inventors or football (soccer) players, where detailed migration data is available, but often find a sizeable response, at least among foreigners, to personal income taxes. See Ufuk Akcigit, Salome Baslandze, and Stephanie Stantcheva, “Taxation and the International Mobility of Inventors,” *American Economic Review*, vol. 106, October 2017, pp. 2930-2981 and Henrik Kleven, Camille Landais, and Emmanuel Saez, “Taxation and International Migration of Superstars: Evidence from the European Football Market,” *American Economic Review*, vol. 103, August 2013, pp. 1892-1924. For an overview of recent work see Henrik Kleven, Camille Landais, Mathilde Munoz, and Stefanie Stantcheva, “Taxation and Migration: Evidence and Policy Implications,” *Journal of Economic Perspectives*, vol. 34, Spring 2020, pp. 119-142.

substantial portion of the burden of the corporate income tax is borne by the owners of capital, then increasing the corporate income tax would raise taxes relatively more from taxpayers with high wealth and high income, thus potentially serving a purpose to increase the progressivity of the U.S. tax system. Although the corporate rate has interactions with many corporate tax provisions (for example modifying the economic value of deductions and accelerated depreciation), such a change could be viewed as relatively simple administratively as it does not fundamentally alter the U.S. corporate income tax system.

Increasing the tax on capital presents certain economic issues related to both fairness and efficiency. In particular, while economic analysis concludes that in the long run owners of domestic capital are more easily able to escape some of the burden of the tax such that a tax on capital is at least partially passed on to labor, there is no consensus among economists on the extent to which the incidence of taxes on the income from capital is borne by owners of capital in the form of reduced returns, or whether reduced returns cause investors to save less and provide less capital to workers, thereby reducing wages in the long run.²⁹⁹ The degree to which incidence of a tax on capital is borne by workers may alter the progressivity of such a tax. In other words, although the owners of capital and recipients of capital income may be the wealthy or high income, some of the burden of an increased tax on capital may be borne by workers lower in the income distribution.

The extent to which individuals respond to increases (or decreases) in the after-tax return to investments by decreasing (or increasing) their savings also relates to the efficiency of a tax on capital. Again, there is no consensus in either the empirical or theoretical economics literature regarding the responsiveness of saving to after-tax returns on investment. However, the savings response matters in considering what effect an increase in tax on capital might have on the growth of the economy.

For noncorporate business income, modifying the qualified business income deduction has also been considered. A reduction in the generosity of the deduction, or its repeal, may be a relatively progressive change to the U.S. tax system. Recent distributional estimates suggest that much of the benefit of the deduction accrues to high-income households.³⁰⁰

In general, the deduction for qualified business income reduces effective tax rates on passthrough business income relative to other forms of income. This may create some horizontal inequity, as the deduction creates a preference for passthrough business income relative to wage income. This may also create a preference for income that is from passthrough businesses other than ineligible service businesses or other ineligible businesses.

²⁹⁹ For a discussion of economic incidence of capital taxes in the context of taxes on business income, see Joint Committee on Taxation, *Modeling the Distribution of Taxes on Business Income* (JCX-14-13), October 16, 2013. The Joint Committee staff assumes that 25 percent of corporate income taxes are borne by domestic labor and 75 percent are borne by owners of domestic capital.

³⁰⁰ While some restrictions apply for qualified business income of taxpayers with prededuction taxable income in excess of certain thresholds, the Joint Committee staff estimates that taxpayers with economic income of \$500,000 or above will claim nearly 50 percent of the dollar amount of the deduction for tax year 2021.

Proponents of the deduction argue that, as with the corporate rate and other deductions on business income, the deduction for qualified business income reduces the user cost of capital and thus may increase investment. Limited empirical research exists on the effect of preferential rates for passthrough business income.³⁰¹ Some preliminary work on the qualified business income deduction does not find much evidence of short-run responses.³⁰²

Some suggest that the complexity of the current rule may make compliance and administration difficult. Complicated rules about what income does and does not qualify and about limitations on the amount of the deduction may increase compliance costs for both the taxpayer and government.³⁰³

Taxation of capital gains

Other possible changes relate to the rules governing the taxation of capital gains or investment income. For example, some have proposed raising the highest marginal rate – currently 20 percent – imposed on long-term capital gains. Some have also considered changes to the treatment of collectible gains or unrecaptured section 1250 gain or increasing the rate of the NIIT, currently set at 3.8 percent.

Under the present-law system where capital gains are generally taxed upon disposition, there is a benefit to the taxpayer from deferral due to the time value of money. The nominal taxes paid at a later date are lower in real terms than those same amounts paid today. Some claim that the taxation of nominal gains ignores inflation and suggest that real gains should be taxed. In cases where the benefit of deferral outweighs the penalty of inflation, the disposition-based system for taxing capital gains can create a “lock-in” effect where taxpayers choose to hold property with built-in capital gain in response to the present-law rules permitting interest-free deferral of tax on gains.³⁰⁴ This effect may create inefficiencies if less productive investments are held rather than disposed of as a means of delaying tax consequences. This effect may also be exacerbated by step-up basis, which can allow the gains from assets held until death to escape tax entirely.

³⁰¹ Jason DeBacker, Lucas Goodman, Bradley T. Heim, Shanthi P. Ramnath, and Justin M. Ross, “Pass-Through Entity Responses to Preferential Tax Rates: Evidence on Economic Activity and Owner Compensation in Kansas,” *National Tax Journal*, vol. 71, December 2018, pp. 687-706, examine a 2012 income tax reform in Kansas affecting preferential rates on passthrough business income and find some effect on guaranteed payments to partners, but none on gross receipts, capital investment, or employment.

³⁰² Lucas Goodman, Katherine Lim e, Bruce Sacerdote, and Andrew Whitten, “How Do Business Owners Respond to a Taxcut? Examining the 199A Deduction for Pass-through Firms,” *NBER Working Paper* No. 28680, April 2021.

³⁰³ U.S. Department of the Treasury, Treasury Inspector General for Tax Administration, Results of the 2019 Filing Season, ref. no. 2020-44-07, January 22, 2020, p. 14 find a sizable number of 2018 returns that appear to qualify for but did not claim the deduction.

³⁰⁴ Analogously, losses may be accelerated as the real tax savings from losses diminish over time.

Within a system for taxation of capital gains where realization is largely defined as disposition, research finds that the sensitivity to changes in the capital gains rates is high.³⁰⁵ Typically the behavioral response to capital gains taxation is split into two categories: permanent responses to the change in the tax rate, and immediate, temporary responses to anticipated tax rate changes. Recent estimates suggest the permanent elasticity of capital gains is approximately -0.7, meaning a 10-percent increase in rates leads to a seven-percent reduction in capital gains income. The transitory elasticity is estimated to be in excess of -1.0, meaning a 10-percent increase in rates leads to a more than 10-percent reduction in capital gains income.³⁰⁶ Some have proposed increasing the tax rate on long-term net capital gains. These results suggest that absent other changes to the tax treatment of capital gain, the behavioral responses to an increase in the tax rate on capital gains may significantly lessen the revenue that would be raised if dispositions were held constant.

Mark-to-market taxation

As discussed above in section II.C.2, the Code currently contains provisions that calculate income using a mark-to-market approach. Those provisions target specific fact patterns: dealers and traders in securities and commodities, expatriating persons, certain derivatives, and marketable PFIC stock. Proposals to expand mark-to-market taxation may identify other specific fact patterns where mark-to-market rules solve a narrow policy problem, or may apply mark-to-market rules to capital assets broadly as a way to address distortions caused by the present-law system where realization is largely defined as disposition.

In terms of proposals to solve narrow policy problems, some have proposed replacing the Code's current patchwork approach to the taxation of derivatives³⁰⁷ with a single set of mark-to-market rules that apply to all derivatives.³⁰⁸ These proposals seek to address the fact that, under

³⁰⁵ See Tim Dowd, Robert McClelland, and Athiphat Muthitacharoen, "New Evidence on the Tax Elasticity of Capital Gains," *National Tax Journal*, vol. 68, no. 3, September, 2015, pp. 511-544; Sacz, Emanuel, "Taxing the Rich More: Preliminary Evidence from the 2013 Tax Increase," *Tax Policy and the Economy*, vol. 31, no. 1, 2017, pp. 71-120; and Gerald Auten, David Splinter, and Susan Nelson, "Reactions of High-Income Taxpayers to Major Tax Legislation," *National Tax Journal*, vol. 69, no. 4, December, 2016, pp. 935-964.

³⁰⁶ For a discussion recent research on taxpayer responses to capital gains tax rates and implications for Joint Committee staff revenue estimates, see Joint Committee on Taxation, *Estimating Taxpayer Bunching Responses to the Preferential Capital Gains Tax Rate Threshold* (JCX-42-19), September 10, 2019.

³⁰⁷ A derivative is a contract in which the amount of at least one contractual payment is calculated by reference to a later change in the value of something (or a combination of things), and includes options, forwards, futures, and swaps.

³⁰⁸ The Federal income tax laws governing taxation of derivatives are complex and inconsistent with one another. Timing and character rules with respect to various derivatives may differ depending on the type of derivative, (e.g., an option), the type of taxpayer entering into the derivative (e.g., a dealer in securities), the use of the derivative (e.g., as a hedge), the type of underlying (e.g., a foreign currency), how the derivative is traded (e.g., on a U.S. exchange), or the application of other overriding rules (e.g., the straddle rules). Further, derivatives or combinations of derivatives that are similar economically may be subject to different tax rules. For a more extensive discussion of issues raised by the present-law taxation of derivatives, see Joint Committee on Taxation, *Description of the Modernization of Derivatives Tax Act of 2017*, pp. 1-18, available at <https://www.finance.senate.gov/imo/media/doc/ICT%20Memo%20on%20MODA%202017.pdf>.

present law, economically similar but formally different derivatives and combinations of derivatives may be taxed differently, both in terms of the timing of inclusions of income on such derivatives and the character of such income. These differences may give sophisticated taxpayers some flexibility to elect the timing and character of income on their economic positions.

To address this issue, there have been proposals to provide a single timing rule – mark to market – and a single character rule – ordinary income – for all derivatives. These proposals grapple with several policy considerations, the foremost of which is defining the scope of financial contracts that should be subject to such a rule.³⁰⁹ On one hand, it may be preferable to cast a broad net if the goal is to avoid giving taxpayers the ability to design financial instruments that skirt the definition and allow a continuation of the issues that exist under present law. But on the other hand, it may be desirable to avoid a definition that is so broad that some taxpayers may hold derivatives subject to the rule without realizing it. Another consideration is whether to reform the straddle rules discussed above as part of the exercise, given that those rules have been criticized for being ambiguous in their application and would continue to be relevant in a world where derivatives are marked to market.³¹⁰

Other proposals would expand mark-to-market taxation to cover a significant subset of capital assets in the economy as part of an attempt to address distortions related to taxpayers' strategic timing of realizations of gains and losses caused by the present-law system where realization is largely defined as disposition.

Proposals in this area draw on commentary over the past few decades proposing taxation of some or all capital gains on a mark-to-market or accrual basis.³¹¹ Both the commentary and the proposals grapple with a number of policy issues.

One issue is which assets should be required to be marked to market, and what (if anything) should be done about assets that are not marked to market. Generally, the proposals limit mark-to-market treatment to assets that have publicly-ascertainable values; as one commentator notes, "it is widely agreed that mark-to-market taxation is impractical for assets that are not publicly traded because their market values cannot be accurately measured."³¹² For these assets, gains and losses would both be taken into account on an annual basis, as they

³⁰⁹ Section 59A(h)(4) provides the Code's only definition of "derivative." This definition could be maintained, expanded, or restricted in the context of a mark-to-market rule.

³¹⁰ In particular, there has been uncertainty around the "substantial diminution of loss" standard in section 1092(c)(2) for determining whether a taxpayer holds offsetting positions that would be subject to the timing rules of section 1092(a). To date, little guidance has been provided.

³¹¹ See, e.g., Alan Auerbach, "Reforming Capital Gains Taxation," *Tax Notes*, vol. 95, no. 112, June 11, 2012, p. 1400; Samuel D. Brunson, "Taxing Investors on a Mark-to-Market Basis," *Loyola University Law Review*, Vol. 43, 2010, pp. 507-550; David S. Miller, "A Progressive System of Mark-to-Market Taxation," *Tax Notes*, vol. 121, Oct. 13, 2008, pp. 213-218; Alan D. Viard, "Moving Away from the Realization Principle," *Tax Notes*, vol. 145, no. 7, Nov. 17, 2014, p. 852.

³¹² Alan D. Viard, "Moving Away from the Realization Principle," *Tax Notes*, vol. 145, no. 7, Nov. 17, 2014, p. 852.

accrue. For assets that are not marked to market because they are not easily valued (e.g., stock in a closely-held corporation and non-publicly-traded partnership interests), some proposals impose an additional tax on disposition that is intended to account for the value of deferral as a way of reducing the economic difference between the taxation of marked and non-marked assets.³¹³ The design of such a “deferral charge” creates its own set of issues, including what interest rate to use and the proper treatment of losses.³¹⁴ With regard to the latter issue, one approach could be for the government to pay a deferral charge on losses that mimics the deferral charge paid by taxpayers on gains, but concerns about timing and valuation could support other approaches.

Another issue in the design of such a system is which taxpayers should be subject to the mark-to-market or accrual regime. Some proposals would apply mark to market to all taxpayers on the premise that mark to market provides a more accurate measure of income than disposition-based realization and reduces distortions associated therewith, and therefore should be applied to all taxpayers. Other proposals limit application to high-income or high-wealth taxpayers, leaving the present-law disposition-based system in place for taxpayers not meeting those standards, perhaps on the theory that a hybrid system is more progressive than requiring all taxpayers to mark. Taking that approach raises two sets of additional related issues: (1) how to manage taxpayers’ inevitable movement across any threshold for application of the regime; and (2) what (if anything) to do about potential distortions related to taxpayers’ desire not to be subject to the regime.

Another question is what to do about capital assets held by entities – e.g., C corporations, S corporations, and partnerships. While ownership interests in entities may be subject to mark to market or a deferral charge on disposition, those entities themselves may hold capital assets, and proposals must address the extent to which such holdings are also subject to the regime. This issue may be particularly significant with regard to passthrough entities, where the income of the entity passes through to the owners, and some owners may be subject to the regime while others are not.

Another issue is how to transition from present law to the mark-to-market or accrual regime. Taxpayers subject to the regime may hold assets with built-in gain or loss at the time the regime goes into effect, which raises the question of how (e.g., when, over what time period, and at what rate) such pre-regime built-in gain or loss is taxed.

Mark-to-market taxation may be viewed as complimentary to proposals that raise capital gains rates. As discussed above, increasing capital gains rates under the present-law tax system may lead to timing responses that could greatly lower the revenue from implementing such a rate change. However, mark-to-market taxation would largely eliminate the effectiveness of timing

³¹³ See, e.g., Alan Auerbach, “Retrospective Capital Gains Taxation” *American Economic Review*, vol. 81, March 1991, pp. 167-178. For an example of how such a system might be designed to eliminate the lock-in effect, see, e.g., James Kwak, “Reducing Inequality with a Retrospective Tax on Capital,” *Cornell Journal of Law and Public Policy*, vol. 25, Fall 2015, pp. 191-244.

³¹⁴ Under present law, where gain and loss are calculated on disposition, use of losses is restricted in various ways to address concerns about improper acceleration of losses. See, e.g., secs. 267, 1091, and 1211. Depending on the design of a deferral charge system, these same concerns may or may not continue to be present with regard to non-marked assets, albeit likely to a lesser degree than under present law.

responses with respect to assets to which it applies, since tax would be owed even without disposition.

An increase in tax on capital gains, whether through a rate increase, mark-to-market regime, or both, is also an increase in taxation on capital, so considerations relating to incidence and savings behavior, as discussed above, would also apply to these changes.

Implement a deemed realization system for gifts and bequests

Some have proposed a “deemed realization” system under which a transfer of property at death and/or by gift is treated as a sale of the property.³¹⁵ Under such proposals, the donor of a lifetime gift realizes and recognizes gain at the time of a gift, the deceased owner of an asset realizes and recognizes gain at the time an asset is bequeathed to an heir or to another beneficiary, or both. The gain is the excess of the fair market value of the asset on the date of the gift or bequest over the donor or decedent’s adjusted basis in the asset. The gain is taxable to a donor of a lifetime gift in the year the gift is made and to a decedent on the decedent’s final individual income tax return. The rules may also allow for realization and recognition of losses.

A deemed realization system might exempt or include preferential rules for gifts or bequests to a spouse or to charity. The system might also provide exemptions for a limited dollar amount of gain or for certain lower-value items of tangible personal property. Finally, the system might include special rules to address concerns about liquidity for gain realized on a deemed sale of a business interest or other illiquid asset.

Certain other countries, including Canada and Australia, tax gains on transfers at death or by gift. These countries employ a deemed realization approach as a primary method of taxing transfers of wealth; they do not impose separate, additional taxes on transfers of wealth, such as estate or inheritance taxes.

Some argue that enacting a deemed realization system is necessary to restore fairness to the U.S. tax system. Whereas wealthier individuals often permanently avoid tax on gains by holding assets until death, less-wealthy individuals often must spend down their assets during retirement and pay income tax on realized gains. This difference, some argue, increases the inequity in the tax system. A tax on deemed realizations attempts to address this perceived

³¹⁵ See, e.g., Harry L. Gutman, “Taxing Gains at Death,” *Tax Notes Federal*, vol. 170, January 11, 2021, pp. 215-227. See also The American College of Trust and Estate Counsel, *Report on Proposals to Tax the Deemed Realization of Gain on Gratuitous Transfers of Appreciated Property*, October 15, 2019, available at https://www.actec.org/assets/1/6/Submission-ACTEC_Deemed_Realization_Report_-10-15-19.pdf; Committee Print, Joint Publication of the House Committee on Ways and Means and the Senate Committee on Finance, *Tax Reform Studies and Proposals*, U.S. Treasury Department, February 5, 1969, Part 1, pp. 28-29; Department of the Treasury, *Blueprints for Basic Tax Reform*, January 17, 1977; Department of the Treasury, *General Explanations of the Administration’s Fiscal Year 2016 Revenue Proposals*, February 2015, pp. 156-157; Department of the Treasury, *General Explanations of the Administration’s Fiscal Year 2017 Revenue Proposals*, February 2016, pp. 155-156.

inequity by treating a taxpayer who gratuitously transfers an asset by gift or at death the same as a taxpayer who sells or exchanges the asset.³¹⁶

Some might argue that imposing income tax on gains on a transfer by gift or at death is overly burdensome, particularly when combined with a separate, additional estate and gift tax. If, for example, an estate has limited liquidity to pay the estate tax – such as where much of the value of the estate is in a family business or farm – an additional tax on capital gains could exacerbate the estate’s cash flow burden and harm the business. A deemed realization proposal might seek to mitigate this liquidity concern by providing special rules under which payment of tax is deferred for deemed sales of business interests and certain other illiquid assets.

The prospect of eliminating gains entirely at death through a step-up in basis might exacerbate the lock-in effect of the present-law disposition-based realization system for taxing capital gains by influencing economic decisions regarding whether to hold or transfer assets during life. Implementing a deemed realization system arguably would reduce this lock-in effect of present law.

As one commentator notes, “[a]lthough the existing law which provides a step-up in basis without tax on unrealized gains is inequitable, it is quite simple.”³¹⁷ Because present law imposes no income tax on gains at death, the enactment of a deemed realization system likely would add complexity to the Code. Deemed realization generally will require valuation of gain assets as of the decedent’s death (or at the time of a gift). This process might in some cases require costly appraisals and lead to valuation disputes, increasing compliance costs for taxpayers and the Internal Revenue Service.

Deemed realization is also an increase in taxation on capital, so considerations relating to incidence and savings behavior, as discussed above, would also apply to these changes.

Require carryover basis for assets acquired from a decedent

An alternative to a deemed-realization system would be to require that the basis of an asset owned by a decedent at the time of her death be carried over to the decedent’s heir. Capital gains tax on any appreciation that accrued before the decedent died would be deferred and paid

³¹⁶ See American Bar Association, Task Force on Federal Wealth Transfer Taxes, *Report on Reform of Federal Wealth Transfer Taxes*, 2004, p. 183. Others might argue that, under present law, unrealized gain does not escape taxation, because the estate tax applies to the entire value of an asset included in the decedent’s estate. Adding a new tax on gains to the existing wealth transfer taxes, they might argue, is unnecessary and will result in double taxation of wealth transfers. The two taxes, however, arguably serve different purposes and apply to different tax bases: the estate and gift taxes impose a tax on transfers across generations, whereas the capital gains tax on deemed realizations taxes accrued gain that has been deferred under rules regarding realizations.³¹⁶ See David Kamin, “How to Tax the Rich,” *Tax Notes* (January 5, 2015), p. 126. Furthermore, the concern about double taxation could be mitigated by allowing tax on deemed realizations resulting from death to be deducted for estate tax purposes, thereby removing the assets used to pay the capital gains tax from the estate tax base.

³¹⁷ Michael J. Graetz, “Taxation of Unrealized Gains at Death—An Evaluation of the Current Proposals,” *Virginia Law Review*, vol. 59, 1973, p. 838.

when the heir sells or disposes of the asset. This approach generally would align the basis rules for assets acquired from a decedent with the rules for assets acquired by gift.

On two prior occasions, the Code has been modified to provide for a carryover basis for certain assets acquired from a decedent. First, the Tax Reform Act of 1976³¹⁸ replaced the section 1014 basis step-up rules with rules that generally provided for the decedent's basis to be carried over to the heir. The rules were short lived; under the weight of heavy criticism, they were repealed only four years later, in 1980.³¹⁹ Second, the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA")³²⁰ provided for the phase-out and eventual temporary repeal of the estate tax. For decedents dying in 2010, the one year in which the estate tax was to be repealed, a new basis regime was to take effect. Specifically, taxpayers who acquired assets from a decedent who died during 2010 would take a modified carryover basis under which only a limited, specified amount of "step up" would be allowed for assets in the estate (generally, \$1.3 million plus an additional \$3 million for assets transferred to a spouse); other assets generally would take a carryover basis. In December 2010, however, the estate tax and step-up in basis rules were restored retroactively for decedents dying during 2010, although an executor was permitted to elect to have the EGTRRA rules apply to the estate and to the decedent's heirs, *i.e.*, no estate tax would apply, but heirs would take a modified carryover basis rather than a stepped-up basis.³²¹

A carryover basis regime, like a deemed-realization proposal, seeks to address concerns about equity by limiting opportunities to avoid permanently the tax on gains that accrue prior to death.³²² A carryover basis regime would not, however, place bequests completely on par with a sale of an asset during life, because gain still could be deferred indefinitely from one generation to the next. In this respect, bequests would be treated more like gifts, which take a carryover basis under present law.³²³

Furthermore, a carryover basis regime for assets acquired from a decedent may not fully address the lock-in concern that arises under the present-law step-up in basis regime. While decedents will have a lesser incentive to hold until death, some argue that a carryover basis requirement might exacerbate the lock-in effect for heirs, as heirs in subsequent generations could face an ever increasing tax burden in the event of a sale, as values continue to rise over time, increasing the gap between fair market value and the initial decedent's tax basis.³²⁴

³¹⁸ Pub. L. No. 94-455 (Oct. 4, 1976), sec. 2005.

³¹⁹ Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223 (April 2, 1980), sec. 401(a).

³²⁰ Pub. L. No. 107-16 (June 7, 2001), secs. 541 and 542.

³²¹ Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312 (December 17, 2010), sec. 301.

³²² See Lawrence Zelenak, "Taxing Gains at Death," *Vanderbilt Law Review*, vol. 46, 1993, p. 361, 367.

³²³ See Graetz, *supra*, p. 833.

³²⁴ See *ibid*, p. 837.

A carryover basis regime also might increase taxpayers' compliance burdens and the costs to the IRS of administering the law. Executors, for example, would need to consider not only the equitable allocation of asset values across a decedent's heirs, but also the allocation of basis across heirs. In addition, basis would in some cases have to be tracked across multiple generations, raising compliance concerns.³²⁵

³²⁵ Zelenak, *supra*, p. 368.

B. Wealth Taxation

Under present law, there is no Federal tax imposed directly on an individual's wealth or assets or property held.³²⁶ The closest analogue may be the combined estate, gift, and generation-skipping transfer tax system, which impose tax on the transfer of wealth. The concepts of gross estate³²⁷ and taxable estate³²⁸ are measures of the wealth transferred by a decedent.

Implementing a wealth tax raises many design considerations. First, which taxpayers will be subject to the wealth tax? Will the tax only apply to individuals, or will it also apply to trusts that own assets? With respect to individuals, is each individual separately subject to tax, or are married couples treated as one unit (as in the case of the income tax)?

A second consideration is determining the base of the wealth tax. Starting with a basic definition of wealth as the fair market value of a taxpayer's assets less liabilities, many questions arise, including: (1) should all assets be included in the tax base, or should certain assets, such as personal effects or hard-to-value assets, be excluded;³²⁹ (2) what amount of wealth, if any, should be exempt from tax; and (3) should wealth include worldwide wealth (like the income and estate tax for citizens and residents) or only domestic wealth?

A third consideration is what tax rate should apply. The wealth tax could have one flat tax rate or have a graduated rate structure with different marginal rates for different levels of wealth.

As shown in section I above, the wealth distribution is highly concentrated. Thus, a direct tax on wealth would be relatively progressive. Proponents argue that such a tax will generate a high proportion of revenue from those with the most ability to pay. Some go beyond standard economic considerations of fairness and efficiency and argue that the wealth tax has broader societal benefits.³³⁰ Opponents of a wealth tax argue that the European experience with wealth taxes shows that efficiency concerns and administrative issues raised by a wealth tax

³²⁶ In contrast, many local governments impose a wealth tax in the form of taxes on the value of real property. See Lincoln Institute of Land Policy and Minnesota Center for Fiscal Excellence, "50-State Property Tax Comparison Study for Taxes Paid in 2019," June 2020, available at https://www.lincolnist.edu/sites/default/files/pubfiles/50-state-property-tax-comparison-for-2019_full.pdf.

³²⁷ Sec. 2031.

³²⁸ Sec. 2051.

³²⁹ A similar question applies to related liabilities.

³³⁰ Some argue excessive inequality leads to either concentration of political power among the rich or perhaps even political instability. For a discussion of such concerns and also a general overview of economic considerations relating to a wealth tax see Florian Scheuer and Joel Slemrod, "Taxing our wealth," *Journal of Economic Perspectives*, vol. 35, Winter 2021, pp. 207-230. An opposing view is that a wealth tax may increase the influence of the wealthy, as they may decide to donate to political causes (which would also reduce wealth tax liability). See Lawrence Summers, "Would a Wealth Tax Help Combat Inequality?" in Olivier Blanchard and Dani Rodrik (eds.), *Combating Inequality: Rethinking Government's Role*, MIT Press, 2021, pp. 141-152.

outweigh the benefits of such a tax.³³¹ Some also argue that a broad wealth tax as generally proposed is unconstitutional.³³²

Income taxes, payroll taxes, and excise and other consumption taxes generally tax economic activity as it occurs. Income and consumption represent ongoing, current economic activity by the taxpayer.³³³ Accumulated wealth does not result from any ongoing, current economic activity.³³⁴ Wealth depends upon previous economic activity either by the current wealth holder or other individuals. For example, current wealth can result from accumulated saving from income or from received bequests.

These differences in the base between an income tax and wealth tax mean that a low rate of tax on wealth can be equivalent to a relatively high rate of tax on capital income. For example, a wealth tax with a two-percent rate applied to an asset with a four-percent rate of return would be equivalent to a tax rate of 52 percent on the income from the asset.³³⁵ Mechanically, a wealth tax is less burdensome on wealth holders with high rates of return, as the rate of tax on capital income that is needed to produce the same amount of revenue as a wealth tax at a particular rate decreases as the rate of return on the asset increases.³³⁶ Some argue that a wealth tax may thus encourage the reallocation of capital to more productive uses.³³⁷ However, if differences in rates of return are due to excess profits such as monopoly rents, then a wealth tax places a higher relative burden on normal rates of return. Consequently, a wealth tax with an

³³¹ See Organisation for Economic Co-operation and Development (OECD), "The Role and Design of Net Wealth Taxes in the OECD," 2018 for a summary the experience of OECD countries with wealth taxes. The report describes that of 12 OECD countries with net wealth taxes in the 1990s, only four had such regimes as of 2017.

³³² Erik Jensen, "Is a Tax on Wealth Constitutional?" *Journal of Taxation of Investments*, vol. 36, Spring 2019, pp. 79-86. For some proposed alternatives to avoid constitutionality issues see Ari Glogower, "A Constitutional Wealth Tax" *Michigan Law Review*, vol. 118, 2020, pp. 717-784.

³³³ Economists call income and consumption "flow" concepts. In simple terms, a flow can only be measured by reference to a unit of time. Thus, one refers to a taxpayer's annual income or monthly consumption expenditures.

³³⁴ Economists call wealth a "stock" concept. A stock of wealth, such as a bank account, may generate a flow of income, such as a annual interest income.

³³⁵ The tax from a two-percent rate on wealth applied to an asset of value A with a return of four-percent is $.02*A*(1+.04) = .0208*A$. Income from that asset is $.04*A$. Thus, a 52-percent rate of tax on capital income is $.52*.04*A = .0208*A$.

³³⁶ For example, consider two taxpayers, one with an asset achieving a four-percent rate of return and one with an asset achieving an eight-percent rate of return. The two-percent rate wealth tax is equivalent to a 52-percent rate on capital income for the first taxpayer, but only a 27-percent rate on capital income for the second taxpayer.

³³⁷ In Faith Gruenen, Gueorgui Kambourov, Burhan Kuruscu, Sergio Ocampo, and Daphne Chen, "Use It or Lose It: Efficiency Gains from Wealth Taxation," *NBER Working Paper* 26284, September 2019, the authors argue that if differences in these rates of return are the result of productivity differences, there are efficiency gains from implementing a wealth tax relative to a capital income tax. They simulate a model to attempt to quantify these gains.

increasing burden on normal rates of return, would be less efficient than a tax on capital income.³³⁸

As with a tax on capital income, a natural question with a tax on wealth is how it will affect the amount of taxed wealth, that is, how sensitive is wealth to wealth taxation. Taxpayers may respond to a wealth tax by changing real savings behavior, avoiding the tax (e.g., shifting wealth into exempt assets), evading the tax (e.g., undervaluing assets), or some combination of the three. Empirical studies are generally based on the experiences of European countries that have implemented wealth taxes, and are therefore relatively limited in number.³³⁹ Additionally some studies use differences in subnational rates to estimate this sensitivity, and results may not generalize to behavioral responses to a national wealth tax.³⁴⁰ In general, these studies find that taxable wealth is quite sensitive to taxation, but that the degree to which that sensitivity may be attributable to savings changes, avoidance, or evasion varies as wealth tax regimes vary in design.³⁴¹

As people become wealthier, they have an incentive to consume more of everything, including leisure time. Theory therefore suggests that, by reducing the amount of wealth transferrable to heirs, transfer taxes may reduce labor supply of the parent,³⁴² although it may increase labor supply of the heir.³⁴³ Over 120 years ago, Andrew Carnegie opined that “the parent who leaves his son enormous wealth generally deadens the talents and energies of the son,

³³⁸ Keeping with the example in the footnote above, with one taxpayer achieving a four-percent rate of return and one taxpayer achieving an eight-percent rate of return, if the normal rate of return is four percent and the second taxpayer achieves excess profit of an additional four percent, then a two-percent rate on wealth could be viewed as falling on the normal rate of return. In other words, the wealth tax applies to the normal rate of return for both taxpayers, but does not apply to the excess profit of the second taxpayer.

³³⁹ For some recent examples see Floris Zoutman, “The Elasticity of Taxable Wealth: Evidence from the Netherlands,” *Working Paper*, 2018, and Katrine Jakobsen, Kristian Jakobsen, Henrik Kleven, and Gabriel Zucman, “Wealth Taxation and Wealth Accumulation: Theory and Evidence from Denmark,” *Quarterly Journal of Economics*, vol. 135, February 2020, pp. 329-388.

³⁴⁰ For a within country example, see Marius Brülhart, Jonathan Gruber, Matthias Krapf, and Kurt Schmidheiny, “Behavioral Responses to Wealth Taxes: Evidence from Switzerland,” *Working Paper*, 2021.

³⁴¹ For a review of this literature, see Arun Advani and Hannah Tarrant, “Behavioural Responses to a Wealth Tax,” *Wealth Tax Commission Evidence Paper* no. 5, October 2020.

³⁴² For a review of this issue, see John Pencavel, “Labor Supply of Men: A Survey,” in Orley Ashenfelter and Richard Layard (eds.), *Handbook of Labor Economics*, vol. 1, North-Holland Publishing Co., 1986.

³⁴³ In recent work, Fabian Kindermann, Lukas Mayr, and Dominik Sachs, “Inheritance taxation and wealth effects on the labor supply of heirs,” *Journal of Public Economics*, vol. 191, November 2020, calibrate a model to estimate how bequest taxes can generate additional labor income tax revenue from changing the labor supply of heirs.

and tempts him to lead a less useful and less worthy life than he otherwise would”³⁴⁴ Some empirical economic studies have found evidence of this effect.³⁴⁵

Taxes on accumulated wealth are taxes on the stock of capital held by the taxpayer. As a tax on capital, issues similar to those that arise in analyzing any tax on the income from capital arise. The incidence and efficiency effects of a tax on capital are discussed above.

A wealth tax may share certain administrative issues with mark-to-market taxation (discussed above). In order to tax the change in the value of assets, assets need to be identified and valued. More information reporting may be needed in order to identify sources of wealth and ownership. Even if all assets and ownership can be identified the question remains how certain assets should be valued. If an asset is freely traded in the market (e.g., a stock or security), this valuation is not difficult to do. Certain other assets may be more difficult to value (e.g. closely-held business interests, vested pensions, and life insurance policies).

Additional administrative considerations include those relating to timing. The wealth tax could be imposed annually or in shorter or longer intervals. A date or period on or over which the value is measured also needs to be chosen. For example, the policy could be to impose an annual wealth tax based on wealth as measured on the last day of the calendar year. However, such a system may lead to inaccurate measures of wealth, if, for example, asset prices are volatile on that date. It may, instead, be preferable to have a system for the measurement of wealth that takes an average of asset values over a fixed time period; however, this may be a greater administrative burden for the taxpayer.

An effective wealth tax system may require new and substantial administrative costs on the government and compliance costs on the taxpayer.

³⁴⁴ Andrew Carnegie, “The Advantages of Poverty,” in *The Gospel of Wealth and Other Timely Essays*, Edward C. Kirkland (ed.), The Belknap Press of Harvard University Press, 1962, reprint of Carnegie from 1891.

³⁴⁵ Douglas Holtz-Eakin, David Joulfaian, and Harvey S. Rosen, “The Carnegie Conjecture: Some Empirical Evidence,” *Quarterly Journal of Economics*, vol. 108, May 1993, pp. 413-435 and Erlend E. Bø, Elin Halvorsen, and Thor O. Thoresen, “Heterogeneity of the Carnegie Effect,” *Journal of Human Resources*, vol. 54, July 2019, pp. 726-759.

C. Wealth Transfer Tax Proposals

Federal wealth transfer taxes are levied on the transfer of accumulated wealth. As taxes on transfers of wealth, much of the discussion above on the economic effects of wealth taxes applies to estate and gift taxes as well.

Proposals to strengthen the present-law wealth transfer taxes range from (1) expanding the existing estate and gift taxes by lowering exemptions and increasing tax rates, to (2) enacting more targeted proposals designed to plug perceived holes in the estate, gift, and GST tax bases, to (3) replacing the existing system, which imposes tax on the transferor, with an inheritance tax or income inclusion system that would instead tax the recipient. These proposals are discussed in greater detail, below.

Some economists assert that an individual's bequest motives are important to understanding saving behavior and aggregate capital accumulation. If estate and gift taxes alter the bequest motive, they may change the tax burdens of taxpayers other than the decedent and his or her heirs.³⁴⁶ It is an open question whether the bequest motive is an economically important explanation of taxpayer saving behavior and level of the capital stock. For example, theoretical analysis suggests that the bequest motive may account for between 15 and 70 percent of the United States' capital stock.³⁴⁷ Others believe the bequest motive is not important in national capital formation,³⁴⁸ and empirical analysis of the existence of a bequest motive has not led to a consensus.³⁴⁹ Theoretically, it is an open question whether estate and gift taxes

³⁴⁶ A discussion of why, theoretically, the effect of the estate tax on saving behavior depends upon taxpayers' motives for intergenerational transfers and wealth accumulation is provided by William G. Gale and Maria G. Perozek, "Do Estate Taxes Reduce Saving?" in William G. Gale and Joel B. Slemrod (eds.), *Rethinking the Estate Tax*, The Brookings Institution, 2001. For a brief review of how different views of the bequest motive may alter taxpayer bequest behavior, see William G. Gale and Joel B. Slemrod, "Death Watch for the Estate Tax," *Journal of Economic Perspectives*, vol. 15, Winter 2001, pp. 205-218.

³⁴⁷ See Laurence J. Kotlikoff and Lawrence H. Summers, "The Role of Intergenerational Transfers in Aggregate Capital Accumulation," *Journal of Political Economy*, vol. 89, August 1981. Also see, Laurence J. Kotlikoff, "Intergenerational Transfers and Savings," *Journal of Economic Perspectives*, vol. 2, Spring 1988. For discussion of these issues in the context of wealth transfer taxes see, Henry J. Aaron and Alicia H. Munnell, "Reassessing the Role for Wealth Transfer Taxes," *National Tax Journal*, vol. 45, June 1992. For attempts to calculate the share of the aggregate capital stock attributable to the bequest motive, see Thomas A. Barthold and Takatoshi Ito, "Bequest Taxes and Accumulation of Household Wealth: U.S.-Japan Comparison," in Takatoshi Ito and Anne O. Krugman (eds.), *The Political Economy of Tax Reform*, The University of Chicago Press, 1992; and William G. Gale and John Karl Scholz, "Intergenerational Transfers and the Accumulation of Wealth," *Journal of Economic Perspectives*, vol. 8, Fall 1994, pp. 145-160. Gale and Scholz estimate that 20 percent of the nation's capital stock can be attributed to "intentional transfers" (including inter vivos transfers, life insurance, and trusts) and another 30 percent can be attributed to bequests, whether planned or unplanned.

³⁴⁸ Franco Modigliani, "The Role of Intergenerational Transfers and Life Cycle Saving in the Accumulation of Wealth," *Journal of Economic Perspectives*, vol. 2, Spring 1988. In this article, Modigliani argues that 15 percent is more likely an upper bound.

³⁴⁹ See B. Douglas Bernheim, "How Strong Are Bequest Motives? Evidence Based on Estimates of the Demand for Life Insurance and Annuities," *Journal of Political Economy*, vol. 99, October 1991, pp. 899-927. Bernheim finds that social security annuity benefits raise life insurance holdings and depress private annuity holdings among elderly individuals. He interprets this as evidence that elderly individuals choose to maintain a

encourage or discourage saving, and there has been limited empirical analysis of this specific issue.³⁵⁰ By raising the after-tax cost of leaving a bequest, a more expansive estate tax may discourage potential transferors from accumulating the assets necessary to make a bequest. On the other hand, a taxpayer who wants to leave a bequest of a certain net size might save more in response to estate taxation to meet that goal. Alternatively, estate and gift taxes may have only a moderate behavioral effect on savings and may instead encourage potential transferors to engage in aggressive estate tax planning.³⁵¹ For example, some individuals purchase additional life insurance to have sufficient funds to pay the estate tax without disposing of other assets in their estate.

Some argue that a rationale for a wealth transfer tax system is to break up excessive concentrations of wealth across generations.³⁵² One avenue by which taxes on the transfer of wealth may affect the concentration of wealth is by creating incentives to distribute accumulated wealth more widely or less widely. Some argue, for example, that because the current U.S. estate tax system is focused solely on the circumstances of the transferor, it does little to break up

positive fraction of their resources in bequeathable forms. For an opposing finding, see Michael D. Hurd, "Savings of the Elderly and Desired Bequests," *American Economic Review*, vol. 77, June 1987, pp. 298-312. Hurd concludes that "any bequest motive is not an important determinant of consumption decisions and wealth holdings.... Bequests seem to be simply the result of mortality risk combined with a very weak market for private annuities." *Ibid.*, p. 308.

³⁵⁰ Wojciech Kopczuk and Joel Slemrod, "The Impact of the Estate Tax on the Wealth Accumulation and Avoidance Behavior of Donors," in William G. Gale and Joel B. Slemrod (eds.), *Rethinking Estate and Gift Taxation*, The Brookings Institution, 2001, use estate tax return data from 1916 to 1996 to investigate the impact of the estate tax on reported estates. They find a negative correlation between measures of the level of estate taxation and reported wealth. This finding may be consistent with the estate tax depressing wealth accumulation (depressing saving) or with the estate tax encouraging a avoidance activity.

David Joulfaian, "The Behavioral Response of Wealth Accumulation to Estate Taxation: Time Series Evidence," *National Tax Journal*, vol. 59, June 2006, pp. 253-268, examines the size of taxable estates and the structure of the estate tax and its effects on the expected rates of return to saving. While he emphasizes the sensitivity of the analysis to how individuals' expectations about future taxes are modeled he concludes that "taxable estates are ten percent smaller because of the estate tax."

³⁵¹ Wojciech Kopczuk, "Bequest and Tax Planning: Evidence from Estate Tax Returns," *Quarterly Journal of Economics*, vol. 122, November 2007, pp. 1801-1854, finds that the onset of a terminal illness leads to a significant reduction in the value of estate reported on tax returns and provides evidence of estate planning rather than real reductions in net worth. Jonathan Goupille-Lebre and Jose Infante, "Behavioral Responses to Inheritance Tax: Evidence from Notches in France," *Journal of Public Economics*, vol. 168, December 2018, pp. 21-34, use French data from a period in which there was a significant policy change to the French inheritance tax and find evidence of real and shifting responses by decedents to the tax, particularly late in life. Their evidence suggests myopia as a reason for late-life rather than throughout-life responses.

³⁵² Commentators have articulated various rationales for taxing transfers of wealth, including breaking up dynastic concentrations of wealth, maximizing equality of opportunity, and contributing to progressivity in the Federal tax system. The articulated rationales themselves are controversial. Moreover, the extent to which the various alternative means of taxing transfers of wealth, such as an inheritance tax, further these policy goals has been a subject of vigorous debate.

concentrations of wealth or to promote equality of opportunity.³⁵³ Such commentators argue that systems that impose a tax based on the circumstances of the transferee – such as an inheritance tax or an income inclusion approach – are more effective in encouraging dispersal of wealth among a greater number of transferees and potentially to lower-income beneficiaries.³⁵⁴

Different types of wealth transfer tax systems raise different administrative and compliance issues, including filing or tax planning burdens, opportunities for aggressive planning, and opportunities for abuse. If, for example, migrating from an estate tax to an inheritance tax would in fact lead to wider dispersal of gifts and bequests, such a migration also might be expected to increase compliance costs, because a greater number of taxpayers would need to file returns or reports with the IRS. Even where no tax is due in a particular year because receipts fall below an annual or lifetime exemption amount, such taxpayers still would need to track and likely report on such receipts to keep track of the amount of exemption used.

Lower exemptions and increase tax rates

Some have proposed expanding application of the present-law wealth transfer taxes by reducing exemption levels, increasing tax rates, or both. Public Law 115-97 generally doubled the estate and gift tax exemption for decedents dying and gifts made during the years 2018 through 2025, with the exemption reverting to the exemptions levels that otherwise would have been in effect for decedents dying and gifts made after 2025.³⁵⁵ The exemption in effect for 2021 is \$11.7 million per person. Some have proposed accelerating the expiration of the increased exemption amount. Others have proposed returning to the exemptions and rates in effect in 2009 – a \$3.5 million estate tax exemption, a \$1 million gift tax exemption, and a top tax rate of 45 percent (as compared to the present-law 40-percent rate).

Administratively, these changes are relatively straightforward and would mostly require changes in forms and calculations of wealth transfer tax. These changes are subject to the general considerations described above.

Reform the present-law estate and gift tax system

Taxpayers sometimes avoid estate or gift tax through planning that artificially reduces the taxable value of property or places wealth beyond the reach of the tax system. Commentators have proposed various reforms designed to prevent such avoidance.

Valuation discounts.—Taxpayers sometimes use valuation discounts to reduce the estate and gift tax values of transferred property. Courts and the IRS have recognized that for various

³⁵³ Joseph M. Dodge, “Comparing a Reformed Estate Tax with an Accessions Tax and an Income-Inclusion System, and Abandoning the Generation-Skipping Tax,” *SMU Law Review*, vol. 56, Winter 2003, pp. 551, 553 (“[A]ny transferee-oriented tax should possess greater appeal than a transferor-oriented tax with respect to achieving such goals as curbing undue accumulations of wealth or improving equality of opportunity.”).

³⁵⁴ *Ibid.* at 560-61.

³⁵⁵ The Joint Committee staff projects that the exemption for decedents dying and gifts made in 2026 will be \$6.44 million per person.

reasons interests in an entity (shares in a corporation or interests in a partnership, for instance) may be worth less than the owner's proportionate share of the value of the entity's assets. In some cases, however, these reductions in value for estate and gift tax purposes do not accurately reflect economic value. This is particularly true in situations where family members together control property in which interests are transferred. Various reforms have been proposed to curb the use of valuation discounts in situations where the discounted value of a transferred asset might be lower than the true economic value.³⁵⁶

Use of trusts.—Taxpayers also use trust arrangements to avoid transfer tax. First, grantors sometimes structure estate "freeze" transactions that leverage the ability to create a trust that is treated as separate from the grantor for transfer tax purposes but not for income tax purposes, sometimes referred to as an "intentionally defective grantor trust," or IDGT. In a simple estate freeze transaction, a grantor might transfer assets to an IDGT by way of a taxable gift during his or her lifetime. The gift tax value is measured ("frozen") at the time of the transfer, and any subsequent appreciation accrues to the trust (and ultimately the trust beneficiaries) without further gift or estate tax consequences, provided the trust is structured to avoid inclusion in the grantor's gross estate.

Some argue that the original concerns that gave rise to the grantor trust rules have diminished and the rules instead are used primarily for transfer tax avoidance, such that some or all of the grantor trust rules should be repealed.³⁵⁷ Other commentators seek to address the use of IDGTs for transfer tax avoidance by harmonizing or coordinating the income and transfer tax rules governing grantor trusts. For example, one academic would repeal most of the grantor trust rules and replace them with a single rule based on the standards for determining whether a transfer is a completed gift for gift tax purposes.³⁵⁸ Alternatively, the Treasury Department has proposed harmonizing the income and transfer tax rules by imposing certain transfer tax consequences on a grantor trust.³⁵⁹

Second, taxpayers sometimes use grantor retained annuity trusts, or GRATs, to avoid gift or estate tax. A GRAT is an irrevocable grantor trust in which the grantor retains an annuity interest, with the remainder passing to other trust beneficiaries, such as the grantor's children, in a taxable gift. Because the interests are valued using rules that often overstate the value of the

³⁵⁶ See, e.g., Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals*, February 2012, p. 79; Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* (JCS-2-12), June 2012, p. 260; Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05), January 27, 2005, pp. 396-405.

³⁵⁷ Leo L. Schmolka, "FLPs and GRATs: What to Do?", *Tax Notes*, March 13, 2000 (special supplement), p. 1473; Jay A. Soled and Mitchell Gans, "Sales to Grantor Trusts: A Case Study of What the IRS and Congress Can Do to Curb Aggressive Transfer Tax Techniques," *Tennessee Law Review*, vol. 78, Summer 2011, pp. 973, 1005.

³⁵⁸ See Robert T. Danforth, "A Proposal for Integrating the Income and Transfer Taxation of Trusts," *Virginia Tax Review*, vol. 18, Winter 1999, pp. 545, 611-615.

³⁵⁹ See, e.g., Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals*, February 2016, pp. 180-182.

retained annuity and understate the value of the remainder interest, the grantor often is able to value the taxable gift at an amount far below the real economic value of the remainder interest.³⁶⁰ Some have proposed additional requirements for GRATs, including a minimum 10-year term, that likely would sharply limit their utility as tools to avoid gift or estate tax.³⁶¹

Third, taxpayers sometimes avoid GST tax by allocating GST exemption to a “perpetual dynasty trust.” Once a taxpayer allocates GST exemption to a trust, the trust assets often may grow indefinitely, benefiting beneficiaries in multiple successive generations without further GST tax consequences. Some have argued that this result is inconsistent with one of the principal purposes of the GST tax: to impose transfer tax at each generational level.³⁶²

Policymakers could address the use of perpetual dynasty trusts by prohibiting any allocation of generation skipping tax exemption to a trust that could benefit generations other than the transferor’s children or grandchildren.³⁶³ Others have suggested that the GST exemption allocated to a trust should expire within a specified period of time. For example, the Secretary proposed a rule under which the generation skipping transfer exclusion allocated to a trust terminates on the 90th anniversary of the creation of the trust.³⁶⁴

These changes may make the wealth transfer tax system administratively less complex and increase tax collection. However, policymakers should consider how these changes may interact with each other, as well as with the wealth transfer tax system and the income tax system. By broadening the base, these changes would increase the transfer tax liability borne by taxpayers.

Implement an inheritance (accessions) tax or income inclusion regime

Whereas estate and gift taxes are imposed on the transferor of a gift or on the estate of a decedent, an inheritance tax (sometimes referred to as an accessions tax) is imposed on the

³⁶⁰ The annuity is valued under tables prescribed by section 7520 of the Code, which requires use of an interest rate equal to 120 percent of the Federal midterm rate in effect under section 1274(d)(1). Sec. 2702(a). The remainder interest is valued by subtracting the value of the annuity interest (as derived from the annuity tables) from the value of assets transferred to the trust. If returns on trust assets exceed the rate of return assumed under the annuity tables, any excess appreciation may pass to the remainder beneficiaries and escape gift or estate taxation.

³⁶¹ See, e.g., Department of the Treasury, *General Explanations of the Administration’s Fiscal Year 2017 Revenue Proposals*, February 2016, pp. 180-182.

³⁶² Since the original enactment of the GST tax, many States have repealed or sharply limited application of their rules against perpetuities, which limited the maximum duration of a trust.

³⁶³ See, e.g., Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05), January 27, 2005, p. 392.

³⁶⁴ See, e.g., Department of the Treasury, *General Explanations of the Administration’s Fiscal Year 2017 Revenue Proposals*, February 2016, pp. 183-184.

recipient of a gratuitous transfer. Among OECD countries, a significant majority have inheritance tax systems.³⁶⁵

Most frequently, an inheritance, or accessions, tax is structured as an annual inheritance tax. An annual inheritance tax is a tax imposed against receipts during a particular year. Most countries that tax transfers of wealth use annual inheritance taxes. As an alternative to an annual inheritance tax, an accessions tax may be structured to apply to cumulative receipts of lifetime gratuitous transfers in excess of a lifetime exemption amount. Relatively few countries currently use such a cumulative accessions tax system.

An inheritance tax, like an estate tax, often provides an exemption from the tax for up to a specified amount of gratuitous transfers. Under an annual inheritance tax, the exemption generally applies on an annual basis to receipts during a particular year. Under a cumulative accessions tax, on the other hand, receipts are cumulated with prior year receipts; only cumulative receipts in excess of a lifetime exemption generally are subject to tax.³⁶⁶

Under an income inclusion approach, gifts and bequests generally are treated as income of the recipient and thus are subject to income tax.³⁶⁷ In Mexico, for example, there is no Federal or State tax on inheritances or gifts, but certain gifts may be included in the recipient's taxable income. Generally, under an income inclusion approach, gifts and bequests are cumulated with the recipient's other income and reported on the recipient's annual income tax return. Because charities generally are exempt from tax on their net income,³⁶⁸ they would not be subject to tax on receipts of gifts or bequests.

Under present U.S. law, gross income generally excludes the value of property acquired through gift, bequest, devise, or inheritance (section 102(a)) and amounts received under a life insurance contract, if received by reason of the death of the insured (section 101(a)).

³⁶⁵ For a more detailed discussion of inheritance taxes in other countries, including selected features of the inheritance tax systems in Germany, France, Spain, Ireland, and Finland, see Joint Committee on Taxation, *Description and Analysis of Alternative Wealth Transfer Tax Systems* (JCX-22-08), March 10, 2008.

³⁶⁶ The amount of exemption typically varies based on the familial relationship of the recipient taxpayer and the transferor, with receipts from closer relatives qualifying for a higher exemption amount. An inheritance tax also may exempt or provide special treatment for certain types of property received. The tax rates also may vary with the relationship between the recipient taxpayer and the transferor, with lower tax rates applying to receipts from closer relatives.

³⁶⁷ See, e.g., Lily L. Batchelder, "Leveling the Playing Field between Inherited Income and Income from Work through an Inheritance Tax," New York University School of Law, *Law and Economics Research Paper Series*, Working Paper No. 20-11, February 2020, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3526520. For a more detailed discussion of the income inclusion approach, see Joint Committee on Taxation, *Description and Analysis of Alternative Wealth Transfer Tax Systems* (JCX-22-08), March 10, 2008.

³⁶⁸ Sec. 501(a).

Commentators have noted that Congress could adopt an income inclusion approach by repealing sections 102(a) and 101(a).³⁶⁹

Proponents of an inheritance tax or income inclusion argue that tax systems that focus on the circumstances of transferees may be more effective in promoting fairness in the tax system. If the burden of any wealth transfer tax falls on the transferee in the form of a reduced inheritance or gift, such commentators argue that systems that compute tax based on the transferee's circumstances are preferable.³⁷⁰ Some also question whether it is appropriate to exclude gifts and bequests from gross income (as under present U.S. law) while income earned through labor is subject to tax.³⁷¹

Some commentators also argue that the need for complex and costly tax planning in advance of death would be reduced under an inheritance tax system, because the current system is unnecessarily complex.³⁷² Some might argue, however, that some of this complexity could be addressed through changes to the current estate and gift tax system.

³⁶⁹ See Joseph C. Dodge, "Taxing Gratuitous Transfers Under a Consumption Tax," *Tax Law Review*, vol. 51, 1996, pp. 529, 589-93; Joseph C. Dodge, "Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income," *Harvard Law Review*, vol. 93, 1978, p. 1177. Dodge argues that, under a comprehensive tax base, "receipts should be included in income regardless of source or nature." Therefore, a gift or bequest should be included in the income of the recipient. Dodge, *Beyond Estate and Gift Tax Reform*, p. 1184. Dodge would not, however, allow the transferor a deduction for the gift or bequest, because "the making of a gift represents the voluntary exercise of the donor's economic power. In other words, the donor's voluntary transfer of the gift itself indicates the donor's ability to pay." *Ibid.*, p. 1186.

³⁷⁰ See, e.g., Batchelder, *supra*, pp. 46-50.

³⁷¹ *Ibid.* at 46-52.

³⁷² *Ibid.* at 52-53. Batchelder identifies the following aspects of the current system that add complexity and lead to costly and complicated planning: (1) allowing stepped up basis for bequests while requiring carry over basis for gifts; (2) the "tax-exclusivity" of the estate tax system (*i.e.*, the assets used to pay the estate tax are included in the estate tax base) versus the "tax inclusivity" of the gift tax system; and (3) the rules for valuing transfers of property through an entity or in trust, including valuation discounts and valuing annuity interests in grantor retained annuity trusts (both discussed above).

APPENDIX

In order to be more consistent with recent income distribution studies, Tables 1 through 4 in this pamphlet differ from standard distributional tables produced by the Joint Committee staff. This appendix describes differences in income measures and incidence assumptions between the methodology used in this pamphlet for Tables 1 through 4 and the Joint Committee staff's standard methodology.

While both Tables 1 through 4 in this pamphlet and Joint Committee staff standard distributional tables use tax units as the unit of observation to rank by income category, the tables here group tax units into percentiles of the population ranked highest to lowest with a tax-unit size-adjustment, rather than according to dollar-based thresholds without any tax-unit size-adjustment. The tax-unit size-adjustment used for ranking tax units in Tables 1 through 4 is intended to account for the costs of supporting dependents and the economies of scale from shared resources. The adjustment is made by dividing tax unit income by the square-root of the number of individuals in the unit.³⁷³

The income definition used for Tables 1 through 4 differs from the definition of "expanded income" generally used by the Joint Committee staff. Expanded income is 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.³⁷⁴

Pre-tax/pre-transfer income (used for Tables 2 and 3) excludes transfers that are included in expanded income—the insurance value of Medicare, Social Security benefits, unemployment benefits, and workers' compensation benefits—and includes all additional sources included in national income, such as imputed rents from owner-occupied housing and undistributed retirement account income. This income measure also accounts for some additional Federal taxes, including the allocation of taxes paid by estates and trusts to beneficiaries and the allocation of estate and gift taxes by decedent income groups.

Pre-tax/after-transfer income (used for Tables 1 and 4) includes all the transfers in expanded income, as well as additional transfers in national income, such as Medicaid, SNAP, and SSI benefits.

To distribute Federal taxes, the Joint Committee staff assigns the individual income tax (including the outlay portion of refundable credits) to taxpayers, payroll taxes (both the employer's and the employee's share) are attributed to employees, corporate income taxes (and

³⁷³ This is the same equivalence scale used by the Congressional Budget Office.

³⁷⁴ See Joint Committee on Taxation, *Overview of the Definition of Income Used by the Staff of the Joint Committee on Taxation in Distributional Analyses* (JCX-15-12), February 8, 2012 for a detailed description of expanded income.

taxes on business income of pass-throughs) are attributed to labor and capital owners,³⁷⁵ and excise taxes are attributed to consumers. The approach used for Table 4 follows the Joint Committee staff's standard methodology to distribute individual income and payroll taxes but differs in how corporate and excise taxes are distributed. For corporate taxes, calculations in Table 4 use the same assumption for the labor share but a different approach to allocate the non-labor share among capital owners, for example, ownership by non-profits is allocated more evenly over the income distribution. Excise taxes and custom duties are allocated by after-tax cash income less savings.

Under the approach used in Table 4 and the Joint Committee staff's standard methodology, Federal average tax rates follow roughly the same pattern in a given year; Federal average tax rates increase as income increases. Table A.1 presents the distribution of average tax rates in 2018³⁷⁶ under the standard methodology.³⁷⁷ For corresponding income groups, these are generally a few percentage points above the average tax rates calculated in Table 4 of this pamphlet.³⁷⁸

³⁷⁵ The Joint Committee staff assumes that 25 percent of corporate income taxes are borne by domestic labor and 75 percent are borne by owners of domestic capital, and five percent of taxes on business income of pass-throughs is borne by domestic labor and 95 percent is borne by owners of domestic capital. See Joint Committee on Taxation, *Modeling the Distribution of Taxes on Business Income* (JCX-14-13), October 16, 2013.

³⁷⁶ Average tax rates derived from Joint Committee on Taxation, *Overview of the Federal Tax System as in Effect for 2018* (JCX-3-18), February 7, 2018.

³⁷⁷ The 50th percentile of tax-unit income by tax filing unit is approximately \$48,000. The 90th percentile of tax-unit income by tax filing unit is approximately \$167,000. The \$1,000,000 and over category corresponds to the top 0.3 percent of tax filing units.

³⁷⁸ The income definition used in this pamphlet is broader than the Joint Committee staff's measure of expanded income leading to lower average tax rates.

A.1—Distribution of Average Tax Rates in 2018 (Projected)

Income Category ¹	Combined Income, Payroll, Excise, and Corporate Taxes ² Average Tax Rate	Individual Income Taxes Average Tax Rate	Payroll Taxes Average Tax Rate	Excise Taxes Average Tax Rate	Corporate Taxes Average Tax Rate
Less than \$10,000.....	10.10%	-8.80%	10.80%	6.80%	1.30%
\$10,000 to \$20,000.....	-0.90%	-13.60%	10.10%	1.80%	0.70%
\$20,000 to \$30,000.....	3.10%	-6.90%	8.00%	1.30%	0.80%
\$30,000 to \$40,000.....	7.20%	-3.30%	8.40%	1.20%	0.90%
\$40,000 to \$50,000.....	9.60%	-0.90%	8.30%	1.10%	1.10%
\$50,000 to \$75,000.....	13.60%	2.40%	8.90%	1.00%	1.30%
\$75,000 to \$100,000.....	15.80%	4.80%	8.60%	0.80%	1.50%
\$100,000 to \$200,000.....	19.60%	7.70%	9.40%	0.70%	1.90%
\$200,000 to \$500,000.....	24.50%	13.40%	8.10%	0.40%	2.50%
\$500,000 to \$1,000,000.....	28.90%	20.70%	4.80%	0.30%	3.10%
\$1,000,000 and over.....	31.50%	26.30%	2.00%	0.10%	3.10%
Total, All Taxpayers.....	19.60%	9.20%	7.70%	0.70%	2.00%

Note: Includes nonfilers, excludes dependent filers and returns with negative income. The average tax rate is equal to Federal taxes described in footnote (2) divided by income described in footnote (1).

[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 2018 levels.
 [2] 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.

* Average tax rates derived from Overview of the Federal Tax System as in Effect for 2018 (JCX-3-18), February 7, 2018.

Mr. SMUCKER. This is from 2018, and this report identifies the U.S. tax system as the most progressive in the developed world. Do you agree, generally?

Dr. MAZUR. I am not going to quarrel with JCT since I used to work there.

Mr. SMUCKER. Okay, yeah. So, I think it is important we establish that.

Dr. MAZUR. Yeah.

Mr. SMUCKER. Because if I had listened to your answer and not had more context, you know, I would have thought that the, you know, the individuals on the lower economic scale are paying a higher percentage than lower, but I will give you some numbers in here.

Dr. MAZUR. Okay.

Mr. SMUCKER. And your point excluding payroll taxes is a good one because they pay payroll taxes, but without payroll taxes, the bottom 50 percent are paying -0.6 percent, -0.6.

Dr. MAZUR. In that year perhaps, yeah.

Mr. SMUCKER. What is that?

Dr. MAZUR. In that year perhaps, yeah.

Mr. SMUCKER. Yeah, -0.6 because of the refundable tax credit they are literally getting money back rather than paying it. That is the bottom 50 percent. Now, with payroll taxes, to your point, their average rate according to—

Dr. MAZUR. Yeah.

Mr. SMUCKER [continuing]. JCT, is 6.3 percent. Compared to the top tenth of a percent are paying on average 33 percent of their taxes. So, it is the most it could be—

Dr. MAZUR. Interestingly though, if you were to break that top tenth even finer, so like the Treasury Department used to put out the top 400 and now—

Mr. SMUCKER. Yeah.

Dr. MAZUR [continuing]. They put out maybe the top .001 percent, but basically, the top sliver pays less than the top 1 percent. So, it kind of goes down at the top end.

Mr. SMUCKER. They don't have that on here but—

Dr. MAZUR. No, but—

Mr. SMUCKER [continuing]. I am willing to look at that—

Dr. MAZUR [continuing]. You could ask JCT about where.

Mr. SMUCKER [continuing]. Because that would be interesting, but, you know, one of the statistics that they list on here is that the top .01 percent, top tenth of a percent pay 30 percent average Federal income tax rate while—I am sorry I just made this point, while the bottom 50 percent is less than zero. Here is the point I wanted. Separate research, and this is from the Tax Policy Center, which is sort of a liberal—

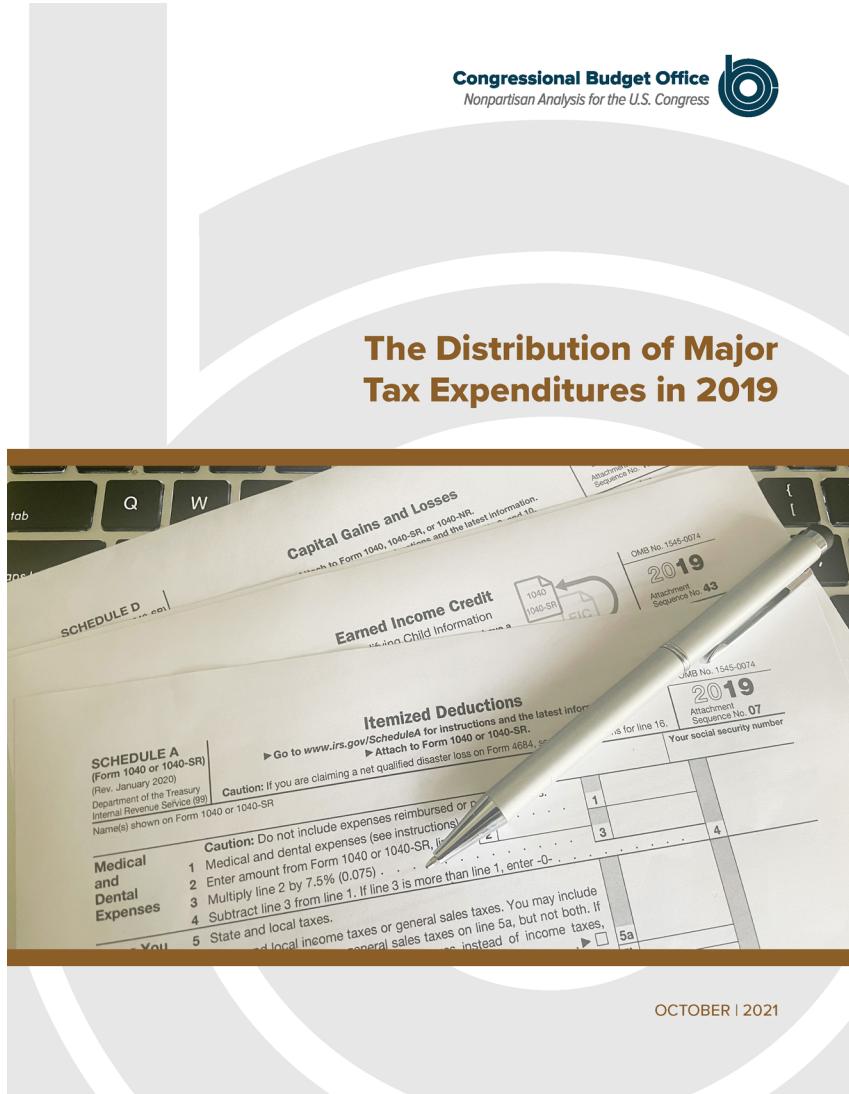
Dr. MAZUR. I used to work there too.

Mr. SMUCKER [continuing]. Entity. Okay. Yeah, you worked at all of them. They say, research that the top one percent of income earners shoulder 25 percent of all Federal taxes paid. In contrast to 53 million households in the U.S. that pay nothing at all, and in fact, six out of ten households actually receive more in direct government benefits than they pay into the system.

Again, just want to be sure that we understand what we are working with here, and the point about the Tax Cuts and Jobs Act making the system benefit more for higher income earners is false, because CBO in 2021, and I would like to enter this into the record as well. This is a 2021 report by CBO.

Chairman ARRINGTON. So ordered.

[The information follows:]



At a Glance

Tax expenditures are exclusions, deductions, credits, and net preferential rates in the federal tax system that cause government revenues to be lower than they would otherwise be for any given structure of tax rates. In this report, the Congressional Budget Office examines how the benefits from major tax expenditures in the individual income tax and payroll tax systems were distributed among households in different income groups in 2019.

CBO estimates that the tax expenditures examined here totaled about \$1.2 trillion in 2019, or 5.8 percent of gross domestic product, and accounted for roughly three-quarters of the total budgetary effects of all tax expenditures that year. The smallest of the tax expenditures discussed here is the state and local tax deduction (\$22 billion); the largest are the exclusion and deferrals for the contributions and earnings associated with pensions and retirement savings accounts (\$276 billion) and the exclusion for employment-based health insurance (\$280 billion including the payroll tax expenditure).

In 2019, the distribution of benefits from the tax expenditures analyzed in this report varied considerably among income groups:

- Overall, about half of the total benefits from income tax expenditures accrued to households in the highest quintile (that is, fifth) of the income distribution, whereas 9 percent of such benefits accrued to households in the lowest quintile. Payroll tax expenditures were more evenly distributed.
- Households in the lowest quintile received benefits equal to 16 percent of their total income before transfers and taxes, whereas households in the highest quintile received benefits equal to 7 percent of such income.
- Among the various tax expenditures, the distribution of benefits varied greatly. For example, about 95 percent of the benefits from the qualified business income deduction accrued to households in the two highest quintiles of the income distribution, whereas 82 percent of the benefits from the earned income tax credit accrued to households in the two lowest quintiles.
- Provisions of the 2017 tax act (Public Law 115-97) reduced the total estimate of benefits from income tax expenditures by 9 percent. On net, those provisions made the distribution of tax expenditures more progressive because most of the benefits reduced by the tax act would have accrued to households in the highest quintile.



Contents

Visual Summary	1
Background	6
Defining Tax Expenditures	6
Types of Tax Expenditures	6
Estimating Tax Expenditures	8
How Changes in Tax Policy Affect Tax Expenditures	10
How Tax Expenditures Affect the Federal Budget	10
The Distribution of Major Tax Expenditures in the Individual Income Tax System	10
Exclusion for Employment-Based Health Insurance	11
Exclusion for Pensions and Retirement Savings Accounts	15
Net Preferential Tax Rates on Capital Gains and Dividends	19
Child Tax Credit	19
Earned Income Tax Credit	20
Premium Tax Credit	20
Charitable Contribution Deduction	21
Qualified Business Income Deduction	21
Exclusion of Capital Gains on Assets Transferred at Death	21
Exclusion of Social Security and Railroad Retirement Benefits	24
Exclusion of Capital Gains on the Sale of Principal Residences	24
Mortgage Interest Deduction	25
State and Local Tax Deduction	25
The Distribution of Major Tax Expenditures in the Individual Income Tax System in Total	25
Distribution in Dollars	25
Distribution as a Share of Income	26
Distribution Excluding Payroll Taxes	27
Appendix: Analytic Method and Additional Characteristics of Tax Expenditures	29
List of Tables and Figures	35
About This Document	36
Boxes	
1. Reference Tax Systems	8
2. How Provisions of the 2017 Tax Act Affected Major Tax Expenditures in 2019	22



Notes

Numbers in the text, tables, and figures may not add up to totals because of rounding.

All dollar amounts are in 2019 dollars and are rounded to the nearest hundred.

Unless this report indicates otherwise, all years referred to are calendar years; “income” refers to household income before accounting for means-tested transfers and federal taxes; “transfers” refers to means-tested transfers; and “taxes” refers to federal taxes.

Supplemental data for this analysis are available on CBO’s website at www.cbo.gov/publication/57413#data.

On the cover: Illustration by Jorge Salazar.

The Distribution of Major Tax Expenditures in 2019

Visual Summary

A number of exclusions, deductions, credits, and net preferential rates in the federal tax system cause government revenues to be lower than they would otherwise be for any given structure of tax rates. Some of those provisions are called *tax expenditures* because they provide financial assistance for specific activities, entities, or groups of people. Tax expenditures, like many forms of federal spending, contribute to the budget deficit, affect the distribution of income, and influence how people work, save, and invest.

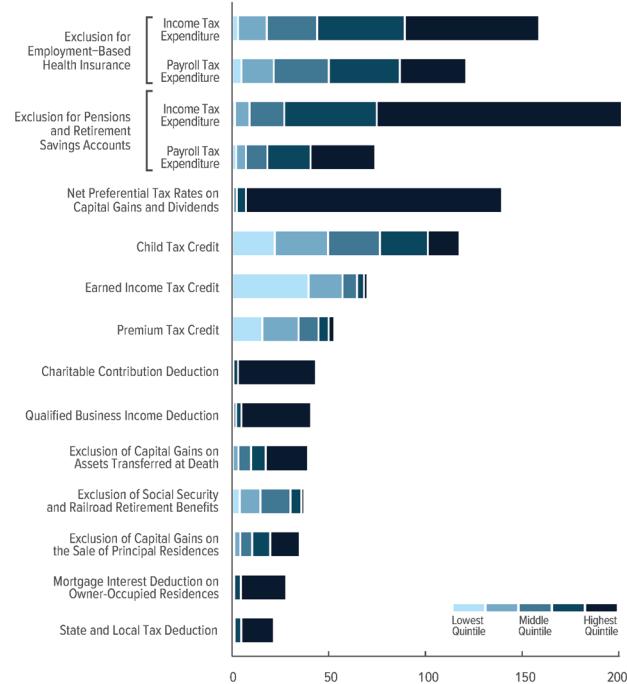
In this report, the Congressional Budget Office examines how certain tax expenditures in the individual income and payroll tax systems were distributed among households in different income groups in 2019, before the economic disruption caused by the 2020–2021 coronavirus pandemic and the enactment of legislation in response to it. Tax expenditures reduce the individual income taxes—and, in certain cases, the payroll taxes—that people would otherwise owe. However, the estimates of tax expenditures presented here, like those produced by the Joint Committee on Taxation and the Treasury Department, do not reflect the additional revenues that would be raised if the relevant tax provisions were eliminated, because the estimates do not account for the way taxpayers would change their behavior as a result.

In its analysis, CBO sorts households into income quintiles (that is, fifths) on the basis of a measure of income that comprises market income (including labor income, business income, and capital income) and social insurance benefits (including Medicare and Social Security). That broad measure of income is the same one the agency regularly uses to analyze the distributional effects of both means-tested transfers and federal taxes.

Shares of Major Tax Expenditures

The size and distribution of benefits across the income scale varied considerably among each of the major tax expenditures in 2019, according to CBO's estimates.

Billions of 2019 Dollars



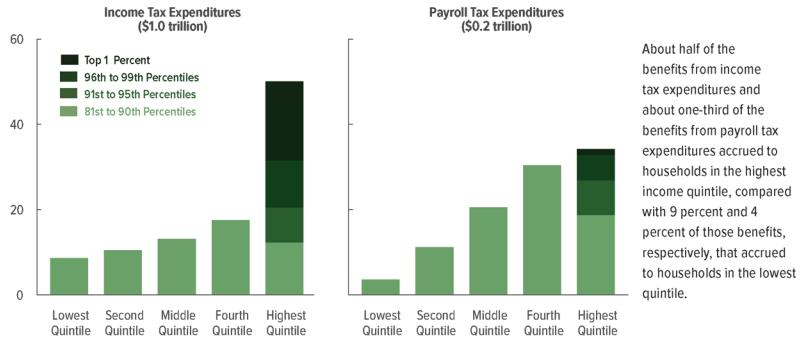
Exclusions for employment-based health insurance and retirement savings were the largest tax expenditures in 2019. Tax expenditures varied in terms of how their benefits were distributed. For example, 95 percent of the benefits from the qualified business income deduction accrued to households in the two highest income quintiles, whereas 82 percent of the benefits of the earned income tax credit accrued to households in the two lowest quintiles.

See Figure 2 on page 13

Shares of Combined Major Tax Expenditures

The total benefits of all major tax expenditures were not evenly distributed in 2019. Higher-income households received a larger share of the benefits than did lower-income households.

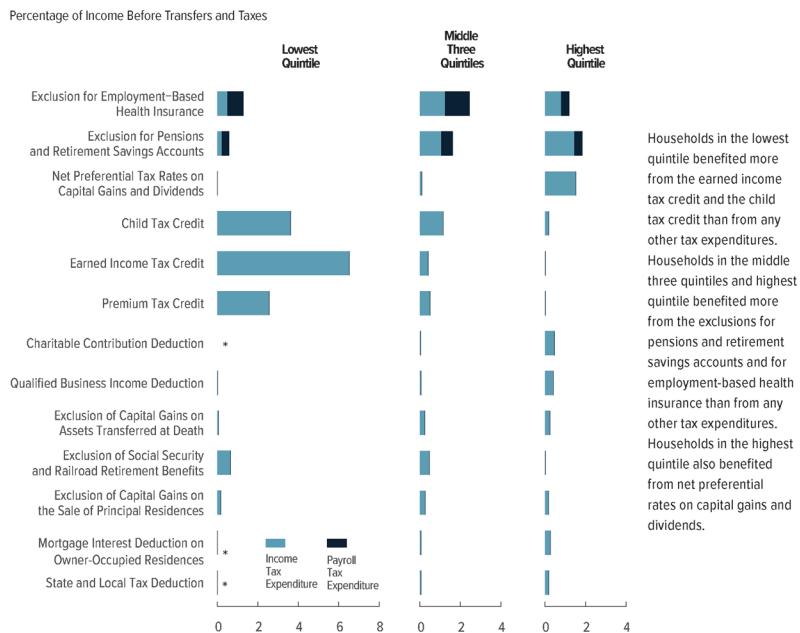
Percent



See Figure 5 on page 26

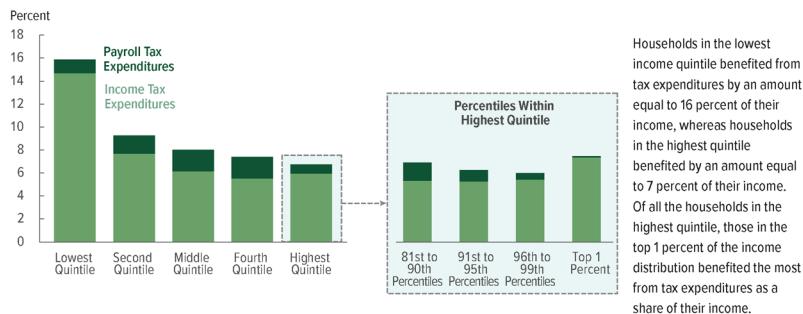
Major Tax Expenditures as a Share of Income

When the benefits of major tax expenditures are measured as a share of income within each income group, households in the lowest quintile benefited the most in 2019.



See Figure 4 on page 17

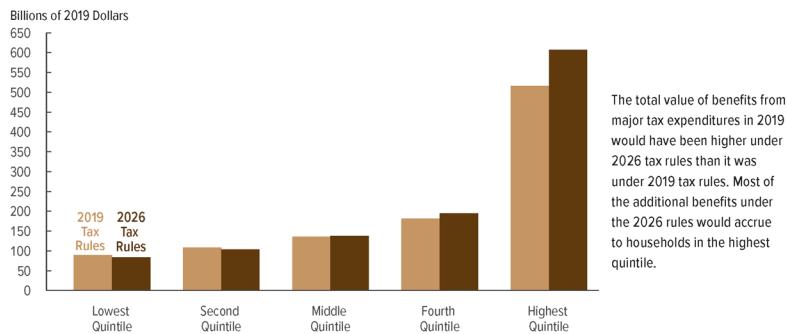
Combined Major Tax Expenditures as a Share of Income



See Figure 6 on page 2

Effects of Provisions of the 2017 Tax Act on Major Tax Expenditures

Provisions of the 2017 tax act reduced individual income tax rates, expanded the child tax credit, and introduced the qualified business income deduction, but at the same time reduced three itemized deductions. The net effect was to decrease CBO's total estimate of major income tax expenditures in 2019 by 9 percent, compared with what the estimate would be under 2026 tax rules, when many of the provisions of the 2017 tax act are set to expire.



See Box 2 on page 22

Background

Exclusions, deductions, credits, and net preferential rates in the federal tax system cause government revenues to be lower than they would otherwise be for any underlying structure of tax rates. Various tax provisions in those four categories are called *tax expenditures* because they resemble federal spending and contribute to the budget deficit.

Like federal spending, tax expenditures provide financial assistance for specific activities, entities, and groups of people. They therefore alter people's participation in the labor market, affect their choices about saving and consumption, and change the allocation of resources in the economy.

However, the budgetary treatment of tax expenditures differs from that of spending programs. Although tax expenditures increase the deficit by reducing the amount of revenues the government receives and records in the budget, the amount of forgone revenues attributable to specific tax expenditures (or to tax expenditures in general) is not separately recorded in the budget, whereas outlays for each spending program are recorded there.¹ As a result, the costs associated with tax expenditures cannot be directly determined from the budget and must be estimated separately.

This analysis presents CBO's estimates of the major tax expenditures in the individual income and payroll tax systems and examines how those tax expenditures were distributed among households with different amounts of income in 2019.² CBO chose 2019 as the year of analysis because the distribution of tax expenditures in that year was unaffected by the economic disruption caused by the pandemic and the legislation enacted in response to it.

Defining Tax Expenditures

According to the Congressional Budget and Impoundment Control Act of 1974, tax expenditures are "those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide

1. The exception to that approach involves the refundable portion of tax credits, which is reported in the budget as mandatory spending.
2. The analysis in this report does not include corporate tax expenditures.

a special credit, a preferential rate of tax, or a deferral of tax liability." The Administration and the Congress regularly publish estimates of tax expenditures prepared by the Department of the Treasury's Office of Tax Analysis and the staff of the Congress's Joint Committee on Taxation (JCT), respectively.

Not all provisions in the tax code that alter tax liabilities create tax expenditures. For example, the standard deduction reduces tax liabilities for many taxpayers, but those reductions are not considered tax expenditures. Rather, tax expenditures are defined relative to a set of tax provisions that would typically be considered part of normal tax law (see Box 1). Each agency therefore uses its judgment to determine which provisions are part of normal tax law and which ones are tax expenditures. For the sake of consistency, in this analysis and in CBO's regular reporting of tax expenditures with its budget projections, CBO follows JCT's determinations about which provisions are tax expenditures.³

Types of Tax Expenditures

In this analysis, tax expenditures are placed in one of four categories depending on how they are treated in the tax system: exclusions, deductions, credits, or net preferential rates.

Exclusions. Income from certain sources, or income used for certain purposes, is excluded from a taxpayer's total income in the year that it is received, thereby reducing that taxpayer's tax liability. The same amount of excluded income typically creates a larger tax expenditure among higher-income taxpayers than among lower-income taxpayers because individual income tax rates rise with income. Higher-income taxpayers are more likely than lower-income taxpayers to be in higher tax brackets, and so more revenues are lost by excluding income from a higher-income taxpayer's taxable income. For example, a taxpayer in the 12 percent tax bracket who excludes \$1,000 from taxable income saves \$120 in taxes, but the same exclusion reduces the tax bill of a taxpayer in the 37 percent tax bracket by \$370.

3. For a summary of how the Joint Committee on Taxation analyzes tax expenditures, see Joint Committee on Taxation, *Background Information on Tax Expenditure Analysis and Historical Survey of Tax Expenditure Estimates, JCX-18-15* (February 6, 2015), www.jct.gov/publications/2015/jcx-18-15/. For the most recent list of JCT's estimates of tax expenditures, see Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2020–2024, JCX-23-20* (November 5, 2020), www.jct.gov/publications/2020/jcx-23-20/.

The exclusions analyzed in this report are for employment-based health insurance premiums, contributions and earnings associated with pensions and retirement savings accounts, capital gains on assets transferred at death, and capital gains on the sale of principal residences.

Deductions. Deductions allow taxpayers to reduce their taxable income, often by an amount that they have spent for a particular purpose. Deductions differ from exclusions because the income being deducted is still counted as part of a taxpayer's adjusted gross income and is subject to payroll taxes. Like exclusions, however, that income is not considered part of the taxpayer's taxable income. Because individual income tax rates increase with income, a deduction claimed by a higher-income taxpayer would typically create a larger tax expenditure than one claimed by a lower-income taxpayer.

Taxpayers can reduce the amount of their taxable income by availing themselves of either the standard deduction (which is not considered a tax expenditure) or of a number of other available deductions called itemized deductions. Three of the four deductions examined in this report are itemized deductions. Such deductions provide the largest benefits—in both absolute dollars and relative to income—to taxpayers with relatively high income because they benefit only those taxpayers for whom the value of the deductions is higher than the standard deduction. In 2019, 11 percent of tax filers itemized their deductions.

The itemized deductions analyzed in this report are for charitable contributions, mortgage interest, and state and local taxes. The other deduction analyzed in this report is for qualified business income.

Tax Credits. Unlike exclusions and deductions, credits reduce tax liability dollar for dollar by the amount of the credit, regardless of which tax bracket the taxpayer is in. Credits can be refundable (that is, fully available to every taxpayer who qualifies for the credit) or non-refundable (that is, available only to the extent that they reduce a taxpayer's liability to zero). For example, a taxpayer whose tax liability is \$500 and who qualifies for a \$600 refundable credit would receive a refund of \$100. But if that credit was nonrefundable, the taxpayer would owe no taxes but would not receive a refund. Thus, rather than just reducing the amount of taxes owed to the government, refundable credits can result in net

payments from the government, which are recorded as outlays in the federal budget.

Unlike the benefits of other types of tax expenditures, benefits from tax credits are skewed toward lower- and middle-income households, mainly for two reasons. First, the largest tax credits phase out to zero as income rises beyond certain thresholds, making higher-income taxpayers ineligible for the credits.⁴ Second, the value of credits is determined in fixed dollar amounts rather than as a proportion of a taxpayer's income. As a result, a credit that goes to a lower-income household constitutes a larger share of that household's income than if it had gone to a higher-income household.

The three tax credits analyzed in this report are the largest credits in the individual income tax system. They are the child tax credit, the earned income tax credit, and the premium tax credit for health insurance, all of which are refundable credits.⁵

Net Preferential Tax Rates. Under current law, some forms of income are taxed at rates that differ from those applied to other types of income. If the tax rate on a given form of income is lower than the ordinary tax rate, that difference will generate a tax expenditure. However, some types of income are also subject to surtaxes, which generate negative tax expenditures.⁶ The net result of those two tax expenditures is referred to in this report as the tax expenditure that arises from the net preferential tax rate.

Tax expenditures generated by net preferential tax rates are derived from the difference between the ordinary tax rate and the net preferential rate. Because ordinary tax rates increase with income, the tax expenditures generated by net preferential tax rates accrue mostly to

4. Despite income restrictions, households in the upper portion of the income distribution may receive the credits in certain cases because they include multiple families or tax filers. For example, a household may comprise a family consisting of a lower-income parent with two children who is eligible for the earned income and child tax credit and a higher-income adult whose income places the entire household near the top of the income distribution.
5. The estimates for those three credits include the refundable portions of the credits.
6. A provision that generates greater revenues than would occur under normal tax law is sometimes referred to as a negative tax expenditure.

Box 1.

Reference Tax Systems

A tax expenditure represents revenues that would have hypothetically been collected under an alternative set of tax provisions. Most provisions in the tax code alter tax liabilities (and therefore revenues), but only some of those provisions, by definition, create tax expenditures. In general, a tax provision creates a tax expenditure if the provision deviates from a hypothetical “normal” tax system known as a reference tax system. What is defined as a tax expenditure can therefore vary significantly according to the reference tax system in which it is based. The most common basis of a reference tax system—and the one used by the Congressional Budget Office (CBO), the Joint Committee on Taxation (JCT), and the Treasury Department’s Office of Tax Analysis (OTA)—is an income tax in which all forms of income are taxed according to a single set of rates. An alternative basis for a reference tax system is a consumption tax, which taxes people on what they spend rather than what they earn.

Challenges of Estimating Tax Expenditures Under an Income Tax Framework

There is some debate about which sources of income should reasonably be counted in a taxpayer’s total net income in an income tax framework. A comprehensive measure of income would include all sources of income. However, the measure of income used by CBO (and by OTA and JCT) in the reference tax system excludes certain types of income that

would theoretically be included in a comprehensive measure of income. The value of housework, for example, cannot be imputed accurately and is therefore excluded from the measure of income.

Another such exception occurs in the treatment of housing. A comprehensive measure of income would count the imputed rental income from owner-occupied housing—that is, the value of housing services consumed by the owner. Under such a system, a taxpayer’s mortgage interest could be deducted as a business expense—that is, an expense incurred to earn income. That corresponding income would be the rent that could have been earned if the taxpayer did not occupy the residence for which the deduction was claimed. The taxation of that imputed rental income would offset the deduction of mortgage interest. However, taxing imputed rent is administratively infeasible. When imputed rent is not taxed, the deduction of mortgage interest becomes a tax expenditure.

Measuring tax expenditures related to capital gains and dividends is also challenging. For example, a comprehensive income tax would tax all income at similar rates, but in the current income tax system and under the reference tax system used in this report, some capital income is subject to both the individual income tax and the corporate income tax. If tax expenditures were measured against a comprehensive income tax system, the estimates for most tax expenditures associated

Continued

higher-income taxpayers, who have higher ordinary rates. The largest individual income tax expenditure of that type—and the only one included in this report—is the tax expenditure that arises from net preferential rates on capital gains and dividends.

Estimating Tax Expenditures

In this analysis, CBO estimated the amount of each tax expenditure for each taxpayer as the difference between the taxpayer’s tax liability under 2019 law and the tax liability if the provisions generating that tax expenditure did not exist, but all other provisions remained in place, and the taxpayer’s behavior was unchanged.

Three characteristics of those estimates should be emphasized (see the appendix for more details about how CBO estimated tax expenditures). First, the tax expenditures

are only allocated to taxpayers who would have been directly liable for more taxes in the absence of the expenditures, even though those expenditures may also affect other people. For example, CBO’s estimates of the distribution of the deduction for mortgage interest leave aside any effect of that tax expenditure on the amount of mortgage debt or on housing values. Those effects may encourage households—particularly higher-income households, which are subject to higher marginal tax rates—to purchase homes that are more expensive and to finance them with more debt than they otherwise would.⁷

7. For more details about the effects of the mortgage interest deduction and other tax expenditures, see Senate Committee on the Budget, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, S. Prt. 116-53 (December 1, 2020), <https://go.usa.gov/xMy5v>.

Box 1.

Continued

Reference Tax Systems

with capital gains and dividends would include the effects of corporate taxes.

Additionally, a comprehensive income tax would tax real income (that is, income adjusted to remove the effects of inflation). To the extent that gains on longer-term investments occur as a result of inflation rather than a real (inflation-adjusted) return on investment, the estimate of the tax expenditure will be larger because capital gains subject to tax are not indexed for inflation.

Differences Under a Consumption Tax Framework

Tax expenditures would still exist under a consumption tax framework, but they would differ from the expenditures estimated on the basis of an income tax.¹ One way to tax consumption is to apply the tax when a good or service is purchased. A similar result is achieved by not taxing the return on saving, for example, by providing a deduction for net saving. The most notable differences between the two frameworks would arise from the classification and measurement of tax expenditures associated with investment and capital income. Because a

1. For an example of an analysis that classifies and measures tax expenditures relative to a consumption tax base, see Robert Carroll, David Joulfaian, and James Mackie, "Income Versus Consumption Tax Baselines for Tax Expenditures," *National Tax Journal*, vol. 64, no. 2.2 (June 2011), pp. 491–510, <https://tinyurl.com/zzj8ycn9>.

consumption tax would exempt the return on saving, any tax resulting from the return on saving would not be considered a tax expenditure. In fact, any tax on capital income would be considered a negative tax expenditure—that is, a deviation from the reference tax system that increases rather than reduces tax liabilities.

For example, the tax expenditure associated with the exclusion for pensions and retirement savings accounts would not be considered a tax expenditure if it was estimated on the basis of a consumption tax. In contrast to an income tax, a consumption tax would not tax the return on assets held in those accounts. That treatment is equivalent to the treatment of the tax expenditure under current law, which provides a deduction for some contributions to pensions and retirement accounts and taxes those assets when they are withdrawn or distributed, usually upon retirement. As a result, that exclusion is defined as a tax expenditure when estimated under a reference tax system that is based on an income tax.

Other tax expenditures in this analysis would be significantly smaller or even negative if estimated relative to a consumption tax, namely the exclusion of capital gains on the sale of principal residences; the exclusion of capital gains on assets transferred at death; and net preferential tax rates on capital gains and dividends.

Second, the analysis presents estimates of forgone payroll taxes in addition to estimates of forgone individual income taxes. Two of the tax expenditures in the analysis reduce both income taxes and payroll taxes: the exclusion for employment-based health insurance and the exclusion for pensions and retirement savings accounts. In both cases, the distributions of the forgone payroll taxes are less skewed toward higher-income households than are the distributions of forgone individual income taxes.⁸

8. Provisions that reduce the payroll tax base also reduce future Social Security benefits. Because those future benefits tend to be distributed more progressively than current payroll taxes are (that is, the benefits are a larger percentage of lifetime earnings for workers with lower lifetime earnings), an analysis that incorporated those exclusions' effects on future Social Security benefits, as well as on payroll and income taxes, would show net benefits to be more progressive than does the present analysis, which considers only the effects on current taxes. For more details, see the appendix.

In this report, those forgone payroll taxes are presented separately in the section on selected tax expenditures and are included in the combined estimates of tax expenditures.

Finally, the estimates of tax expenditures are not estimates of the additional government revenues that would be raised if the relevant provisions of law were eliminated. That is because the estimates of tax expenditures do not account for the way taxpayers would change their behavior as a result of eliminating the provisions. For example, if the net preferential tax rates on capital gains realizations were eliminated, some taxpayers would reduce the amount of capital gains they realize. Because the size of that tax expenditure is estimated on the basis of the amount of capital gains that are projected to be realized under current tax law, the amount of additional revenues that would be raised if that preference was

eliminated would be smaller than the estimated size of the tax expenditure.

How Changes in Tax Policy Affect Tax Expenditures

The size of tax expenditures depends on tax law and on economic conditions. The total value of individual and corporate income tax expenditures (not including forgone payroll taxes) has risen over the past few decades.⁹ For example, tax legislation has expanded the earned income tax credit and adjusted the tax rate for long-term capital gains. More recently, both the Affordable Care Act and the 2017 tax act (Public Law 115-97) introduced new tax expenditures in the individual income tax system, such as the premium tax credit and the qualified business income deduction.¹⁰

Changes to tax policy can affect tax expenditures either directly or indirectly. For example, the 2017 tax act reduced the tax expenditure for state and local taxes paid by directly limiting the deduction to \$10,000 per tax return, but it also indirectly reduced nearly all other tax expenditures by reducing ordinary tax rates and increasing the standard deduction. Some taxpayers who would otherwise have elected to itemize their deductions are now better off taking the standard deduction instead, thereby reducing the tax expenditures for itemized deductions such as those for charitable contributions or mortgage interest. (See Box 2 on page 22 for more details about how the 2017 tax act affected the distribution of tax expenditures.)

How Tax Expenditures Affect the Federal Budget

Tax expenditures significantly affect the federal budget by causing revenues to be lower than they would otherwise be for any underlying structure of tax rates. On the basis of estimates prepared by JCT, CBO estimates that the value of all tax expenditures in the individual and corporate income tax systems totaled \$1.6 trillion, or

7.8 percent of gross domestic product (GDP), in fiscal year 2019. That amount was equal to nearly half of all federal revenues, exceeded all discretionary outlays, and equaled 61 percent of all mandatory spending in the federal budget, which includes spending on Social Security and Medicare (see Figure 1).

The Distribution of Major Tax Expenditures in the Individual Income Tax System

The tax expenditures examined in this report comprised the largest tax expenditures in the individual income tax system in 2019. The results of the analysis are thus unaffected by the economic disruption caused by the pandemic and the enactment of legislation in response to it. Included here are relatively new tax expenditures, such as the premium tax credit for health insurance, as well as those that were significantly altered by the 2017 tax act, such as the state and local tax deduction.

In this analysis, CBO reports calendar-year estimates for the tax expenditures. Where relevant, the estimates also include the effects of forgone payroll taxes. The estimates do not reflect the increase in revenues that would occur if the provisions that create the tax expenditures were eliminated, because they do not account for changes in taxpayers' behavior that would likely occur in response to changes in tax law.

Although the tax expenditures analyzed here represent a small fraction of the more than 200 tax expenditures in the individual and corporate income tax systems, they accounted for about three-quarters of the total budgetary effects of all tax expenditures in 2019, CBO estimates.¹¹ The total estimated value of the tax expenditures in this analysis was \$1.2 trillion, or 5.8 percent of GDP (including forgone payroll taxes).

The tax expenditures varied in size, from \$22 billion to \$280 billion (see Table 1). The two largest tax expenditures, the exclusions for employment-based health insurance and for pensions and retirement savings accounts, are estimated to account for nearly half of the total estimated value of the tax expenditures in this report, or about 2.6 percent of GDP. The tax expenditure arising from net preferential tax rates on capital gains and

9. For details about the history of tax expenditures, see Joint Committee on Taxation, *Background Information on Tax Expenditure Analysis and Historical Survey of Tax Expenditure Estimates*, JCX-18-15 (February 6, 2015), www.jct.gov/publications/2015/jcx-18-15/.

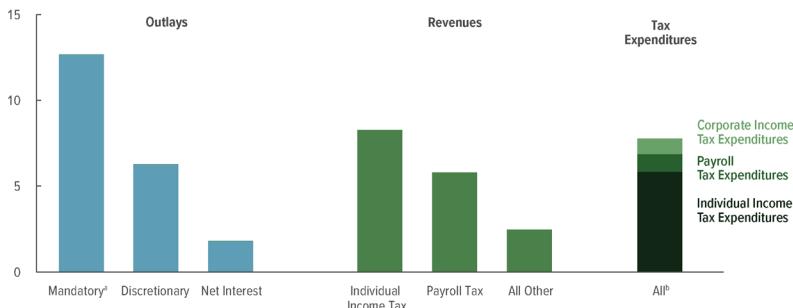
10. Recent legislation enacted in response to the pandemic also created several large, temporary tax expenditures, most notably the credit from recovery rebates for individuals and a temporary expansion of the child tax credit. Created by legislation enacted in 2020, those tax expenditures are not reflected in this report.

11. For the complete list of the tax expenditures that JCT estimates, see Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2020–2024*, JCX-23-20 (November 5, 2020), www.jct.gov/publications/2020/jcx-23-20/.

Figure 1.

Spending, Revenues, and Total Tax Expenditures, Fiscal Year 2019

Percentage of Gross Domestic Product

Data source: Congressional Budget Office, using estimates from the staff of the Joint Committee on Taxation. See www.cbo.gov/publication/57413#data.

a. The portions of refundable tax credits classified as outlays are included in both tax expenditures and mandatory outlays. In fiscal year 2019, they are estimated to have totaled 0.7 percent of gross domestic product.

b. This total is the sum of the estimates for all of the separate tax expenditures and does not account for any interactions among them. However, CBO estimates that in fiscal year 2019, the total for all tax expenditures, including the effects of their interactions, roughly equaled the sum of each expenditure considered separately. Furthermore, because estimates of tax expenditures are based on people's behavior with the expenditures in place, they do not reflect the amount of revenues that would be raised if those provisions of the tax code were eliminated and taxpayers altered their behavior in response to the changes.

dividends equaled about 0.7 percent of GDP, and the child tax credit equaled about 0.6 percent of GDP. The other nine tax expenditures examined here each equaled between 0.1 percent and 0.3 percent of GDP.

Benefits from tax expenditures tend to skew toward one end of the income distribution or the other. Although there is significant variation in the distribution of each of the tax expenditures in this report, tax expenditures in a given category tend to have similar distributional effects. In general, deductions and net preferential tax rates tend to provide larger benefits to higher-income taxpayers, relative to income, than to other taxpayers. Exclusions of taxable income tend to be more evenly distributed, and tax credits generally provide larger benefits to lower-income taxpayers.

Exclusion for Employment-Based Health Insurance

Many employers contribute to the cost of providing health insurance to their employees and their employees' families. Typically, employers and employees each pay a portion of insurance premiums. The employer's portion

is exempt from federal income and payroll taxes. In most cases, the employee's portion is also excluded from both income and payroll taxes.¹²

In general, the benefit from the exclusion for employment-based health insurance is more likely to accrue to higher-income households because they are more likely to have access to employment-based health insurance. The premium tax credit, another tax expenditure examined in this report, is designed to benefit lower-income households, who typically do not have access to such insurance.

12. The estimates of the tax expenditure created by the exclusion of employment-based health insurance in this analysis differ from the tax value of that exclusion, which appears in some other CBO reports. The tax expenditure represents the change in tax revenues that would occur if the amount of excluded compensation was taxed, whereas the tax value represents the change in tax revenues that would occur if the exclusion was repealed and the total compensation paid by the employer (including the employer's payroll taxes) remained constant because wages were increased. Neither measure reflects employees' behavioral responses to the change.

Table 1.

Major Tax Expenditures, 2019

Type of Tax Expenditure		Income Tax Expenditure (Billions of 2019 dollars)	Payroll Tax Expenditure (Billions of 2019 dollars)	Income and Payroll Tax Expenditure (Percentage of gross domestic product)
Exclusion for Employment-Based Health Insurance	Exclusion	159	121	1.3
Exclusion for Pensions and Retirement Savings Accounts ^a	Exclusion	202	74	1.3
Net Preferential Tax Rates on Capital Gains and Dividends ^b	Preferential Tax Rate	140	0	0.7
Child Tax Credit ^c	Credit	118	0	0.6
Earned Income Tax Credit ^c	Credit	70	0	0.3
Premium Tax Credit ^c	Credit	53	0	0.2
Charitable Contribution Deduction	Deduction	43	0	0.2
Qualified Business Income Deduction	Deduction	41	0	0.2
Exclusion of Capital Gains on Assets Transferred at Death	Exclusion	39	0	0.2
Exclusion of Social Security and Railroad Retirement Benefits	Exclusion	37	0	0.2
Exclusion of Capital Gains on the Sale of Principal Residences	Exclusion	35	0	0.2
Mortgage Interest Deduction on Owner-Occupied Residences	Deduction	28	0	0.1
State and Local Tax Deduction	Deduction	22	0	0.1

Data source: Congressional Budget Office, using estimates from the staff of the Joint Committee on Taxation. See www.cbo.gov/publication/57413/data.

In this analysis, the incidence of tax expenditures is assigned to the taxpayers who would have been directly liable for the relevant taxes if the provisions that generated the tax expenditure did not exist. Moreover, behavioral responses can affect the incidence of tax expenditures, but those responses and the resulting changes in incidence are not reflected in this report. For more details, see the section titled "Incidence of Tax Expenditures" in the appendix.

a. The tax expenditure arising from the exclusion for pensions and retirement savings accounts was estimated using a present-value method, which reflects the value of forgone taxes over time that would result from current-year contributions. For more details, see the section titled "How CBO Estimated the Tax Expenditure Created by the Exclusion for Pensions and Retirement Savings Accounts" in the appendix.

b. The estimate of the tax expenditure arising from net preferential tax rates on capital gains and dividends includes the net effect of reduced rates on capital gains and dividends and the surtax on net investment income for high-income taxpayers.

c. The estimates of the tax expenditures arising from the three refundable tax credits—the child tax credit, the earned income tax credit, and the premium tax credit—include the portions of those tax credits that are classified as outlays in the federal budget.

The exclusion for employment-based health insurance is the largest tax expenditure. According to CBO's estimates, the total tax expenditure arising from that exclusion was \$280 billion in 2019, of which \$159 billion constituted the income tax expenditure and \$121 billion constituted the payroll tax expenditure.

Most of the benefits from the exclusion for employment-based health insurance accrued to higher-income households (see Figure 2). CBO estimates that 44 percent of the income tax expenditure accrued to households in the highest quintile of the income distribution, 29 percent to the fourth quintile, 16 percent to the middle quintile, and 11 percent to the bottom two quintiles combined (see Table 2).

About 64 million households benefited from the exclusion (see Figure 3). The share of households in each quintile that benefited from it also grew with income,

ranging from 12 percent in the lowest quintile to 55 percent in the middle quintile and 74 percent in the highest quintile (see Table 3 on page 16).

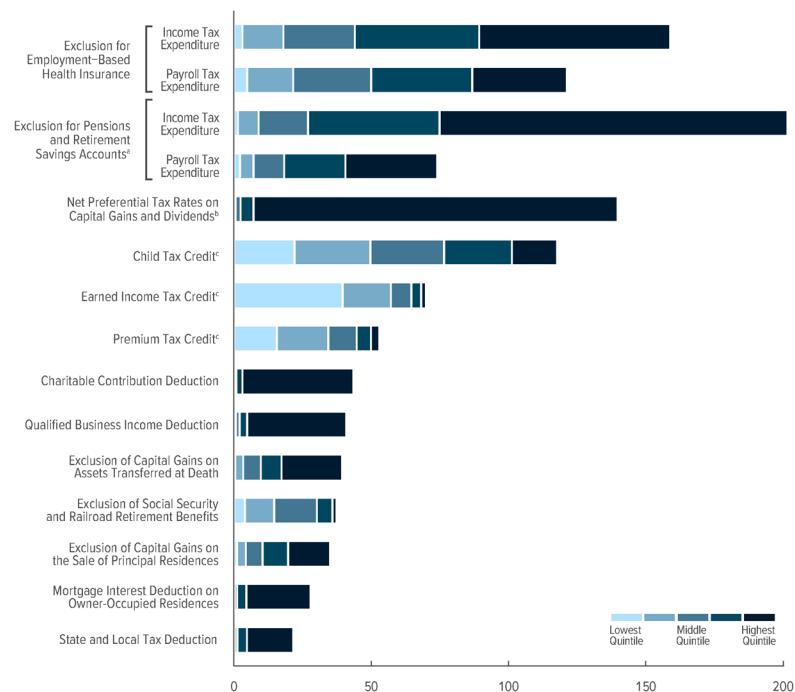
Measured as a share of income before transfers and taxes, the income tax expenditure arising from the exclusion for employment-based health insurance was relatively flat among the middle three quintiles, ranging from 1.1 percent to 1.4 percent of income. Households in the lowest quintile received benefits equal to 0.5 percent of their income, and those in the highest quintile received benefits equal to 0.8 percent of their income (see Figure 4 on page 17). Households in the top 1 percent of the distribution received benefits equal to 0.2 percent of income (see Table 4 on page 18).

Two factors explain that distributional pattern. First, although the likelihood of having employment-based health insurance increases with income, premium

Figure 2.

Shares of Major Tax Expenditures, 2019

Billions of 2019 Dollars

Data source: Congressional Budget Office, using estimates from the staff of the Joint Committee on Taxation. See www.cbo.gov/publication/57413#data.

In this analysis, the incidence of tax expenditures is assigned to the taxpayers who would have been directly liable for the relevant taxes if the provisions that generated the tax expenditure did not exist. Moreover, behavioral responses can affect the incidence of tax expenditures, but those responses and the resulting changes in incidence are not reflected in this report. For more details, see the section titled "Incidence of Tax Expenditures" in the appendix.

- a. The tax expenditure arising from the exclusion for pensions and retirement savings accounts was estimated using a present-value method, which reflects the value of forgone taxes over time that would result from current-year contributions. For more details, see the section titled "How CBO Estimated the Tax Expenditure Created by the Exclusion for Pensions and Retirement Savings Accounts" in the appendix.
- b. The estimate of the tax expenditure arising from net preferential tax rates on capital gains and dividends includes the net effect of reduced rates on capital gains and dividends and the surtax on net investment income for high-income taxpayers.
- c. The estimates of the tax expenditures arising from the three refundable tax credits—the child tax credit, the earned income tax credit, and the premium tax credit—include the portions of those tax credits that are classified as outlays in the federal budget.

Table 2.

Shares of Major Tax Expenditures, Including Percentiles Within the Highest Quintile, 2019

Percent

	Percentiles Within the Highest Quintile								
	Lowest Quintile	Second Quintile	Middle Quintile	Fourth Quintile	Highest Quintile	81st to 90th	91st to 95th	96th to 99th	Top 1 Percent
Exclusion for Employment-Based Health Insurance (Income tax expenditure)	1.9	9.4	16	29	44	20	11	11	2.9
Exclusion for Employment-Based Health Insurance (Payroll tax expenditure)	4.0	14	23	30	28	16	6.6	4.4	0.9
Exclusion for Pensions and Retirement Savings Accounts (Income tax expenditure) ^a	0.7	3.8	8.9	24	63	22	16	19	5.3
Exclusion for Pensions and Retirement Savings Accounts (Payroll tax expenditure) ^a	2.9	6.7	15	30	45	23	11	9.0	1.9
Net Preferential Tax Rates on Capital Gains and Dividends ^b	0.1	0.4	1.3	3.4	95	3.4	3.8	12	75
Child Tax Credit ^c	19	23	23	21	14	8.2	4.1	1.7	0.0
Earned Income Tax Credit ^c	56	25	11	5.1	2.5	1.5	0.6	0.3	0.1
Premium Tax Credit	29	35	19	9.9	5.6	3.2	1.3	1.0	0.2
Charitable Contribution Deduction	0.1	0.3	1.5	5.2	93	7.3	7.1	15	63
Qualified Business Income Deduction	0.3	1.6	3.2	6.7	88	8.1	9.0	21	50
Exclusion of Capital Gains on Assets Transferred at Death	1.0	7.5	16	19	56	15	9.4	13	18
Exclusion of Social Security and Railroad Retirement Benefits	11	28	42	15	4.1	2.5	1.1	0.5	0.1
Exclusion of Capital Gains on the Sale of Principal Residences	3.1	9.1	17	26	44	17	9.9	11	5.3
Mortgage Interest Deduction on Owner-Occupied Residences	0.1	0.9	3.2	12	84	16	15	28	25
State and Local Tax Deduction	0.2	1.2	4.4	16	78	21	18	27	11

Data source: Congressional Budget Office, using estimates from the staff of the Joint Committee on Taxation. See www.cbo.gov/publication/57413#data.

In this analysis, the incidence of tax expenditures is assigned to the taxpayers who would have been directly liable for the relevant taxes if the provisions that generated the tax expenditure did not exist. Moreover, behavioral responses can affect the incidence of tax expenditures, but those responses and the resulting changes in incidence are not reflected in this report. For more details, see the section titled "Incidence of Tax Expenditures" in the appendix.

- a. The tax expenditure arising from the exclusion for pensions and retirement savings accounts was estimated using a present-value method, which reflects the value of forgone taxes over time that would result from current-year contributions. For more details, see the section titled "How CBO Estimated the Tax Expenditure Created by the Exclusion for Pensions and Retirement Savings Accounts" in the appendix.
- b. The estimate of the tax expenditure arising from net preferential tax rates on capital gains and dividends includes the net effect of reduced rates on capital gains and dividends and the surtax on net investment income for high-income taxpayers.
- c. The estimates of the tax expenditures arising from the three refundable tax credits—the child tax credit, the earned income tax credit, and the premium tax credit—include the portions of those tax credits that are classified as outlays in the federal budget.

amounts are more evenly distributed for those who have such insurance. Second, the income tax rate rises with the income distribution, so the tax savings from each dollar excluded increases along with the tax rate.

At \$121 billion, the payroll tax expenditure arising from the exclusion for employment-based health insurance was nearly as large as the income tax expenditure in 2019. The payroll tax expenditure was more evenly distributed than was the income tax expenditure because payroll taxes generally rise less quickly with income than

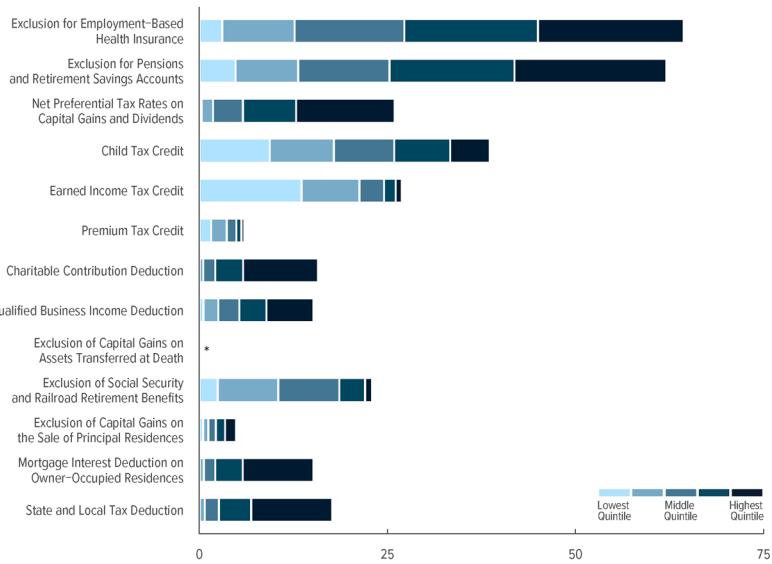
income taxes do. CBO estimates that 28 percent of that tax expenditure accrued to households in the highest quintile, 30 percent to the fourth quintile, 23 percent to the middle quintile, and 18 percent to the two lowest quintiles combined.

Measured as a share of income, the payroll tax expenditure was relatively flat among the middle three quintiles. Households in those quintiles received benefits equal to between 1.1 percent and 1.3 percent of their income. Households in the lowest quintile received benefits equal

Figure 3.

Number of Households That Benefited From Major Tax Expenditures, 2019

Millions

Data source: Congressional Budget Office, using estimates from the staff of the Joint Committee on Taxation. See www.cbo.gov/publication/57413#data.

In this analysis, the incidence of tax expenditures is assigned to the taxpayers who would have been directly liable for the relevant taxes if the provisions that generated the tax expenditure did not exist. Moreover, behavioral responses can affect the incidence of tax expenditures, but those responses and the resulting changes in incidence are not reflected in this report. For more details, see the section titled "Incidence of Tax Expenditures" in the appendix.

* = Fewer than 2 million households in total benefited from the tax expenditure.

to 0.8 percent of their income, whereas those in the highest quintile received benefits equal to 0.4 percent of their income.

Exclusion for Pensions and Retirement Savings Accounts

The federal tax system treats retirement savings more favorably than it does other forms of savings. Certain contributions to pension plans and retirement accounts can be excluded from income taxes and payroll taxes when they are made, and investment earnings in those plans and accounts are generally not subject to individual

income taxes when they accrue. Instead, taxes are deferred—that is, they are paid when withdrawals are made from the accounts, typically during retirement. Thus, one key benefit of the exclusion for pensions and retirement savings accounts is that it enables taxpayers to save for retirement at the before-tax rate of return.¹³

13. An alternative type of retirement savings account is a Roth plan. Although contributions to a Roth plan are made with after-tax income, the earnings on the investments in such a plan, and any withdrawals from it, are not taxed. Like traditional retirement savings plans, Roth plans allow taxpayers to save for retirement at the before-tax rate of return.

Table 3.

Shares of Households That Benefited From Major Tax Expenditures, 2019

Percent

	Lowest Quintile	Second Quintile	Middle Quintile	Fourth Quintile	Highest Quintile	81st to 90th	91st to 95th	96th to 99th	Top 1 Percent	Percentiles Within the Highest Quintile
Exclusion for Employment-Based Health Insurance	12	35	55	69	74	74	75	73	69	
Exclusion for Pensions and Retirement Savings Accounts	19	30	46	64	77	75	80	80	75	
Net Preferential Tax Rates on Capital Gains and Dividends	1.2	5.6	15	27	50	38	51	69	89	
Child Tax Credit	37	31	30	29	20	23	23	14	1.7	
Earned Income Tax Credit	54	28	12	6.0	3.0	3.7	2.6	1.9	1.8	
Premium Tax Credit	6.2	7.6	4.7	2.6	1.5	1.7	1.4	1.2	1.0	
Charitable Contribution Deduction	0.2	1.8	6.0	14	38	28	41	52	71	
Qualified Business Income Deduction	2.2	7.2	11	14	24	17	23	35	56	
Exclusion of Capital Gains on Assets Transferred at Death	0.2	0.8	1.4	1.3	1.2	1.3	1.0	1.0	1.0	
Exclusion of Social Security and Railroad Retirement Benefits	9.7	29	31	13	3.5	4.2	3.7	2.1	1.7	
Exclusion of Capital Gains on the Sale of Principal Residences	2.0	2.6	3.7	4.8	5.6	5.6	5.6	5.8	5.4	
Mortgage Interest Deduction on Owner-Occupied Residences	0.3	2.0	5.7	14	36	27	39	49	59	
State and Local Tax Deduction	0.4	2.3	7.1	17	41	31	44	56	69	

Data source: Congressional Budget Office, using estimates from the staff of the Joint Committee on Taxation. See www.cbo.gov/publication/57413#data.

In this analysis, the incidence of tax expenditures is assigned to the taxpayers who would have been directly liable for the relevant taxes if the provisions that generated the tax expenditure did not exist. Moreover, behavioral responses can affect the incidence of tax expenditures, but those responses and the resulting changes in incidence are not reflected in this report. For more details, see the section titled "Incidence of Tax Expenditures" in the appendix.

In this report, CBO combined several tax expenditures related to multiple types of pension plans and retirement savings accounts—such as defined-benefit and defined-contribution employer plans, individual retirement arrangements (IRAs), Roth plans, and Keogh plans—in its estimate of the tax expenditure arising from pensions and retirement savings accounts.

For the purposes of this analysis, CBO estimated the tax expenditure for pension and retirement contributions using a present-value method, which reflects the value of forgone taxes over time that would result from current-year contributions. That method compares the current and future taxes paid for retirement contributions made today with the current and future taxes that would have been paid on an equivalent investment in a taxable account. Some analysts use a cash-flow method instead, which estimates the tax expenditure for pension contributions as the difference between the current tax treatment and an alternative one in which there was no deduction for contributions, in which investment earnings in existing accounts were taxed, and in which

withdrawals from existing accounts were not taxed. Because such retirement savings accounts allow the taxpayer to save at the before-tax rate of return, the present-value estimate better reflects the economic benefit of altering the timing of taxes on retirement income. (See the appendix for a discussion of the differences between the present-value method and the cash-flow method.)

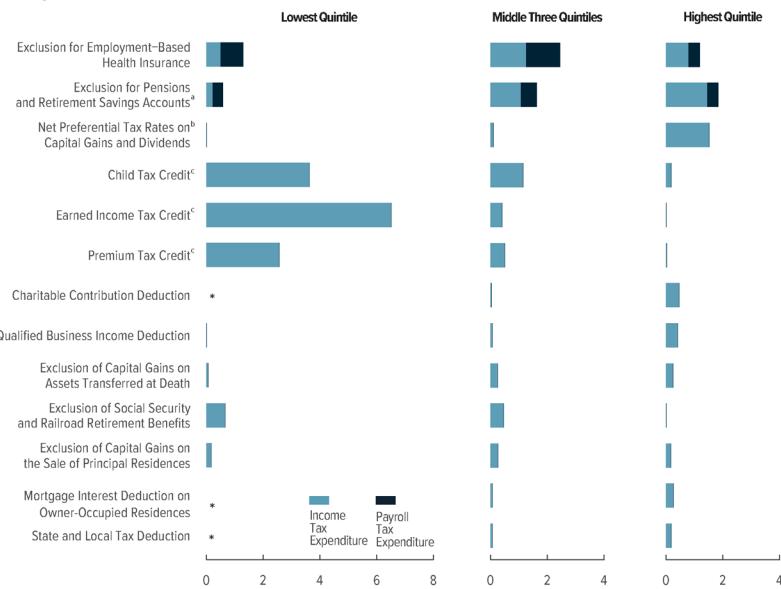
The tax expenditure arising from the exclusion and deferrals for the contributions and earnings associated with pensions and retirement savings accounts is the second-largest tax expenditure considered in this analysis. CBO estimates that it totaled \$276 billion in 2019, of which \$202 billion constitutes the income tax expenditure and \$74 billion constitutes the payroll tax expenditure.¹⁴ Those estimates reflect the present value of tax savings attributable to contributions made in 2019.

14. The payroll tax expenditure is created because employer contributions to pension and retirement savings accounts are not subject to the payroll tax. Employee contributions are subject to the payroll tax and therefore do not contribute to the estimate of the payroll tax expenditure.

Figure 4.

Major Tax Expenditures as a Share of Income, 2019

Percentage of Income Before Transfers and Taxes

Data source: Congressional Budget Office, using estimates from the staff of the Joint Committee on Taxation. See www.cbo.gov/publication/57413#data.

In this analysis, the incidence of tax expenditures is assigned to the taxpayers who would have been directly liable for the relevant taxes if the provisions that generated the tax expenditure did not exist. Moreover, behavioral responses can affect the incidence of tax expenditures, but those responses and the resulting changes in incidence are not reflected in this report. For more details, see the section titled "Incidence of Tax Expenditures" in the appendix.

* = less than 0.01 percent.

- a. The tax expenditure arising from the exclusion for pensions and retirement savings accounts was estimated using a present-value method, which reflects the value of forgone taxes over time that would result from current-year contributions. For more details, see the section titled "How CBO Estimated the Tax Expenditure Created by the Exclusion for Pensions and Retirement Savings Accounts" in the appendix.
- b. The estimate of the tax expenditure arising from net preferential tax rates on capital gains and dividends includes the net effect of reduced rates on capital gains and dividends and the surtax on net investment income for high-income taxpayers.
- c. The estimates of the tax expenditures arising from the three refundable tax credits—the child tax credit, the earned income tax credit, and the premium tax credit—include the portions of those tax credits that are classified as outlays in the federal budget.

Table 4.

**Major Tax Expenditures as a Share of Income, Including Percentiles
Within the Highest Quintile, 2019**

Percentage of Income Before Transfers and Taxes

	Percentiles Within the Highest Quintile								
	Lowest Quintile	Second Quintile	Middle Quintile	Fourth Quintile	Highest Quintile	81st to 90th	91st to 95th	96th to 99th	Top 1 Percent
Exclusion for Employment-Based Health Insurance (Income tax expenditure)	0.5	1.1	1.2	1.4	0.8	1.3	1.1	0.8	0.2
Exclusion for Employment-Based Health Insurance (Payroll tax expenditure)	0.8	1.2	1.3	1.1	0.4	0.8	0.5	0.3	0.0
Exclusion for Pensions and Retirement Savings Accounts (Income tax expenditure) ^a	0.2	0.5	0.8	1.5	1.5	1.9	2.0	1.8	0.4
Exclusion for Pensions and Retirement Savings Accounts (Payroll tax expenditure) ^a	0.4	0.4	0.5	0.7	0.4	0.7	0.5	0.3	0.1
Net Preferential Tax Rates on Capital Gains and Dividends ^b	0.0	0.0	0.1	0.1	1.5	0.2	0.3	0.8	4.1
Child Tax Credit ^c	3.6	2.0	1.2	0.8	0.2	0.4	0.3	0.1	0.0
Earned Income Tax Credit ^c	6.5	1.3	0.3	0.1	0.0	0.0	0.0	0.0	0.0
Premium Tax Credit	2.6	1.3	0.5	0.2	0.0	0.1	0.0	0.0	0.0
Charitable Contribution Deduction	0.0	0.0	0.0	0.1	0.5	0.1	0.2	0.3	1.1
Qualified Business Income Deduction	0.0	0.0	0.1	0.1	0.4	0.1	0.2	0.4	0.8
Exclusion of Capital Gains on Assets Transferred at Death	0.1	0.2	0.3	0.2	0.3	0.3	0.2	0.2	0.3
Exclusion of Social Security and Railroad Retirement Benefits	0.7	0.8	0.7	0.2	0.0	0.0	0.0	0.0	0.0
Exclusion of Capital Gains on the Sale of Principal Residences	0.2	0.2	0.3	0.3	0.2	0.3	0.2	0.2	0.1
Mortgage Interest Deduction on Owner-Occupied Residences	0.0	0.0	0.0	0.1	0.3	0.2	0.3	0.4	0.3
State and Local Tax Deduction	0.0	0.0	0.0	0.1	0.2	0.2	0.2	0.3	0.1

Data source: Congressional Budget Office, using estimates from the staff of the Joint Committee on Taxation. See www.cbo.gov/publication/57413#data.

In this analysis, the incidence of tax expenditures is assigned to the taxpayers who would have been directly liable for the relevant taxes if the provisions that generated the tax expenditure did not exist. Moreover, behavioral responses can affect the incidence of tax expenditures, but those responses and the resulting changes in incidence are not reflected in this report. For more details, see the section titled "Incidence of Tax Expenditures" in the appendix.

a. The tax expenditure arising from the exclusion for pensions and retirement savings accounts was estimated using a present-value method, which reflects the value of forgone taxes over time that would result from current-year contributions. For more details, see the section titled "How CBO Estimated the Tax Expenditure Created by the Exclusion for Pensions and Retirement Savings Accounts" in the appendix.

b. The estimate of the tax expenditure arising from net preferential tax rates on capital gains and dividends includes the net effect of reduced rates on capital gains and dividends and the surtax on net investment income for high-income taxpayers.

c. The estimates of the tax expenditures arising from the three refundable tax credits—the child tax credit, the earned income tax credit, and the premium tax credit—include the portions of those tax credits that are classified as outlays in the federal budget.

Most of the benefits of the exclusion for pensions and retirement savings accounts accrued to higher-income households. Households in the highest quintile received more than 60 percent of the benefits of the income tax expenditure. The two lowest quintiles together received less than 5 percent of the benefits.

About 62 million households benefited from the tax expenditure, and the share of households that benefited increased with income. CBO estimates that 19 percent

of households in the lowest quintile, 46 percent of households in the middle quintile, and 77 percent of households in the highest quintile benefited from the tax expenditure. CBO estimates that, in 2019, households in the lowest quintile received benefits from the income tax expenditure equal to 0.2 percent of their income before transfers and taxes, whereas those in the middle quintile and the highest quintile received benefits equal to 0.8 percent and 1.5 percent of such income, respectively.

Higher-income taxpayers tend to benefit more from the exclusion for pensions and retirement savings accounts for three main reasons. First, such taxpayers are more likely to have employers who offer pension plans and who are also more likely to contribute to retirement savings accounts. Second, the generosity of such plans and contributions increases with income, although that effect is limited by caps on contributions and antidiscrimination rules that prevent employers from making retirement plans significantly more valuable for highly compensated employees than for other employees. Finally, higher-income taxpayers face higher marginal tax rates—that is, the tax rate that would apply to an additional dollar of income—which increases the value of the tax expenditure for each additional dollar of their retirement savings.

The payroll tax expenditure arising from the exclusion of contributions to pension and retirement savings plans was more evenly distributed than was the corresponding income tax expenditure because payroll taxes generally increase more slowly with income than income taxes do. Households in the highest quintile received 45 percent of the benefits of the payroll tax expenditure, CBO estimates, compared with 63 percent of the benefits of the income tax expenditure. The two lowest quintiles together received 10 percent of the benefits of the payroll tax expenditure, compared with less than 5 percent of the benefits of the income tax expenditure. When measured as a share of income, the payroll tax expenditure arising from the exclusion for pensions and retirement savings accounts was relatively evenly distributed. Each of the five quintiles received benefits equal to between 0.4 percent and 0.7 percent of their income.

Net Preferential Tax Rates on Capital Gains and Dividends

Long-term capital gains (that is, the profit from the sale of an asset that was held for longer than one year) and certain dividends are taxed at lower rates than are other forms of income. In 2019, income from those long-term gains and dividends was subject to a maximum marginal rate of 20 percent for taxpayers with taxable income above \$434,550 (\$488,850 for joint filers). In addition, taxpayers with income above certain thresholds—\$200,000 for single filers and \$250,000 for joint filers—faced a surtax equal to 3.8 percent of their investment income (including capital gains and dividend income, as well as interest income and some passive business income). The surtax offsets some of the benefits

associated with the lower tax rates on long-term capital gains and dividends.¹⁵

The tax expenditure arising from the net preferential rate on long-term capital gains and dividends totaled \$140 billion in 2019, CBO estimates.¹⁶ CBO's estimates of that tax expenditure comprise the net effects of both the reduced rates on capital gains and dividends and the portion of the surtax that falls on those gains and dividends. The former amounted to \$174 billion in 2019, and the latter amounted to \$34 billion, CBO estimates.

Ninety-five percent of the benefits from the net preferential rates on capital gains and dividends accrued to households in the highest quintile in 2019—75 percent of them to households in the top 1 percent of the income distribution. Although only about half of the 26 million households that benefit from this tax expenditure are in the highest quintile, those households have much higher amounts of capital gains and dividends. CBO estimates that the tax expenditure equals 1.5 percent of income before transfers and taxes for households in the highest quintile and 4.1 percent of income for households in the top 1 percent, for two key reasons. First, the largest share of capital gains realizations and dividends accrues to those households. Second, those households are typically in the highest tax bracket for ordinary income. As a result, the tax expenditure estimate for those households typically reflects a larger difference between the ordinary rate and the lower rate on capital gains and dividends.

Child Tax Credit

In 2019, taxpayers with children under age 17 were eligible to receive a \$2,000 credit per child, up to \$1,400 of which was refundable. An additional, nonrefundable \$500 credit was available for older dependent children

15. The estimates in this report do not account for corporate taxation and do not distinguish between real and inflationary capital gains. See Box 1 for details about how that treatment differs from the measurement of tax expenditures based on a comprehensive income tax.

16. As is true of many of the other tax provisions that create the tax expenditures in this report, changes to the rate at which capital gains and dividends are taxed could cause taxpayers to alter their behavior regarding saving and investing. For example, higher tax rates on capital gains could cause taxpayers to realize fewer capital gains. The estimates presented here do not account for such behavior changes. For more details, see the section titled "Incidence of Tax Expenditures" in the appendix.

and other dependent relatives.¹⁷ The credit was reduced for taxpayers with income above \$200,000 (\$400,000 for joint filers). The credit is currently scheduled to shrink to \$1,000 in 2026, when the eligibility for it is also scheduled to change to span a narrower range of income.

CBO estimates that the tax expenditure arising from the child tax credit totaled \$118 billion in 2019. The credit was relatively evenly distributed. Households in the four lower quintiles received between 19 percent and 23 percent of the total benefits; those in the highest quintile received 14 percent of the benefits, of which 8 percent went to households in the 81st to 90th percentiles. Thirty-nine million households benefited from the expenditure. Between 29 percent and 37 percent of households in each of the four lower quintiles benefited, as did 20 percent of households in the highest quintile.

The credit accounted for 3.6 percent of income before transfers and taxes for households in the lowest quintile, 2.0 percent of such income for households in the second quintile, and 1.2 percent for those in the middle quintile. Because the credit had a fixed maximum value, it constituted a smaller share of income as income increased, even among taxpayers who received the full credit (in contrast to exclusions or deductions, which are uncapped and can rise with income). As a result, the benefits accounted for only 0.8 percent of income for households in the fourth quintile and 0.2 percent of income for those in the highest quintile.

Earned Income Tax Credit

A fully refundable credit is available to low-income workers, which increases up to a certain level of income depending on a worker's marital status and number of children. The maximum credit for taxpayers with two qualifying children was \$5,828 in 2019. The credit was reduced for taxpayers at higher income levels and was unavailable to those with income above certain thresholds.¹⁸

17. As part of the American Rescue Plan, a larger credit amount was temporarily made available to taxpayers with income below \$75,000 (\$150,000 for joint filers) in 2021. In addition, the credit was made fully refundable.

18. The earned income tax credit is much larger for families with children than for childless workers, and the child tax credit is only available to families with children. As a result, the estimates of the distributions of those credits depend heavily on the distribution of families with children throughout the income scale. When ranking the population by income, CBO adjusts income for household size; as a result, more households with

CBO estimates that the tax expenditure arising from the earned income tax credit totaled \$70 billion in 2019. More than half of households in the lowest quintile benefited from the credit, and CBO estimates that 56 percent of its benefits accrued to those households. For those households, the credit equaled 6.5 percent of their income before transfers and taxes. One-quarter of the benefits from the credit accrued to households in the second quintile, equaling 1.3 percent of income before transfers and taxes for those households. In contrast, about 8 percent of the benefits from the credit accrued to households in the two highest quintiles—largely because some low-income taxpayers who qualify for the credit live in high-income households.

Premium Tax Credit

Under current law, subsidies for health insurance obtained through the marketplaces established under the Affordable Care Act are primarily provided through premium tax credits. In 2019, those credits were available to people with a modified adjusted gross income between 100 percent and 400 percent of the federal poverty level (FPL), and who were lawfully present in the United States, were not eligible for public coverage (such as Medicaid or the Children's Health Insurance Program), and who did not have an affordable offer of employment-based coverage.¹⁹ The value of the credit varies on the basis of income, of the chosen health insurance plan, and of the cost of a benchmark plan in the same local market.

CBO estimates that the total tax expenditure arising from the premium tax credit was \$53 billion in

children are included in the lowest income quintile. Without such an adjustment, the tax credits would appear to be less progressive than they do in this report. For more information about how CBO ranks households and adjusts for household size, see Congressional Budget Office, *The Distribution of Household Income, 2018* (August 2021), www.cbo.gov/publication/57061.

19. In 2019, the threshold for determining the affordability of an offer of employment-based health coverage was set at 9.86 percent of income for a single plan—that is, a plan that covers one person. The American Rescue Plan Act of 2021 (Public Law 117-2), which was enacted in March 2021, included provisions that temporarily expanded the premium tax credit in 2021 and 2022. The law increased tax credits for those with income between 100 percent and 400 percent of the FPL. It also extended eligibility for the credits to those with income at or above 400 percent of the FPL, ensuring that they do not pay more than 8.5 percent of their income for a benchmark plan. Those changes are not included in the estimates of the tax expenditures provided in this report.

2019. The credit was designed to assist lower- and middle-income people, but not those toward the very bottom of the income distribution, who are typically eligible for Medicaid. Eighty-four percent of the benefit from the premium tax credit went to households in the lower three quintiles: 35 percent to those in the second quintile, and 29 percent and 19 percent to the lowest and middle quintiles, respectively. Nearly 5 million of the 6 million households that benefited from the expenditure came from the lower three quintiles. The benefits equaled 2.6 percent of income before transfers and taxes for households in the lowest quintile, 1.3 percent for those in the second quintile, and 0.5 percent for those in the middle quintile.

Charitable Contribution Deduction

Taxpayers who itemize their deductions can deduct contributions to eligible charities and nonprofit organizations from their taxable income, subject to some limitations.

The deduction for charitable contributions was the largest itemized deduction in the individual income tax system in 2019. The tax expenditure arising from that deduction was an estimated \$43 billion. Ninety-three percent of its benefits accrued to households in the highest quintile, including 63 percent to households in the top 1 percent of the income distribution.

Higher-income households are more likely to claim a deduction for their contributions to charity—38 percent of households in the highest quintile claimed the deduction in 2019, compared with 14 percent in the fourth quintile and 6 percent in the middle quintile. CBO estimates that, in 2019, the tax expenditure equaled 0.1 percent of income before transfers and taxes for households in the fourth quintile, 0.5 percent for those in the highest quintile, and 1.1 percent for the top 1 percent of the distribution. Among households that claim the deduction, higher-income households tend to deduct larger amounts. Because they are typically in higher tax brackets, those households also receive a larger proportional benefit for every dollar of charitable contribution.

Qualified Business Income Deduction

Owners of certain pass-through businesses (such as S corporations, partnerships, and sole proprietorships) can deduct up to 20 percent of their net income from the

business, depending on the amount of the income and the size and nature of the business. That deduction is scheduled to expire in 2026.

Although the qualified business income deduction is structured as a deduction, it is similar to the net preferential tax rate on capital gains and dividends because it is equivalent to a reduced tax rate on a certain type of income and applies only to a taxpayer's positive qualified business income. In addition, it differs in two important ways from the deductions for charitable contributions, mortgage interest, and state and local taxes paid. First, it is available to taxpayers whether or not they itemize their deductions. Second, it allows taxpayers to deduct a portion of their income without first requiring them to spend that income on any particular item.

Because higher-income households tend to have more qualifying income, benefits from the qualified business income deduction were skewed toward the top of the distribution. The tax expenditure arising from that deduction totaled \$41 billion in 2019, CBO estimates, of which 88 percent accrued to households in the highest quintile, including 50 percent that accrued to households in the top 1 percent of the distribution. Nearly two-thirds of the 15 million households that benefited from the deduction were in the two highest quintiles in 2019, according to CBO's estimates. The tax expenditure equaled 0.1 percent of income for households in the middle quintile and in the fourth quintile, 0.4 percent for those in the highest quintile, and 0.8 percent for those in the top 1 percent of the distribution.

Exclusion of Capital Gains on Assets Transferred at Death

Increases in the value of an asset beyond its purchase value (or cost basis) are exempt from the tax on capital gains when the asset is transferred to heirs upon the death of its owner. When the asset is transferred, the cost basis is adjusted to the current market value. As a result, heirs are not liable for taxation on increases in value that occurred before they acquired the asset.²⁰

20. The estimates in this report do not account for corporate taxation and do not distinguish between real and inflationary capital gains. See Box 1 for details about how that treatment differs from the measurement of tax expenditures based on a comprehensive income tax.

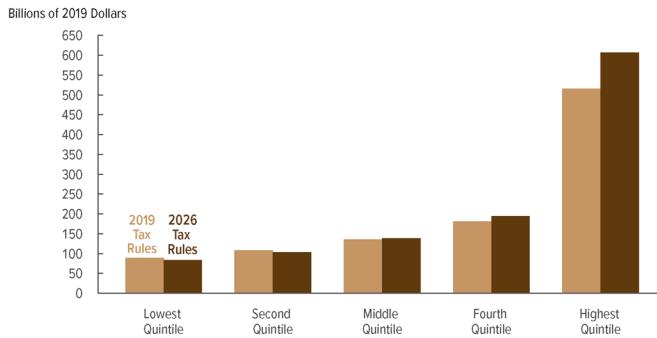
Box 2.

How Provisions of the 2017 Tax Act Affected Major Tax Expenditures in 2019

Public Law 115-97 (referred to here as the 2017 tax act) made important changes to the tax system. Beginning in 2018, provisions of that act reduced individual income tax rates, added new limitations on itemized deductions, increased the standard deduction, repealed the personal exemption, and increased the child tax credit. Those changes affected the size and distribution of nearly every tax expenditure in the individual income tax system. In addition to creating the qualified business income deduction, the tax act also directly changed three tax expenditures: the child tax credit, the mortgage interest deduction, and the state and local tax deduction.

Changes attributable to the tax act also affected tax expenditures indirectly through interactions between existing tax expenditures and other changes in the law. Some provisions in the tax act affected tax liability in ways that changed the benefits associated with tax expenditures, such as reduced marginal tax rates, the elimination of the personal exemption, and the larger standard deduction. Mainly because of the larger standard deduction, the number of tax returns in which taxpayers itemized their deductions decreased from 47 million in 2017 to 18 million in 2018—that is, from about 31 percent of all tax returns to 11 percent of them. That decrease reduced the

Distribution of Combined Major Income Tax Expenditures in 2019, Under 2019 Tax Rules and 2026 Tax Rules



Data source: Congressional Budget Office, using estimates from the staff of the Joint Committee on Taxation. See www.cbo.gov/publication/57413#data.

In this analysis, the incidence of tax expenditures is assigned to the taxpayers who would have been directly liable for the relevant taxes if the provisions that generated the tax expenditure did not exist. Moreover, behavioral responses can affect the incidence of tax expenditures, but those responses and the resulting changes in incidence are not reflected in this report. For more details, see the section titled "Incidence of Tax Expenditures" in the appendix.

The 2026 tax law reflects the scheduled expiration of many provisions of the 2017 tax act. To construct the alternative scenario under 2026 tax rules, CBO adjusted the tax parameters for that year to be consistent with the economic conditions in 2019. The combined estimates shown here for the two scenarios do not include payroll tax expenditures, which would be the same in either scenario.

The combined estimates include interactions among the tax expenditures that would occur if the tax expenditures were simultaneously eliminated, except the tax expenditure arising from the exclusion for pensions and retirement savings accounts. Although that tax expenditure is included in the combined estimates, the effect of its interaction with the other tax expenditures is omitted because it is estimated using a present-value method, which reflects the value of forgone taxes over time that would result from current-year contributions. For more details, see the section titled "How CBO Estimated the Tax Expenditure Created by the Exclusion for Pensions and Retirement Savings Accounts" in the appendix.

The estimate of the tax expenditure arising from net preferential tax rates on capital gains and dividends includes the net effect of reduced rates on capital gains and dividends and the surtax on net investment income for high-income taxpayers.

The estimates of the tax expenditures arising from the three refundable tax credits—the child tax credit, the earned income tax credit, and the premium tax credit—include the portions of those tax credits that are classified as outlays in the federal budget.

Continued

Box 2.

Continued

How Provisions of the 2017 Tax Act Affected Major Tax Expenditures in 2019

estimate of tax expenditures created by deductions, such as the one for charitable contributions.

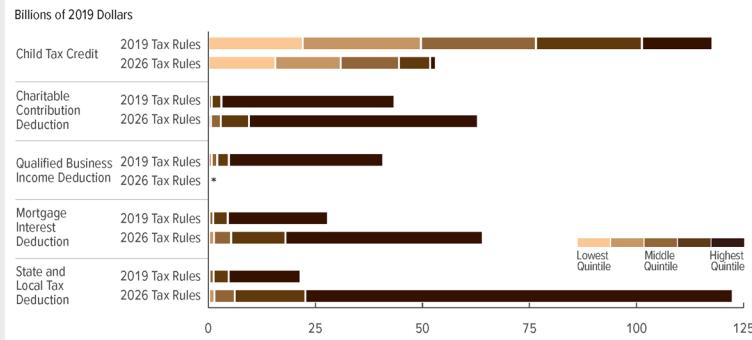
To examine the effects of provisions of the 2017 tax act, the Congressional Budget Office estimated how the benefits from the tax expenditures analyzed in this report were distributed under the tax rules in 2019, when the act was fully in effect, and how they would be distributed in 2026, when many of the provisions of the 2017 tax act are scheduled to expire. To calculate those differences, the agency used its microsimulation tax model to estimate the benefits of tax expenditures under both the 2019 tax rules and the tax rules scheduled to be in place in 2026. The demographic and economic conditions were identical in both scenarios.¹

1. To construct the alternative scenario under 2026 tax rules, CBO adjusted the tax parameters for that year to be consistent with the economic conditions in 2019. For example, many tax parameters, such as the standard deduction, are indexed for inflation. In the alternative scenario, those parameters were deflated to reflect what their value would have been in 2019.

Income tax expenditures estimated under the 2026 tax rules are, in total, 9 percent more than estimated income tax expenditures in 2019—that is, provisions of the 2017 tax act reduced the total estimate of the income tax expenditures examined in this report by 9 percent. Most of the additional benefits that would occur under 2026 tax rules (when the tax act expires) would accrue to households in the highest quintile, which means that the tax act made the distribution of tax expenditures more progressive, even though the amount of tax expenditures accruing to the four lower quintiles remained roughly unchanged in aggregate (see the first figure in this box).

That result is mainly attributable to multiple offsetting effects among 5 of the 13 tax expenditures analyzed here (see the second figure, below). On the one hand, the child tax credit became larger and more available to taxpayers in higher-income households, and the benefits of the new qualified business income deduction were skewed toward the top of the distribution. On the other hand, the three preexisting deductions, which mostly benefited higher-income households, shrank.

Distribution of Selected Major Tax Expenditures in 2019, Under 2019 Tax Rules and 2026 Tax Rules



Data source: Congressional Budget Office, using estimates from the staff of the Joint Committee on Taxation. See www.cbo.gov/publication/57413#data.

In this analysis, the incidence of tax expenditures is assigned to the taxpayers who would have been directly liable for the relevant taxes if the provisions that generated the tax expenditure did not exist. Moreover, behavioral responses can affect the incidence of tax expenditures, but those responses and the resulting changes in incidence are not reflected in this report. For more details, see the section titled "Incidence of Tax Expenditures" in the appendix.

The 2026 tax law reflects the scheduled expiration of many provisions of the 2017 tax act. To construct the alternative scenario under 2026 tax rules, CBO adjusted the tax parameters for that year to be consistent with the economic conditions in 2019.

The estimate of the tax expenditure arising from the child tax credit includes the portion of that tax credit that is classified as an outlay in the federal budget.

* = The amount is zero because the qualified business income deduction is currently scheduled to expire in 2026.

The tax expenditure arising from the exclusion of capital gains on assets transferred at death totaled about \$39 billion in 2019, CBO estimates. The benefits from the exclusion were skewed toward the top of the income distribution: CBO estimates that 56 percent of the benefits accrued to households in the highest quintile (including 18 percent that accrued to households in the top 1 percent of the distribution), and 19 percent accrued to households in the fourth quintile.²¹ The exclusion largely benefits taxpayers with a high net worth, who tend to be in households in the upper portion of the income distribution.²²

Because the exclusion is only available when a taxpayer dies and has assets to transfer, very few households benefit from it in any given year. About 1 percent of households in every quintile (except the lowest quintile) used the exclusion in 2019. However, the value of the benefit increases with the value of assets being transferred, so most of the benefits from the exclusion accrue to households with a high net worth, which tend to be in the upper portion of the income distribution.

Exclusion of Social Security and Railroad Retirement Benefits

Payments of Social Security and Railroad Retirement benefits are funded by payroll taxes, and the amount of the benefits is determined in part by the amounts that employees and employers contribute during the period

of employment. Both the employer and the employee pay payroll taxes to fund an employee's Social Security (and Railroad Retirement benefit) payments. Under current law, most Social Security benefits are exempt from taxation. Currently, Social Security recipients only pay taxes on a portion of their benefits, and only if their total income exceeds a certain threshold.²³ The benefits of recipients who do not exceed that threshold are not taxed, and that loss of revenues is considered a tax expenditure. Under the reference income tax system, the portion of Social Security benefits that cannot be traced back to a recipient's contributions would be taxable.

The tax expenditure arising from the exclusion of Social Security and Railroad Retirement benefits totaled about \$37 billion in 2019, accruing to about 23 million households. That exclusion almost exclusively benefited middle-income households, CBO estimates, with 85 percent going to those in the middle three income quintiles. Higher-income taxpayers benefit little from the exclusion because they are required to include most of their Social Security benefits in their taxable income under current law. Lower-income taxpayers also benefit little from the exclusion because the standard deduction already excludes a large portion of those benefits from their taxable income.

Exclusion of Capital Gains on the Sale of Principal Residences

In 2019, taxpayers could exclude from their taxable income up to \$250,000 (or \$500,000 for a married couple filing jointly) of the capital gains arising from the sale of their primary residence, with some limitations.

CBO estimates that the tax expenditure totaled about \$35 billion in 2019, 70 percent of which accrued to households in the two highest quintiles, including 5 percent that accrued to households in the top 1 percent of the distribution.²⁴ About 5 million households benefited from the exclusion in 2019. The share of households that benefited in each quintile was relatively flat throughout the income distribution: 2 percent

21. In this report, the estimates of tax expenditures arising from capital gains exclusions—that is, the exclusion of capital gains on assets transferred at death and of capital gains on the sale of principal residences—rely on estimates of lifetime unrealized capital gains, which are not available in the tax data. Although CBO includes realized capital gains in the measure of income that it uses to rank households and place them in different income groups, estimates of accrued capital gains are not included in that measure. As a result, the households that benefit from those tax expenditures are likely to appear lower in the income distribution than they would be if unrealized gains were included. However, other households with unrealized capital gains who do not avail themselves of either of those exclusions also likely appear lower in the distribution, so the amount of ranking that would occur if unrealized capital gains were added to the income measure is uncertain.

22. There is uncertainty about whether the incidence of this tax expenditure falls on decedents or their heirs. CBO allocates the tax to decedents. In addition, as is the case with other taxes on capital income, the ways in which the exclusion affects saving behavior could have broader effects on labor and capital income. For more details, see the section titled "Incidence of Tax Expenditures" in the appendix.

23. In 2019, single filers were required to pay taxes on up to 50 percent of their benefits if their income was between \$25,000 and \$34,000; they were required to pay taxes on up to 85 percent of their benefits if their income was over \$34,000.

24. The estimates presented here do not distinguish between real and inflationary capital gains. See Box 1 for details about how that treatment differs from the measurement of tax expenditures based on a comprehensive income tax.

of households in the lowest quintile benefited from the expenditure, as did 4 percent of households in the middle quintile and 6 percent of those in the highest quintile. A larger share of the total tax expenditure accrues to higher-income taxpayers because they tend to realize larger gains when their homes are sold. However, the share of the tax expenditure decreases with income within the highest quintile, largely because the exclusion is capped (at \$250,000 for a single filer and \$500,000 for a married couple filing jointly).

Mortgage Interest Deduction

Under current law, taxpayers who elect to itemize their deductions are typically allowed to deduct from taxable income the interest paid on the mortgage of their primary and secondary residences. In 2019, the deduction was limited to the interest paid on qualifying mortgage debt up to \$750,000. The limit is scheduled to increase to \$1 million in 2026, when many of the individual income tax provisions of the 2017 tax act are scheduled to expire.

The tax expenditure arising from the mortgage interest deduction on owner-occupied residences totaled \$28 billion in 2019. Households in the highest quintile received 84 percent of the benefits from the deduction that year, including 25 percent that accrued to the top 1 percent of the distribution. CBO estimates that 15 million households benefited from the expenditure in 2019, with the benefits skewed toward the top of the distribution: 36 percent of households in the highest quintile benefited from the tax expenditure, compared with 14 percent of households in the fourth quintile and 6 percent of households in the middle quintile. The mortgage interest deduction equaled 0.3 percent of income before transfers and taxes for households in the highest quintile and 0.1 percent of such income for those in the fourth quintile, CBO estimates.

Taxpayers in higher-income households receive a larger share of the mortgage interest deduction than do other households for three main reasons. Those taxpayers are more likely to itemize their deductions; they tend to hold larger mortgages; and the value of the tax expenditure is higher for them because they are typically in higher tax brackets.

State and Local Tax Deduction

In 2019, taxpayers who elected to itemize their deductions could deduct from their taxable income the taxes they paid to state and local governments. The deduction

was capped at \$10,000 that year but is scheduled to become unlimited in 2026.

CBO estimates that the tax expenditure arising from the state and local tax deduction totaled \$22 billion in 2019. Because higher-income households pay more state and local taxes than other households do, they are more likely to deduct those taxes and to deduct higher amounts when they do. About 94 percent of the benefits from the tax expenditure accrued to households in the two highest quintiles in 2019. Seventeen percent of households in the fourth quintile, and 41 percent of households in the highest quintile, benefited from the tax expenditure. The deduction accounted for 0.1 percent of income before transfers and taxes for households in the fourth quintile and 0.2 percent for those in the highest quintile.

The Distribution of Major Tax Expenditures in the Individual Income Tax System in Total

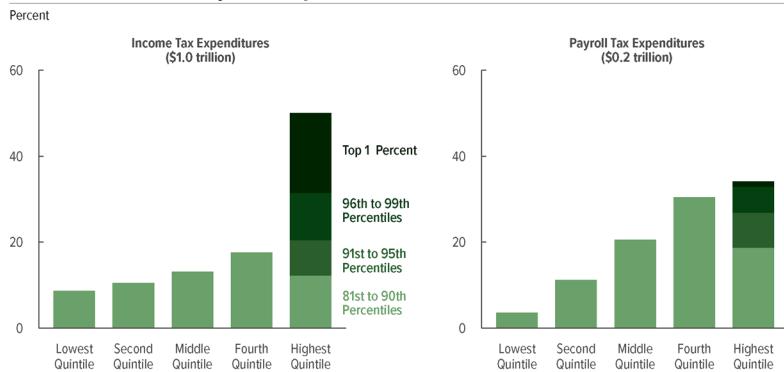
In total, the benefits from the major tax expenditures examined in this report were distributed unevenly across the income scale in 2019. When measured in dollars, the combined benefits from the tax expenditures accrued more to higher-income households than to lower-income ones. However, when measured relative to income before transfers and taxes, the combined benefits were greater for lower-income households than for higher-income ones. If the effects of payroll taxes were excluded from CBO's estimates, the distribution of benefits would be slightly more evenly distributed.²⁵

Distribution in Dollars

In 2019, higher-income households benefited more from the major tax expenditures, when measured in dollars, than did lower-income households. CBO estimates that 50 percent of the total benefits of the income tax expenditures accrued to households in the highest quintile of the income distribution, 13 percent accrued to those in the middle quintile, and 9 percent accrued to those in

25. When preparing the combined estimates of the tax expenditures in this report, CBO accounted for the interactions among the tax expenditures that would occur if certain tax expenditures were eliminated simultaneously. One exception is the exclusion for pensions and retirement savings accounts. Because CBO uses a present-value method in its estimates of that tax expenditure, its interaction with the other tax expenditures is not included. Instead, the estimate of that tax expenditure is added to the combined estimate of the other tax expenditures. For a discussion about the types of interactions that can occur among tax expenditures, see the section titled "Interactions Among Tax Expenditures" in the appendix.

Figure 5.
Shares of Combined Major Tax Expenditures, 2019



Data source: Congressional Budget Office, using estimates from the staff of the Joint Committee on Taxation. See www.cbo.gov/publication/57413#data.

In this analysis, the incidence of tax expenditures is assigned to the taxpayers who would have been directly liable for the relevant taxes if the provisions that generated the tax expenditure did not exist. Moreover, behavioral responses can affect the incidence of tax expenditures, but those responses and the resulting changes in incidence are not reflected in this report. For more details, see the section titled "Incidence of Tax Expenditures" in the appendix.

The combined estimates include interactions among the tax expenditures that would occur if the tax expenditures were simultaneously eliminated, except the tax expenditure arising from the exclusion for pensions and retirement savings accounts. Although that tax expenditure is included in the combined estimates, the effect of its interaction with the other tax expenditures is omitted because it is estimated using a present-value method, which reflects the value of forgone taxes over time that would result from current-year contributions. For more details, see the section titled "How CBO Estimated the Tax Expenditure Created by the Exclusion for Pensions and Retirement Savings Accounts" in the appendix.

The estimate of the tax expenditure arising from net preferential tax rates on capital gains and dividends includes the net effect of reduced rates on capital gains and dividends and the surtax on net investment income for high-income taxpayers.

The estimates of the tax expenditures arising from the three refundable tax credits—the child tax credit, the earned income tax credit, and the premium tax credit—include the portions of those tax credits that are classified as outlays in the federal budget.

the lowest quintile (see Figure 5). The payroll tax expenditures, which represent a smaller total value, were more evenly distributed: 34 percent accrued to households in the highest quintile, 21 percent accrued to households in the middle quintile, and 4 percent accrued to households in the lowest quintile.

Benefits were not evenly distributed within the highest quintile. About 18 percent of the benefits from the income tax expenditures accrued to households in the top 1 percent of the distribution, 11 percent accrued to households in the 96th to 99th percentiles, 8 percent accrued to households in the 91st to 95th percentiles, and 12 percent accrued to households in the 81st to 90th percentiles. Of the payroll tax expenditures, 1 percent accrued to households in the top 1 percent of the

distribution, and 19 percent accrued to households in the 81st to 90th percentiles.

Distribution as a Share of Income

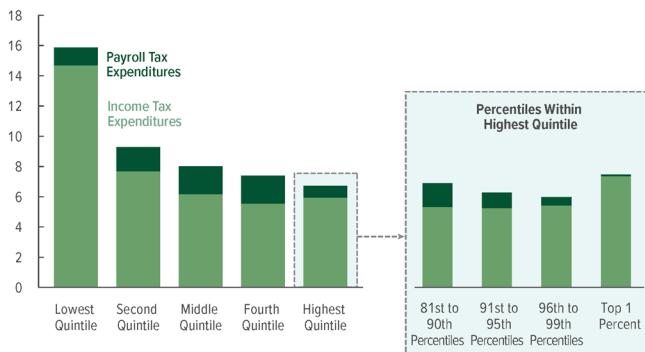
Although about 8 percent of the benefits of the income and payroll tax expenditures examined here accrued to households in the lowest quintile in 2019, those households received an even smaller share of income. CBO estimates that in 2018, the most recent year for which the agency estimated the distribution of household income, households in the lowest quintile received less than 4 percent of total income before transfers and taxes.²⁶

26. See Congressional Budget Office, *The Distribution of Household Income, 2018* (August 2021), www.cbo.gov/publication/57061.

Figure 6.

Combined Major Tax Expenditures as a Share of Income, 2019

Percentage of Income Before Transfers and Taxes

Data source: Congressional Budget Office, using estimates from the staff of the Joint Committee on Taxation. See www.cbo.gov/publication/57413#data.

In this analysis, the incidence of tax expenditures is assigned to the taxpayers who would have been directly liable for the relevant taxes if the provisions that generated the tax expenditure did not exist. Moreover, behavioral responses can affect the incidence of tax expenditures, but those responses and the resulting changes in incidence are not reflected in this report. For more details, see the section titled "Incidence of Tax Expenditures" in the appendix.

The combined estimates include interactions among the tax expenditures that would occur if the tax expenditures were simultaneously eliminated, except the tax expenditure arising from the exclusion for pensions and retirement savings accounts. Although that tax expenditure is included in the combined estimates, the effect of its interaction with the other tax expenditures is omitted because it is estimated using a present-value method, which reflects the value of forgone taxes over time that would result from current-year contributions. For more details, see the section titled "How CBO Estimated the Tax Expenditure Created by the Exclusion for Pensions and Retirement Savings Accounts" in the appendix.

The estimate of the tax expenditure arising from net preferential tax rates on capital gains and dividends includes the net effect of reduced rates on capital gains and dividends and the surtax on net investment income for high-income taxpayers.

The estimates of the tax expenditures arising from the three refundable tax credits—the child tax credit, the earned income tax credit, and the premium tax credit—include the portions of those tax credits that are classified as outlays in the federal budget.

As a result, when tax expenditures are measured as a share of income before transfers and taxes, they benefit households in the two lowest quintiles more than they do households in the rest of the income distribution. CBO estimates that, in 2019, the benefits accruing from the tax expenditures analyzed in this report (including both income tax and payroll tax expenditures) equaled 16 percent of income for households in the lowest quintile, 9 percent of income for households in the second quintile, 8 percent of income for households in the middle quintile, and 7 percent of income for households in the two highest quintiles (see Figure 6). The shares were similar among income groups within the highest quintile, with each group receiving benefits equal to between 6.0 percent and 7.5 percent of income.

Distribution Excluding Payroll Taxes

In 2019, the forgone payroll tax revenues from tax expenditures were relatively evenly distributed as a share of income in the four lowest quintiles of the distribution, but they represented a smaller share of income in the highest quintile and a much smaller share in the top 5 percent of the income distribution. Thus, the shares of the benefit from tax expenditures accruing to each income group rose more sharply with income when only income taxes—rather than both income taxes and payroll taxes—are considered. Still, tax expenditures from the individual income tax alone provided the greatest benefit as a share of income to households in the lowest quintile, consistent with the results reported here for tax expenditures from income and payroll taxes together.

Appendix: Analytic Method and Additional Characteristics of Tax Expenditures

This appendix provides details about how the Congressional Budget office estimated the distribution of tax expenditures presented in this report. The appendix also provides information about the differences between the present analysis and CBO's previous work on the distribution of tax expenditures; the agency's present-value approach for estimating the exclusion for pensions and retirement savings accounts (a present value is a single number that expresses a flow of current and future payments in terms of a lump sum paid today); issues related to the incidence of tax expenditures; how tax expenditures can interact with each other; and the agency's analysis of payroll taxes, which excludes effects on future Social Security benefits related to taxes paid.

Analytic Method

To evaluate the distribution of major tax expenditures, CBO used a sample of income tax returns filed in 2013. That sample was the most recent public-use data with detailed information about tax returns that was available when this analysis began.¹ CBO used its microsimulation tax model to adjust the sample of returns from 2013 to account for changes in the population and the economy between 2013 and 2019, which yielded a sample of tax returns for 2019 that reflected the income and demographic characteristics of the population in that year. The agency used a measure of income before transfers and taxes that comprises both market income (including labor income, business income, and capital income—the

latter counting capital gains) and social insurance benefits (such as Social Security and Medicare).²

For its analysis, CBO divided the U.S. population into income groups, such as the lowest quintile (that is, the lowest fifth) or the top 1 percent.³ In constructing those income groups, households (all people living in a single housing unit, regardless of their relationships) were ranked by income before transfers and taxes, adjusted for household size, which reflects the fact that larger households need more income than smaller ones do to achieve the same economic status. CBO adjusted income for household size by dividing household income by an adjustment factor equal to the square root of the number of people in the household, counting adults and children equally. That adjustment reflects the agency's assessment that each additional person increases a household's needs but at a decreasing rate.⁴

In CBO's analysis, families or individuals who live together but file separate tax returns were treated as a single household to reflect the fact that they share resources. As a result, the distribution of tax expenditures among households differs from the distribution of tax expenditures among tax-filing units. For example, someone who qualifies for a tax expenditure, such as the earned income tax credit (EITC), on the basis of the income of his or her tax-filing unit may live in a household that includes

1. For its analyses of the distribution of household income, CBO uses a sample of confidential tax data, which is typically available two years after the period to which the data pertain. CBO's most recent report presenting the analysis of household income was for 2018. For the analysis in the present report, however, the agency used public-use tax data that are statistically altered to protect the confidentiality of individual taxpayers; those data typically become available about six years after the period to which they pertain.

2. For information about how CBO estimates the distribution of taxes and household income, see Congressional Budget Office, *The Distribution of Household Income, 2018* (August 2021), www.cbo.gov/publication/57061.

3. In this report, CBO's estimate of the U.S. population excludes members of the armed forces on active duty and people in institutions such as prisons or nursing homes.

4. The adjustment for household size is only applied to household income for the sake of ranking households to construct income groups. The income amounts reported for each income group are not adjusted for household size.

people in higher-income tax-filing units. That pattern would make the distribution of benefits from the EITC less progressive on a household basis than on the basis of tax-filing units.

CBO simulates what the tax liabilities would have been for each taxpayer in 2019 if the provisions that created tax expenditures were eliminated; but the analysis does not account for any change in taxpayers' behavior in response to eliminating those provisions. (See the section titled "Incidence of Tax Expenditures" in this appendix for more details about the potential effects of taxpayers' behavior.)

Most tax expenditures can be directly computed from the information available on tax returns, but some must be calculated using external data sources. To estimate the effect on tax liabilities of the exclusion for employment-based health insurance, for example, CBO used estimates from its health insurance simulation model. That model provided the probabilities of people having employment-based health insurance (as well as the value of that insurance) on the basis of each taxpayer's age, sex, marital status, number of dependents, employment, and income. Also, CBO estimated pension contributions from employers and employees using tabulations from the Survey of Consumer Finances. Those tabulations included the probabilities of people participating in various forms of retirement savings plans, as well as average contributions and balances estimated on the basis of income, age, and marital status. Those parameters were then applied to the income tax data. CBO used a similar method to estimate capital gains from unrealized gains at death and the sale of owner-occupied housing.

Although the data CBO used in its analysis contained information about income from pass-through businesses, those data did not contain information about which businesses were eligible for the qualified business income deduction. The agency therefore estimated the effects of that deduction by applying it to all the pass-through income of taxpayers with income below certain thresholds that limit who can claim the deduction. CBO also applied a smaller deduction to the pass-through income of taxpayers with income above those thresholds, so that the total value of the tax expenditure in the extrapolated 2019 data set matched the agency's estimate of the total for that year.

Each estimated tax expenditure for each taxpayer was scaled so that, for a given expenditure, the sum of the

estimates among all taxpayers was equal to the aggregate amount of that tax expenditure in 2019, as estimated by the staff of the Joint Committee on Taxation (JCT).⁵ JCT's estimates are calculated on the basis of fiscal years; CBO adjusted those estimates to obtain calendar-year totals for the estimates in this report.

In this report, CBO follows JCT's method of estimating each tax expenditure "as the difference between tax liability under present law and the tax liability that would result from a recomputation of tax without benefit of the tax expenditure provision."⁶ In that way, it is assumed that taxpayers would take advantage of any of the remaining tax expenditure provisions that apply to the income or the expenses associated with the tax expenditure in question. For example, the tax expenditure created by the exclusion for employment-based health insurance is estimated as the difference in tax liability that would result if the exclusion was repealed but taxpayers were still allowed to claim the next-best tax treatment available for health insurance contributions under current law. For some taxpayers, that next-best treatment would be to claim those contributions as an itemized medical deduction.

How This Report Differs From CBO's 2013 Report on Tax Expenditures

In 2013, CBO published a report on the distribution of the largest tax expenditures in that year. Although the present report is an update to that earlier one, there are three important differences in the analysis. First, CBO has updated its distributional framework so that households are grouped on the basis of income before transfers and taxes, which comprises market income (including labor income, business income, and capital income—the latter counting capital gains) and social insurance benefits (such as Social Security and Medicare).⁷ In the previ-

5. For a list of JCT's aggregate estimates of tax expenditures in fiscal year 2019, see Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2019–2023*, JCX-55-19 (December 18, 2019), www.jct.gov/publications/2019/jcx-55-19/.

6. See Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2020–2024*, JCX-23-20 (November 5, 2020), p. 17, www.jct.gov/publications/2020/jcx-23-20/.

7. For more details about CBO's framework for distributional analyses and why the agency updated that framework, see Kevin Perese, *CBO's New Framework for Analyzing the Effects of Means-Tested Transfers and Federal Taxes on the Distribution of Income*, Working Paper 2017-09 (Congressional Budget Office, December 2017), www.cbo.gov/publication/53345.

ous report, households were grouped on the basis of their before-tax income, which also included means-tested transfers. Furthermore, when reporting tax expenditures as a share of income, the previous report used after-tax income, whereas this report uses income before transfers and taxes to be consistent with the measure of income used to rank households in the distributional framework.

Second, legislative changes since 2013 have changed the set of major tax expenditures being examined. For example, new tax expenditures have been added, such as the premium tax credit and the qualified business income deduction. In addition, the size and distribution of nearly all existing tax expenditures were altered by the 2017 tax act, which significantly changed the tax system.

Finally, this analysis reflects economic changes since 2013, which altered the distribution of income. Most notably, a larger share of income was concentrated at the top of the distribution in 2019 than in 2013. However, this analysis does not reflect any economic or legislative changes to the economy since 2019.

How CBO Estimated the Tax Expenditure Created by the Exclusion for Pensions and Retirement Savings Accounts

Provisions related to pensions and retirement savings accounts affect the timing and amount of income subject to income taxes and payroll taxes in several ways. First, certain contributions to pension and retirement plans are excluded from taxation when they are made. (Generally, contributions from employers are excluded from both income taxes and payroll taxes; most contributions from employees are excluded from income taxes.) Second, the investment earnings on balances held inside pension and retirement accounts—the largest component of the tax expenditure—are untaxed. Finally, pension benefits and distributions from retirement accounts that were not previously taxed are subject to income taxes upon withdrawal; that component partially offsets the first two components.⁸

Most tax expenditures, including the one created by the exclusion for pensions and retirement savings accounts, are typically estimated using a cash-flow method. That method measures the effect of all current and past tax-preferred retirement contributions on current-year tax liability as the difference between the current tax treatment and an alternative tax treatment. Under the alternative tax treatment, there is no deduction for contributions, investment earnings in existing accounts are taxed, and withdrawals from existing accounts are not taxed. Estimating the tax expenditure using the cash-flow method requires estimating the unobserved asset appreciation and the corresponding rates at which that investment income would be taxed.

However, CBO used a present-value method in the current analysis.⁹ That method evaluates the entire future stream of tax payments for an investment in a pension account (in general, contributions to retirement accounts and investment earnings are not taxed, but withdrawals are) and the future stream of tax payments for an equivalent investment in a taxable account (in which contributions and investment earnings are taxed, but withdrawals are not). Both payment streams are then adjusted for inflation, and the estimate of the tax expenditure is calculated as the difference between them.

The estimates derived using CBO's present-value method also depend on the agency's choice of modeling parameters. In the estimates presented in this report, taxpayers make contributions until they reach age 65, at which point they withdraw those contributions in equal installments until they reach age 85. Taxpayers face the same marginal tax rates in retirement as they faced in 2019. Investments are held in interest-bearing securities that are taxed as ordinary income. Those investments earn a rate of return of 3.5 percent, and future taxes are discounted at that same rate.

Many of the modeling parameters that CBO uses are uncertain and could affect the size and distribution of the tax expenditure. One such important parameter is the tax rate on withdrawals from retirement savings accounts. Although the tax rate on contributions can be estimated reliably, the tax rate on withdrawals is more uncertain. Some taxpayers may have lower tax rates on

8. Most retirement savings plans are subject to the tax treatment outlined here. However, there is a category of plans known as Roth individual retirement arrangements (Roth IRAs) and Roth 401(k)s that are subject to a different treatment. For those plans, contributions are not excluded from taxation, but distributions from those plans are not subject to taxation upon withdrawal.

9. The Treasury also provides present-value estimates for tax expenditures related to deferrals of income, including expenditures for retirement savings and accelerated depreciation of property.

their withdrawals than on their contributions, whereas others may have higher rates on withdrawals. To the extent that the rate on withdrawals is lower than the rate on contributions, the value of the tax expenditure will be smaller under the present-value method. In this analysis, CBO has adopted the convention of applying the same tax rate to both withdrawals and contributions for all taxpayers.

The agency tested that approach and found that in 2019, the marginal income tax rate on contributions was only about 2 percentage points higher than that on withdrawals. Furthermore, CBO estimates that in 2026, after many provisions of the 2017 tax act expire, that difference will shrink, and the marginal tax rate on withdrawals will be higher than that on contributions by 1 percentage point. If CBO instead applied a tax rate on withdrawals that was 1 percentage point lower than that on contributions, the size of the income tax expenditure would be higher than that presented in this report by about \$10 billion, or 5 percent, and the distribution of benefits would remain unchanged.

Another important set of parameters includes the rate of return on investments, the discount rate, and the tax rates on investment income. Higher returns on investment generally increase the size of the tax expenditure, as do higher tax rates on those returns. In its analysis, CBO used a rate of return of 3.5 percent, which is equal to the agency's July 2021 forecast of the interest rate on 10-year Treasury notes at the end of the 10-year budget window. However, many retirement assets are held in investments that offer both higher risk and higher returns than Treasury notes. In the absence of the tax expenditure for pensions and retirement savings accounts, any returns that take the form of dividends and capital gains would typically be taxed at lower rates than is ordinary income. The higher rate of return and lower tax rates tend to offset each other in the estimate of the tax expenditure.

CBO also set the rate of return to equal the discount rate, which reflects the conventional view that people choose investments in such a way that their risk-adjusted rate of return is equal to their discount rate. To test an alternative scenario, CBO also used a rate of return and a discount rate of 6 percent in the analysis. Although the estimate of the income tax expenditure created by the exclusion for pensions and retirement savings accounts would be about 38 percent larger in that alternative scenario, the share of benefits that accrued to each quintile

from that tax expenditure would be similar to the share that accrued to them if the discount rate was set at 3.5 percent.

In CBO's assessment, the cash-flow method is useful for estimating the overall budgetary effect of the tax expenditure, but the present-value method is more appropriate for the distributional analysis in this report for three key reasons. First, the present-value method is better suited to evaluate the benefits over many years within a cross-sectional framework (that is, a framework in which the same households are not observed over time). Second, that method allows for a more consistent treatment of contributions to deductible and non-deductible (Roth plan) accounts. Third, the present-value method does not treat taxable distributions of past contributions as a negative tax expenditure. For example, it does not treat retirees as being better off if the tax expenditure was eliminated.

CBO's estimate of the income tax expenditure arising from the exclusion for pensions and retirement savings accounts in 2019 is 24 percent higher when measured by the cash-flow method than when measured as the present value of one year's retirement contributions. The cash-flow method also yields a distribution of benefits for that income tax expenditure that is more skewed toward the top of the distribution than is the estimate obtained using the present-value method. Under the cash-flow method, 73 percent of the benefits of the income tax expenditure would accrue to households in the highest quintile, compared with 63 percent under the present-value method. Similarly, 11 percent of the benefits would accrue to households in the top 1 percent of the distribution, compared with 5 percent under the present-value method.

Incidence of Tax Expenditures

The economic incidence of a change in taxes is the distribution of the change in the economic burdens associated with that tax, after accounting for changes in behavior and prices. Tax expenditures may affect people other than those who directly benefit from them (and they may have different effects on people who ostensibly benefit by the same amounts). But in the present analysis, the incidence of tax expenditures is assigned to the taxpayers who would have been directly liable for the relevant taxes if the provisions that generated the tax expenditure did not exist. Although behavioral responses can affect the incidence of tax expenditures, those responses



and the resulting changes in incidence are not reflected in this report. Taxpayers in different income groups may be more or less able to adjust their behavior in response to provisions of law, and taxpayers not directly affected by tax expenditures might be indirectly affected by them.

For example, the estimated tax expenditure arising from the mortgage interest deduction on owner-occupied residences does not reflect any adjustments by taxpayers in the amount of mortgage debt they hold or any effect on housing values. However, high-income taxpayers with other significant assets tend to hold more mortgage debt than they would otherwise because mortgage interest receives preferential tax treatment.¹⁰ In addition, the value of that deduction is probably built into housing prices, so even homeowners who do not hold mortgage debt or currently claim the deduction for mortgage interest may benefit from the deduction. However, the estimates in this report attribute the benefit from that tax expenditure to taxpayers entirely on the basis of the mortgage interest deduction they claim.

Another example is the estimate of the tax expenditure created by the exclusion for employment-based health insurance. Removing that exclusion would increase the price of health insurance for many people and could thereby alter their choices about how to obtain health insurance or whether to purchase it at all. Furthermore, by reducing the cost of health insurance for both employers and employees, the exclusion also probably increases prices of health insurance and health care services for people without employment-based health insurance, including those who do not purchase any health insurance. However, neither of those effects is reflected in the estimate of the benefit arising from that exclusion.

There is also uncertainty about the ultimate incidence of the tax expenditure created by the exclusion of capital gains on assets transferred at death. That exclusion could narrowly benefit either decedents or their heirs, or it could have much broader effects on labor income and capital income by affecting saving behavior, much like other taxes on capital income. CBO allocates the tax to decedents; it calculates the value of the tax expenditure

by first estimating the tax that each household would owe if a member died and then multiplying that amount by each member's probability of death.

Finally, in the analysis in this report, CBO allocates the entire value of payroll tax expenditures to employees, which reflects the theoretical incidence of payroll taxes. In other words, if the payroll tax did not exist, an employee's wages and salaries would, in theory, be higher by approximately the amount of the payroll tax. However, the research literature suggests that many factors could cause the incidence of payroll taxes to differ from CBO's allocation, especially in the short term.¹¹

Interactions Among Tax Expenditures

When preparing its estimates of tax expenditures in this report, CBO accounted for the interactions among the tax expenditures that would occur if all the tax expenditures were simultaneously eliminated. For example, eliminating a particular income tax exclusion would increase taxable income, pushing some income into tax brackets with higher marginal rates. Eliminating all income tax exclusions would generally increase taxable income by the sum of the individual increases, but a larger share of that additional income would end up in tax brackets with higher marginal rates, thereby increasing government revenues by more than if the income was taxed at lower marginal rates. As a result, the budgetary effect of eliminating all exclusions would be larger than the sum of the effects of eliminating each exclusion separately. Conversely, eliminating all itemized deductions simultaneously would have a smaller effect than eliminating each deduction separately because if all deductions were eliminated, more taxpayers would claim the standard deduction (instead of itemizing deductions) than would be the case if any single deduction was repealed.

However, the combined estimates provided in this report do not include the interaction between the exclusion for pensions and retirement savings accounts and other tax expenditures. The interaction between that tax expenditure and the others is omitted because CBO uses a present-value approach to estimate that exclusion. Because the present-value approach estimates the tax expenditure over a taxpayer's lifetime rather than in a single year, the interaction of that expenditure with the others cannot be reliably assessed.

10. For a detailed description of the distributional effects of the mortgage interest deduction, including estimates of the mean mortgage value by income quintile, see Austin J. Drukker, Ted Gayer, and Harvey S. Rosen, "The Mortgage Interest Deduction: Revenue and Distributional Effects," *Journal of Housing Research*, vol. 30, no. 1 (May 2021), pp. 1–33, <https://tinyurl.com/uy24ef7>.

11. See Dorian Carloni, *Revisiting the Extent to Which Payroll Taxes Are Passed Through to Employees*, Working Paper 2021-06 (Congressional Budget Office, June 2021), www.cbo.gov/publication/57089.

Accounting for the interactions among the tax expenditures examined in this report produces a combined estimate that is 4 percent higher than the combined estimate that would result if those interactions were disregarded. However, the interactions among certain subsets of tax expenditures may increase or decrease the estimate by an amount that is greater or less than that percentage.

Effects of Including Payroll Taxes

The exclusions for employment-based health insurance and for pensions and retirement savings accounts not only reduce income subject to the income tax; they also reduce earnings subject to the payroll taxes for Social Security (Old-Age, Survivors, and Disability Insurance, or OASDI) and for Medicare's Hospital Insurance (HI) Trust Fund. In this report, the estimates of those two exclusions include their effects on payroll taxes.¹²

Exclusions from payroll taxes also generally reduce future OASDI benefits, which are determined by a person's lifetime earnings subject to Social Security taxes. The exclusions are unlikely to have much effect on future HI benefits because all workers meeting the eligibility requirements for the HI program are eligible for the same benefits. An ideal measure of the effect of the exclusions on Social Security payroll taxes might subtract the present value of the expected incremental benefits from the amount of the tax in the current year, but CBO's estimates do not include any effects on future benefits. Including those effects would decrease the budgetary cost of the exclusions.

12. In its analysis of tax expenditures, the Treasury provides estimates of the payroll tax expenditure created by the exclusion for employment-based health insurance. Although the Joint Committee on Taxation does not typically provide estimates of payroll tax expenditures, it has previously estimated the effect on payroll taxes of the provision that excludes employers' contributions for health insurance premiums from workers' taxable income. See Joint Committee on Taxation, *Background Materials for Senate Committee on Finance Roundtable on Health Care Financing*, JCX-27-09 (May 8, 2009), www.jct.gov/publications/2009/jcx-27-09/.

Researchers who have studied the implicit marginal tax rate on earnings (that is, taxes paid minus the present value of benefits) in the Social Security system have found that the rate varies considerably depending on a worker's circumstances. Some workers' implicit marginal tax rate equals the statutory OASDI rate because the workers pay tax but receive no additional benefits from additional earnings. But other workers face a much lower, or even negative, marginal tax rate on their additional earnings. (A negative marginal rate implies that the present value of benefits accruing from additional earnings exceeds the Social Security payroll taxes paid on those earnings.)

Importantly, because the Social Security system replaces a larger share of earnings for low-earning workers than for high-earning ones, high-earning workers face a higher implicit tax rate from Social Security than do low-earning workers. Thus, a full accounting of payroll taxes and Social Security benefits would make the distribution of the exclusions for pensions and retirement savings accounts and for employment-based health insurance appear more progressive than does the current analysis, which examines only the tax effects. However, because other factors besides earnings are important for future Social Security benefits—age, sex, career length, and marital status also affect the implicit tax rate—the effects of the exclusions on future benefits are difficult to estimate.¹³

13. CBO has estimated the lifetime benefits of Social Security and Medicare, net of payroll taxes paid. See Congressional Budget Office, *CBO's Long-Term Projections for Social Security: Additional Information* (September 2019), www.cbo.gov/publication/55590, and Xiaotong Niu, *Distribution of Lifetime Medicare Taxes and Spending by Sex and by Lifetime Household Earnings*, Working Paper 2017-05 (Congressional Budget Office, August 2017), www.cbo.gov/publication/52985.

List of Tables and Figures

Tables

1. Major Tax Expenditures, 2019	12
2. Shares of Major Tax Expenditures, Including Percentiles Within the Highest Quintile, 2019	14
3. Shares of Households That Benefited From Major Tax Expenditures, 2019	16
4. Major Tax Expenditures as a Share of Income, Including Percentiles Within the Highest Quintile, 2019	18

Figures

1. Spending, Revenues, and Total Tax Expenditures, Fiscal Year 2019	11
2. Shares of Major Tax Expenditures, 2019	13
3. Number of Households That Benefited From Major Tax Expenditures, 2019	15
4. Major Tax Expenditures as a Share of Income, 2019	17
5. Shares of Combined Major Tax Expenditures, 2019	26
6. Combined Major Tax Expenditures as a Share of Income, 2019	27

About This Document

This report was prepared at the request of the Chairman of the Senate Committee on the Budget. In keeping with the Congressional Budget Office's mandate to provide objective, impartial analysis, the report makes no recommendations.

Bilal Habib wrote the report with guidance from Edward Harris, John McClelland, and Joseph Rosenberg. Kathleen Burke, Kurt Seibert, and James Williamson contributed to the analysis. Omar Morales fact-checked the report.

Rebecca Heller, Nadia Karamcheva, Sarah Masi, Jennifer Shand, and Carolyn Ugolino (all of CBO) offered comments. Harvey Rosen, Professor Emeritus at Princeton University; Frank Sammartino of the Urban-Brookings Tax Policy Center; and the staff of the Joint Committee on Taxation commented on an earlier draft. The assistance of external reviewers implies no responsibility for the final product; that responsibility rests solely with CBO.

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CBO seeks feedback to make its work as useful as possible. Please send comments to communications@.cbo.gov.



Phillip L. Swagel
Director
October 2021

Mr. SMUCKER. And they state that the provisions of the 2017 Tax Act reduced the total estimate of benefits from income tax expenditures by nine percent, and on that those provisions made the distribution of tax expenditures more progressive because most of the benefits that were reduced by the Tax Act would have accrued to households in the highest quintile. So, we started with the most progressive, according to JCT, of developed countries, and we made it even more progressive with the Tax Cuts and Jobs Act.

Dr. MAZUR. I am going to have to quarrel with CBO on that. You might want to look at the Tax Policy Center's work that was done on the Tax Cuts and Jobs Act. I think they come to a somewhat different conclusion, and it really depends on the timeframe you look at.

Mr. SMUCKER. Sure.

Dr. MAZUR. And it depends on—because the individual ones expire, and it depends on what you do with the corporate income tax.

Mr. SMUCKER. Yeah, I am just telling you what—

Dr. MAZUR. Yeah.

Mr. SMUCKER [continuing]. CBO said in their report. They said that our tax structure got more progressive after the Tax Cuts and Jobs Act, but, Mr. Kuhlman, you know, I was a small business owner myself, understand the impact of tax policy and the benefits of growing a business, and I have heard from so many small businesses in my area who benefitted from the Tax Cuts and Jobs Act, and I am not talking about the top one percent or top tenth of a percent. I am talking about people who maybe, you know, they had \$10,000 more in their pocket at the end of the year that they could reinvest back into the business, grow jobs, and so on, and I just wonder what is the top provision that you hear about? What are some of the things that you hear about that have been most beneficial, and then how concerned are you about some of those provisions expiring?

Mr. KUHLMAN. Sure, yeah, what we call the small business deduction, Section 199A, the 20 percent deduction for pass-through businesses, it added great benefit for small business owners, NFIB members. 91 percent of them support making it permanent. 81 percent thinks it is very important, and just a quick example is a Pennsylvania business owner, David Cranston, Jr. of Cranston Material Handling Corporation said it is only a couple employees, but he said in real terms, this means I will be able to keep between \$1,200 and \$2,500 a quarter in my business that I would otherwise have paid in taxes. The ability to keep \$5,000 or \$10,000 in a year in my company is a big deal to a small business owner like me. Moreover, the cumulative effect over several years is substantial. They allowed him and millions of other businesses like him to be in a better position to take advantage of opportunities to grow and improve. They are going to take the—

Mr. SMUCKER. Thank you. I know I am way out of time. Thank you for your indulgence, Mr. Chair.

Chairman ARRINGTON. I go from thumping to gaveling.

Mr. SMUCKER. Yeah, sorry about that so, yeah.

Chairman ARRINGTON. Thank you, Mr. Smucker, and now we will yield five minutes to Dr. Michael Burgess from the Great State of Texas.

Mr. BURGESS. I thank the Chairman. Actually, let me start with a unanimous consent request for two documents. One being the *Democrats' Corporate Tax Plan Threatens Higher Bills for Manufacturers*. The second, *Chinese Communist Party Linked Solar Panel Company Could Reap Inflation Reduction Act Handouts with U.S. Factory*.

Chairman ARRINGTON. So ordered.
[The information follows:]



CHAIR JODEY ARRINGTON

HOUSE BUDGET COMMITTEE

ARTICLE:

“Democrats’ Corporate Tax Plan Threatens Higher Bills for Manufacturers”

By: Richard Rubin and Theo Francis | Wall Street Journal |

July 30, 2022

Description: Democrats are targeting American manufacturers with the Inflation Reduction Act’s (IRA) corporate minimum tax.

- “Overall, the (IRA) would affect about 150 companies annually and raise about \$313 billion over a decade,...Nearly half of the revenue would come from manufacturers.”



6/21/23, 1:55 PM

Democrats' Corporate Tax Plan Threatens Higher Bills for Manufacturers - WSJ

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<https://www.wsj.com/articles/democrats-corporate-tax-plan-threatens-higher-bills-for-manufacturers-11659173401>

POLITICS

Democrats' Corporate Tax Plan Threatens Higher Bills for Manufacturers

Proposed 15% minimum tax on large profitable companies would claw back benefits of faster equipment write-offs

By Richard Rubin [Follow](#) and Theo Francis [Follow](#)

July 30, 2022 5:30 am ET



The corporate minimum tax is meant to prevent large, profitable companies, such as Amazon, from paying little or no taxes. PHOTO: RACHEL JESSEN/BLOOMBERG NEWS

WASHINGTON—Manufacturers and other companies making capital investments could pay the bulk of the new corporate minimum tax in Senate Democrats' fast-moving fiscal legislation, according to an analysis of the plan.

The 15% minimum tax would take effect next year and apply to U.S.-based companies that report financial-statement profits averaging at least \$1 billion over three years, according to legislation released this week that mirrors a House-passed bill from last year.

The proposal, if it becomes law, would raise companies' tax bills until they hit that minimum rate. It would affect some companies that generate income in low-taxed foreign jurisdictions or use aggressive tax planning to drive their global tax rates far below the 21% U.S. corporate tax rate.

<https://www.wsj.com/articles/democrats-corporate-tax-plan-threatens-higher-bills-for-manufacturers-11659173401>

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6/21/23, 1:55 PM

Democrats' Corporate Tax Plan Threatens Higher Bills for Manufacturers - WSJ

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But much of the money would likely come from companies that report low tax rates now because their capital investments—in factories and machines, for example—are treated differently in tax and financial accounting.



Senate Majority Leader Chuck Schumer (D, N.Y.) talking Thursday about a bill he backs that raises money for healthcare and climate initiatives, with some of the revenue coming from a 15% corporate minimum tax. PHOTO: J. SCOTT APPLEWHITE/ASSOCIATED PRESS

Overall, the plan would affect about 150 companies annually and raise about \$313 billion over a decade, according to a report this week from the congressional Joint Committee on

6/21/23, 1:55 PM

Democrats' Corporate Tax Plan Threatens Higher Bills for Manufacturers - WSJ

Taxation. Nearly half of the revenue would come from manufacturers, the committee said, using a broad definition that might include some pharmaceutical and technology companies.

"This is a domestic manufacturing tax, plain and simple," said Sen. Mike Crapo (R., Idaho), the top Republican on the Senate Finance Committee.

Some large companies have been objecting to the idea throughout the Biden administration. The minimum tax would "inflict maximum damage on manufacturers," said Jay Timmons, president and CEO of the National Association of Manufacturers.

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That opposition didn't stop Democrats from making it the largest tax increase in the agreement reached by Senate Majority Leader Chuck Schumer (D., N.Y.) and Sen. Joe Manchin (D., W.Va.). Republicans are unanimously opposed. Mr. Schumer is now trying to get all 50 members of the Senate Democratic caucus to back the bill, which raises money for healthcare spending and climate-change initiatives.

6/21/23, 1:55 PM Democrats' Corporate Tax Plan Threatens Higher Bills for Manufacturers - WSJ



FedEx appeared on a progressive think tank's recent list of low-taxed profitable companies. PHOTO: COOPER NEILL/BLOOMBERG NEWS

The minimum tax agreed to this week isn't the same thing as the 15% global minimum tax that Treasury Secretary Janet Yellen has been trying to get Congress to implement in concert with more than 130 other countries. Mr. Manchin objected to the latter proposal and forced it out of the plan.

The minimum tax that is part of the international agreement is focused on companies' foreign income and has different definitions of income and taxes. It would require U.S. companies to pay at least 15% in each country in which they operate.

The Schumer-Manchin minimum-tax proposal would mark about a 7% addition to the Congressional Budget Office's projection for corporate tax collections during that period, or roughly the equivalent of raising the corporate tax rate by 3 percentage points. It wouldn't be spread as evenly as a straight rate increase, which many Democrats want but Sen. Kyrsten Sinema (D., Ariz.) blocked.

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For accounting purposes, deductions for capital investments are spread over the life of the asset. For tax purposes, they are often accelerated, reducing current tax rates. The proposal, included in a deal that could pass the Senate as early as next week, would largely erase that difference for affected companies, raising their taxes now and deferring or denying the benefit of accelerated depreciation.

An analysis from the Tax Foundation, which favors simpler tax systems with lower rates, found that the coal, automobile and utilities industries would face larger tax bills.

Large retailers, who generally pay relatively high effective tax rates, support the proposal, particularly compared with a corporate tax rate increase. Democrats floated a variety of other corporate tax increases before settling on the minimum tax, which may be clunky to implement and disfavored by tax experts but is easy to describe as making a few profitable companies pay for important public priorities.

6/21/23, 1:55 PM

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"If we sort of judge any tax measures by the principle of good tax policy, we'd want revenue, we'd want fairness, we'd want efficiency," said Kimberly Clausing, who was a deputy assistant Treasury secretary earlier in the Biden administration. "When you look at this one, it does well on revenue and fairness."



Sen. Mike Crapo (R., Idaho), pictured at a hearing in June, has called the corporate minimum tax a 'domestic manufacturing tax, plain and simple.' PHOTO: SARAH SILBINGER/BLOOMBERG NEWS

Rhetorically, the corporate minimum tax works as a way to address complaints from President Biden and progressive groups that large, profitable companies such as Amazon.com Inc. can report very low tax bills. Those estimates come directly from companies' financial statements, and companies as varied as Booz Allen Hamilton Holding Corp., FedEx Corp., Archer Daniels Midland Co. and Advanced Micro Devices Inc. appeared on the most recent list published by the Institute on Taxation and Economic Policy, a progressive think tank.

"This bill requires the largest corporations to begin to—begin to pay toward their fair share of taxes," Mr. Biden said.

A spokeswoman for Booz Allen said the company pays federal income tax and doesn't expect the minimum-tax proposal to materially affect its federal income-tax liability. A FedEx spokesman called ITEP's conclusions on its tax costs misleading. Archer Daniels Midland and Amazon declined to comment.

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CHAIR JODEY ARRINGTON
**HOUSE BUDGET
COMMITTEE**

ARTICLE:

“Chinese Communist Party-Linked Solar Panel Company Could Reap ‘Inflation Reduction Act’ Handouts with US Factory”

By: Jack McEvoy | Daily Caller News Foundation | January 13, 2023

Description: JA Solar, ran by 40-year CCP member and former Delegate to the National People’s Congress of China Jin Baofang, will be able to take advantage of the Inflation Reduction Act’s green energy tax credits when it opens a solar panel manufacturing site in the United States.

6/20/23, 11:45 AM Chinese Communist Party-Linked Solar Panel Company Could Reap 'Inflation Reduction Act' Handouts With US Factory | The D...

US

Chinese Communist Party-Linked Solar Panel Company Could Reap 'Inflation Reduction Act' Handouts With US Factory



(Photo by Ethan Miller/Getty Images)

DAILY CALLER NEWS FOUNDATION



JACK MCEVOY
ENERGY & ENVIRONMENT REPORTER

January 13, 2023
8:23 AM ET

FONT SIZE: + -

JA Solar, a Chinese green energy giant whose chairman is tied to the Chinese Communist Party (CCP), has leased a plot of land in Phoenix, Arizona, to construct a \$60 million solar panel factory that is poised to benefit from huge green energy tax incentives included in the Inflation Reduction Act (IRA).

Jin Baofang, chairman and CEO of the Beijing-based company, said that he had been a CCP member for 40 years during a 2020 [interview](#) with the Chinese state-run newspaper “The Paper.” The JA Solar factory, which could take advantage of the green energy tax credits included in the [Inflation Reduction Act](#) (IRA), will create 600 jobs and use automated assembly lines to manufacture 2 gigawatts’ worth of solar panels annually once it becomes fully operational, according to a Tuesday Arizona Commerce Authority [press release](#). **(RELATED: China Strikes A Deal To Get Oil From The Taliban)**

6/20/23, 11:45 AM Chinese Communist Party-Linked Solar Panel Company Could Reap 'Inflation Reduction Act' Handouts With US Factory | The D...

Baofang also works for the China Chamber of Commerce for Import and Export of Machinery and Electronic Products and also served as a delegate to the 10th, 11th and 12th National People's Congress of China, the country's legislative body, according to JA Solar's website. On its website, the China Chamber of Commerce for Import and Export of Machinery and Electronic Products purports to be a nonprofit trade organization; however, Chinese chambers of commerce and similar trade groups are often state-controlled and have long been a part of efforts to expand CCP influence around the world, according to 2019 report published by the Jamestown Foundation, a conservative defense policy think tank.

The IRA, which President Joe Biden signed into law in August, offers up \$369 billion in tax credits for domestic solar, wind and other renewable energy projects that begin construction before Dec. 31, 2025, according to Marcum LLP, an accounting and advisory firm. The bill establishes the "Advanced Manufacturing Production Tax Credit" which will reward PV module (solar panel) manufacturers 7 cents per watt of energy produced in the U.S., according to the Energy Department (DOE).

The legislation package also includes an investment tax credit of up to 30% of qualifying investment costs if solar producers are able to satisfy labor requirements issued by the Treasury Department pertaining to the construction of the manufacturing facility.

6/20/23, 11:45 AM Chinese Communist Party-Linked Solar Panel Company Could Reap 'Inflation Reduction Act' Handouts With US Factory | The D...

Foreign multinational companies with existing or planned subsidiaries in the U.S. will be eligible to receive IRA tax credits, according to Vistra, a corporate service provider. In addition to the manufacturing credits, the legislation will allow homeowners to subtract 30% of the cost of installing solar panels and other sun-powered home products from their federal taxes, incentivizing Americans to buy solar products, according to the DOE.

“Arizona is proud to welcome JA Solar’s first U.S. manufacturing facility to Phoenix,” Democratic Arizona Gov. Katie Hobbs said in a statement. “There’s no better place in the world for sustainable industries like solar and we are excited to see this facility add to Arizona’s clean energy reputation.”

JA Solar, the Arizona Commerce Authority, Hobbs’ office and the White House did not immediately respond to the Daily Caller News Foundation’s request for comment.

Mr. BURGESS. Thank you, Mr. Chairman. You know, staying with the Inflation Reduction Act for just a minute. It created two new corporate taxes. Dr. McBride, two new corporate taxes were created in the Inflation Reduction Act. 26 tax credit programs on top of an already complex and burdensome tax code. So, I think your colleagues at the Tax Foundation have estimated that over \$300 billion a year is lost in productivity due to the complexity of the United States tax code.

So, every Congress that I have been here I have introduced H.R. 1040. You know, this is a flat tax, a version of the same flat tax that was created by my predecessor, Leader Armey, when he was here, and honestly, I mean, you referenced the Estonia tax code and how people can file their taxes in under five minutes, and wouldn't reducing the complexity of the tax code and perhaps flattening the rate a little bit, would that not have a positive effect on people's compliance with the tax code, as well as overall tax collections?

Dr. MCBRIDE. Absolutely would. So, the real-world examples we have not just in Estonia, but a lot of their neighbors in Eastern Europe, that is where flat taxes really took off in the 1990s. Many countries there implemented flat taxes, and they did so because one reason, they were having a big compliance problem. They were having all sorts of, you know, major tax evasion with a complicated income tax like ours. So, they came upon a solution which is to simplify the rules. Flatten the tax, you know, toss out all the special provisions, and low and behold they found it generated better compliance and more stable and reliable revenues over the years, and so, they stuck with those flat taxes, and Estonia went further and eventually with their business tax, they simplified it even further to this distributed profits tax. There is basically no taxable income. There is no calculation of taxable income at all. Instead, it is just a tax on whatever is distributed to shareholders. You know, taxing one stream rather than calculating all items of income and all items of expense, et cetera and sending it to the tax authorities.

Mr. BURGESS. As a practical matter have they suffered from not bringing—

Dr. MCBRIDE. Sorry, say that again.

Mr. BURGESS. As a practical matter, has Estonia suffered from not bringing in enough tax revenue?

Dr. MCBRIDE. No, absolutely not. They generate revenues today 20 years into this new system that have essentially, are pretty typical across the developed world in terms of income tax collections.

Mr. BURGESS. So, just my own observation, living and working in this country in 1986, when the Reagan tax cuts were introduced and passed, the Bush tax cuts in 2004, and Chairman Brady's tax reform in 2017. My observation is you seem to have an increase in compliance. You didn't have to hire 87,000 new IRS agents but you made things more straightforward and people complied because it was easier to comply than it was to hide your income and try to not comply. Is that a valid assumption?

Dr. MCBRIDE. It is absolutely valid. When we have a tax code today that is four million words, I don't think any person on earth has the ability to understand something like that.

Mr. BURGESS. Now, Mr. Chairman, in the time I have remaining, I am going to have another unanimous consent request. It also deals with the Inflation Reduction Act. This is a page from the Federal Register from October 14, 2022, from the Department of Health and Human Services, and reports the establishment of the Medicare Drug Rebate Negotiation Group within the Center for Medicare. Most people did not realize that with the passage of the Inflation Reduction Act, the Federal Government will now have the largest and most secretive PBM that has ever been developed.

Now, a lot of us decried the PBM because we say they only add complexity and they don't bring anything of value to the system. When you read through these words in the Federal Register, it absolutely describes a nightmare going forward, and, of course, their enforcement mechanism is the tax code, a 1,900 percent tax on any profits—not profits, I am sorry—gross revenues that the company may create. So, Mr. Chairman, this is a very serious matter and we haven't talked about it enough, but I do want to introduce this for the record and perhaps at some point in the future we can have a hearing on the deleterious effects on what is happening in the United States with the so-called mislabeled Inflation Reduction Act.

Chairman ARRINGTON. I thank the gentleman from Texas. So ordered.

[The information follows:]

Sherrette A. Funn,
Paperwork Reduction Act Reports Clearance Officer, Office of the Secretary.
 [PR Doc. 2022-22319 Filed 10-13-22; 8:45 am]
 BILLING CODE 4153-01-P

DEPARTMENT OF HEALTH AND HUMAN SERVICES

Establishment of the Medicare Drug Rebate and Negotiations Group Within the Center for Medicare (CM)

AGENCY: Centers for Medicare & Medicaid Services, HHS.

SUMMARY: Establish the Medicare Drug Rebate and Negotiations Group within the Center for Medicare (CM) to implement the Drug Price Negotiation Program and the Inflation Rebate Program in Medicare Part B and Part D as authorized under the Inflation Reduction Act of 2022. CMS is responsible for implementing these new programs.

DATES: This reorganization was approved by the Secretary of Health and Human Services and takes effect October 8, 2022.

SUPPLEMENTARY INFORMATION: Statement of Organization, Functions, and Delegations of Authority Part F of the Statement of Organization, Functions, and Delegations of Authority for the Department of Health and Human Services, Centers for Medicare & Medicaid Services (CMS) (last amended at *Federal Register* Vol. 75, No. 56, pp. 14176-14178, dated March 24, 2010; Vol. 76, No. 203, pp. 65197-65199, dated October 20, 2011; Vol. 78, No. 86, p. 26051, dated May 3, 2013; Vol. 79, No. 2, pp. 397-398, dated January 3, 2014; and Vol. 84, No. 32, p. 4470, dated February 15, 2019) is amended to reflect the establishment of the Medicare Drug Rebate and Negotiations Group within the Center for Medicare (CM) to implement the Drug Price Negotiation Program and the Inflation Rebate Program in Medicare Part B and Part D as authorized under the Inflation Reduction Act of 2022. CMS is responsible for implementing these new programs.

Title I, Subtitle B, Part 1, sections 11001-11004, of the Inflation Reduction Act of 2022 (IRA) Public Law 117-169 enacted on August 16, 2022, establishes a new Drug Price Negotiation Program under Medicare Part B and Medicare Part D to lower prices for certain high-spend single source drugs. Title I, Subtitle B, sections 11101 and 11102 of the IRA also enacts a new program to establish Inflation Rebates in Medicare Part B and Medicare Part D. CMS is

responsible for implementing these new programs.

The work required to implement and administer these new programs will be novel and differ significantly from the Medicare functions that CMS performs today. Given the unique nature of this new work, there is not an existing operating component, group, office or division in CMS or CM that performs these actions. Moreover, the scope and complexity of these new programs, and the deadlines for implementation, require that a new, dedicated organization be established to ensure that CMS is able to implement these programs successfully and on time. In order to implement and operate these new programs, CMS is creating a new group—the Medicare Drug Rebate and Negotiations Group—within CM.

Part F, Section FC, 10 (Organization) is revised as follows:

Center for Medicare, Medicare Drug Rebate and Negotiations Group

Part F, Section FC, 20 (Functions) for the new organization is as follows:

Medicare Drug Rebate and Negotiations Group

With regard to the Drug Price Negotiation Program, each year, the new group will negotiate drug prices with pharmaceutical manufacturers for certain Part B and Part D drugs. This will require identifying negotiation-eligible drugs, entering into agreements with manufacturers, collecting extensive data from manufacturers and other sources, calculating ceiling and maximum fair prices, negotiating prices with manufacturers, re-negotiating prices as necessary and publishing the results of the negotiation. Under the Inflation Rebate Program, manufacturers of certain drugs will be required to pay a penalty or "rebate" if the price of their drug increases faster than the rate of inflation. For this program, the new group will need to identify the universe of rebatable drugs under Part B and Part D; determine which drugs had price increases in excess of inflation; and compute, invoice, and collect rebates owed by manufacturers.

To carry out these functions, the major tasks of the new group will include:

- Developing policy, including identifying and vetting policy options and preparing policy memoranda, rulemaking and technical guidance;
- Briefing policy officials in CMS, U.S. Department of Health and Human Services (HHS), and Executive Office of the President (EOP);
- Establishing operational processes to collect data from manufacturers and other sources;

- Conducting pharmacoeconomic analyses and assessments of selected drugs;
- Establishing operational processes to negotiate and re-negotiate drug prices and conducting those negotiations with manufacturers;
- Establishing operational processes to calculate and invoice rebates;
- Developing contractual agreements with manufacturers necessary to effectuate both programs;
- Monitoring manufacturer compliance with programmatic rules;
- Procuring and managing contractors to support these functions;
- Conducting stakeholder outreach and educational materials; and
- Responding to inquiries from Congress, the press, and other external stakeholders.

Authority: 44 U.S.C. 3101.

Dated: October 7, 2022.

Xavier Becerra,
Secretary, Department of Health and Human Services.

[PR Doc. 2022-22236 Filed 10-12-22; 4:15 pm]

BILLING CODE 4120-01-P

DEPARTMENT OF HEALTH AND HUMAN SERVICES

National Institutes of Health

National Institute on Drug Abuse; Notice of Closed Meeting

Pursuant to section 10(d) of the Federal Advisory Committee Act, as amended, notice is hereby given of the following meeting.

The meeting will be closed to the public in accordance with the provisions set forth in sections 552b(c)(4) and 552b(c)(6), Title 5 U.S.C., as amended. The contract proposals and the discussions could disclose confidential trade secrets or commercial property such as patentable material, and personal information concerning individuals associated with the contract proposals, the disclosure of which would constitute a clearly unwarranted invasion of personal privacy.

Name of Committee: National Institute on Drug Abuse Special Emphasis Panel; Blueprint MedTech (BPMT); Biocompatibility, Sterilization, and Animal Studies.

Date: November 15, 2022.

Time: 1:00 p.m. to 2:30 p.m.

Agenda: To review and evaluate contract proposals.

Place: National Institutes of Health, National Institute on Drug Abuse, 301 North Stoenest Avenue, Bethesda, MD 20892 (Virtual Meeting).

Contact Person: Ipolia R. Ramadan, Ph.D., Scientific Review Officer, Scientific Review

Chairman ARRINGTON. I now yield five minutes to my friend from Virginia, Mr. Bob Good.

Mr. GOOD. Thank you, Mr. Chairman, and thank you to our witnesses. I think you are starting to see the light at the end of the tunnel here. I appreciate your investment of time today. I wanted to touch with the limited time that we have on a couple of the President or the Administration's key policy priorities, energy, or climate, as well as immigration/border and how they impact the economy, and a couple of questions to Dr. McBride first. Dr. McBride, the President has stated many times that his proposed tax reforms would help average Americans. How would you reconcile that or contrast that perhaps, with the estimate that 80 percent of the electric vehicle tax credits are going to households with incomes of \$100,000 or higher?

Dr. MCBRIDE. Well, clearly that is, like you describe and like anybody can recognize when they look at the sticker prices on electric vehicles, that those are luxury goods. They are not targeting a low-income community with those products. Those are luxury goods that, as good as they are for the planet, perhaps, they are very expensive, and they have been expensive for, you know, ever since they have been produced, and so, these tax credits, of course, then go to high income individuals that can afford a 50,000, 60, 70, up to \$80,000 is what is allowed under these new tax credits towards—that is the sticker price of an electric vehicle. Then there is a loophole around that so that, around that provision and then the income provision. So, that is the leasing loophole, and so, none of the restrictions as I understand it apply to vehicles, electric vehicles that are leased. You can get the credit. It basically flows through the leasing company to the consumer. So, you know, someone making millions of dollars a year, for instance could get a—could lease an electric vehicle and benefit from the credit that way.

Mr. GOOD. Yeah, it is really just obscene that we would on the backs of regular taxpayers subsidize vehicles for the wealthiest of Americans and then as we are trying to force Americans to electric vehicles and restrict production of gas-powered vehicles, what is going to happen to the prices of gas-powered vehicles as their supply is limited? You know, what is that going to do? We can only imagine and speculate what that will do.

Consistent with what you said, reports that I have read are that the vast majority of electric vehicle owners, you used the term luxury, it is a secondary vehicle because of the impractical nature of it. You know, it is impractical, insufficient number of charging stations, impractical for long distance travel, that sort of thing.

The Biden energy agenda, more broadly, combined with the massive inflationary spending, combined with the response, I would suggest misguided response of massively raising interest tax—or excuse me, interest rates so the housing prices are up. Inflation is up. Grocery prices are up. Utility prices are up. Gas prices are up. So, let's sock the American people with higher interest rates to make it so they can't afford to buy homes where we make the average cost of the mortgage go up about 50 percent. So, your thoughts on how is his doubling down on his Green New Deal tax credits, how is that going to impact the economic or financial future for average Americans?

Dr. MCBRIDE. Well, I think it was sold as an Inflation Reduction Act, of course, that is the title, and that was all premised on the idea that it would reduce deficits, which was what was originally thought based on the original score from CBO and JCT. We now know that that score was off. It was off in the direction of actually underestimating the cost of these green credits greatly, and so, we now, based on the new scores from JCT, it appears the IRA legislation as a whole increases deficits. It is not clear how much. We should hopefully get a new score for the entire bill to find that out, but if there is no deficit reduction on this bill, then there goes the idea that it reduces inflation.

Mr. GOOD. Mr. Pomerleau, with the limited time that we have, I saw a study that says the net cost of illegal immigration in the United States, 16 million or more illegals in the country now, is about \$150 billion last year. Roughly \$9,000 per illegal. Could you speak to the cost to the American taxpayer for the flow of illegals into the country?

Mr. POMERLEAU. Thanks for your question, but this is a little outside of my area of expertise. I don't know if anyone else has any thoughts on this issue in particular.

Mr. GOOD. Well, I will just say with the eight seconds I have got left, you know, it is funny we have a law in this country where, if legal immigrants can't be on the public dole, but illegal immigrants, if you break the law, your first act on the soil of the United States is to break the law, then we give you all the social safety nets, the social welfare, the healthcare, the social services that we can provide to you. So, it is really incredible as we reward illegal immigration. I yield back, Mr. Chairman.

Chairman ARRINGTON. I thank the gentleman from Virginia, and yield five minutes I think to close out our hearing, my friend Buddy Carter from Georgia.

Mr. CARTER. Thank you, Mr. Chairman, and thank all of you all for being here, and I promise you it will be brief and try to get through this five minutes as quickly as we can, but I wanted to ask you, you know, our current tax code and I think most people would agree it is built on government control, and it is built on trying to control actions of people and what they do. You know, I have served in a number of different capacities. I have been a mayor. I have been a state legislator, and now I serve in Congress. I started when I was ten so that explains that, but nevertheless, I have always noticed that people given the choice between a property tax or an income tax, that they don't like taxes, but given that choice, they would prefer a consumption tax. Are any of you familiar with the fair tax?

Can you tell me, I am the sponsor of the fair tax. You know, the fair tax was started in the late 1990s by John Linder and then Rob Woodall, who was his chief of staff at the time, became a Member. After John left, Rob took his place, and then when Rob left, he asked me if I would carry it and I did and I am proud to. It was the very first bill that I sponsored when I became a Member of Congress, and tell me, if you will, what you think about a consumption tax and about specifically the fair tax in that proposal.

Mr. POMERLEAU. So, I think consumption taxes are good policy. I think that in general they are less distortive than the income tax.

They do not discourage investment. They do not discourage saving, and if they are structured well, they can reduce noncompliance in the tax system. The fair tax in particular, I think the policy, you know, the heart is in the right place but I think structurally needs—

Mr. CARTER. Well, what would you change? Tell me, how can I make it better?

Mr. POMERLEAU. So, I think the fundamental weakness of the fair tax is that it is a retail sales tax. I think retail sales taxes, they are collected all at the very last point in the chain of production at the retailer, and as a result, all of the revenue is collected at that point, which creates a pretty significant incentive to avoid the tax, especially if the rate is high enough to replace current revenues, and I actually have a recent paper that I did that estimated how high the tax rate would need to be under the fair tax to replace current revenues.

Mr. CARTER. And what did you come up with?

Mr. POMERLEAU. And with a reasonable amount of avoidance, which I think might be on the low end—

Mr. CARTER. Do you think we have any avoidance in the current tax system?

Mr. POMERLEAU. The current tax code does have avoidance but I think any tax system has avoidance, and if you were given—

Mr. CARTER. But you think that the fair tax would have more avoidance than—

Mr. POMERLEAU. Well, in our paper we assumed that it would have just the same amount as—

Mr. CARTER. Okay, fair enough.

Mr. POMERLEAU [continuing]. The current tax system.

Mr. CARTER. Fair enough. Continue on.

Mr. POMERLEAU. We found the tax rate would have to be in the high 30 percents in order to cover current tax revenues. So, at a rate that high, I think a retail sales tax would also be high.

Mr. CARTER. And what do we have it at?

Mr. POMERLEAU. Sorry?

Mr. CARTER. In the proposal, do you know what it is at?

Mr. POMERLEAU. So, in the proposal you have two rates. You have a standard rate and a variable rate for the trust funds and those in the first year add up to a tax inclusive rate of 23 percent.

Mr. CARTER. Right.

Mr. POMERLEAU. The tax exclusive rate is closer to 29 or 30 percent.

Mr. CARTER. Right.

Mr. POMERLEAU. But that would be insufficient to cover current revenues plus—

Mr. CARTER. How do you base that assumption on that it would be inconsistent?

Mr. POMERLEAU. Sorry?

Mr. CARTER. How do you base that assumption to be inconsistent to replace what we currently have in revenue?

Mr. POMERLEAU. So, we did our estimates based on national accounts. So, this was using BEA data and IRS data.

Mr. CARTER. Okay. Let me cut to the chase, what would you do differently? How would you improve it?

Mr. POMERLEAU. So, first I think that—

Mr. CARTER. Because would you agree first of all that people prefer a consumption tax and that—

Mr. POMERLEAU. So, I personally—

Mr. CARTER [continuing]. People would have control?

Mr. POMERLEAU [continuing]. I would prefer a consumption tax over income tax.

Mr. CARTER. And this would give people control as opposed to the government having control.

Mr. POMERLEAU. So, I think that one of the weaknesses is that you are resting the entire tax code on a single tax, which can create problems with avoidance. I think having multiple taxes is good, and second, I think you could improve over a retail—

Mr. CARTER. You might be alone in that—

Mr. POMERLEAU [continuing]. Sales tax.

Mr. CARTER [continuing]. In that assumption.

Mr. POMERLEAU. I think you can improve over a retail sales tax with a value added tax. Under a value added tax, you would be collecting the same amount as under a retail sales tax, but it would be done each stage in the production process. So, if there is avoidance—

Mr. CARTER. Okay.

Mr. POMERLEAU [continuing]. It only ends up being a small amount of avoidance.

Mr. CARTER. All right. Anybody else want to comment real quick? I am sorry.

Dr. MCBRIDE. I agree with those comments. I would just add further what the VAT does, it has a bad reputation because it comes from Europe.

Mr. CARTER. Yes.

Dr. MCBRIDE. But what they are doing makes a lot of sense, which is removing the cascading effect of sales taxes on business inputs as they go through the production process.

Mr. CARTER. Well, look—

Dr. MCBRIDE. The sales tax, you know, has the cascading effect.

Mr. CARTER [continuing]. I am appealing to you. I want help. I want to make this even better. So, help me.

Dr. MCBRIDE. So, the best thing in my view that you could do is remove that cascading effect of taxes on business inputs.

Mr. CARTER. Okay. All right. Well, we, you know, we are hopefully going to be taking this up. So, I need your help and I want your input. So, I am appealing to you to help me with that. Thank you all. I appreciate it and I yield back, Mr. Chairman.

Chairman ARRINGTON. I thoroughly enjoyed the dialog and I appreciate the time of our witnesses. In closing, just a quick thought and then I am going to ask my Ranking Member to close it up for me, but our first hearing was about the Fiscal State of the Nation. I don't think there was any disagreement that we have got problems, and those problems are getting worse very quickly, and that the financial health of the country is deteriorating rapidly. How we address that, I think there is definitely disagreement, but there is probably commonality as well.

Today, we focused on one part of the equation, the revenue side, and the growth side, and I appreciate that good, open, robust dis-

cussion and debate. Here is my biggest concern that gnaws at me in every Committee hearing, and that is that we have \$1.5 trillion in the gap of the funding of our government that we borrow on the backs of future generations of Americans, and it is completely unsustainable, and so, you have colleagues on one side that may want to raise taxes or some combination, and you have people like me who think we need to massively right size and shrink the government and cut expenses, or some combination, but it is immoral in my mind to rack up this kind of debt and to stack it and shift it as a deferred tax on our children, and that is the unfortunate nature of the budget process, is that we just continue to perpetuate this to the demise, I think, of future generations. With that, Mr. Scott, bring us home.

Mr. SCOTT. Thank you. Thank you, Mr. Chairman. I think if we just pay for what we do we can balance the budget. I think Dr. Mazur pointed out that it is arithmetic. If you are going to have a new spending program, pay for it. If you are going to have tax cuts, just pay for it, and things won't get worse, and under Clinton they got so much better. We were on course to paying off the entire national debt held by the public by 2008. Entire debt held by the public and put all the money back into the trust funds by 2013, but you can't do it if you have unpaid spending or unpaid tax cuts. You got to pay for what you want to spend.

Chairman ARRINGTON. You know, I know this is not a colloquy, but I actually agree with that. See, look at, look here, I am in the most Republican district in Texas. Whether you offset through a cut to pay for tax cuts, tax reform, or you raise revenue, because we rarely do and we reach for the more expedient mechanism, which is finance it, which doesn't hurt anybody. You don't have to raise the tax and take any money out of anyone's wallet. We don't have to cut somebody's favorite program. When that happens and we can still grow the government, there is not a real rational decision as to do we really want that? Can we really afford that? So, those trade offs aren't there in this unfortunate sort of fantastical system that we have today.

If we had one that considered the cost that we paid for it, in one way or the other, I think we would have a very different dynamic between the electorate and representative leaders of our great country.

Mr. SCOTT. That was PAYGO under Democrats—

Chairman ARRINGTON. Yes.

Mr. SCOTT [continuing]. Right?

Chairman ARRINGTON. Yes.

Mr. SCOTT. Good.

Chairman ARRINGTON. Yes.

Mr. SCOTT. And we can get it back.

Chairman ARRINGTON. Well, you know, Mr. Scott, I am going to invite you up here to the upper deck more often. I think we may have to have an executive session about the Ranking Member's job since he is gone.

Thank you, Dr. McBride, Mr. Pomerleau, Mr. Kuhlman, Dr. Mazur, got that right, for appearing before us today. Please be advised that Members may submit their written questions to be an-

swered later in writing. Those questions and your answers will be made part of the formal hearing record.

Any member who wishes to submit their questions for the record may do so within seven days. With that the Committee stands adjourned.

[Whereupon, at 3:23 p.m., the Committee was adjourned.]

United States House Committee on the Budget Questions for the Record**Hearing on "Reigniting American Growth and Prosperity Series: Incentivizing Economic Excellence Through Tax Policy"**

June 22, 2023

Will McBride, Vice President of Federal Tax Policy and Stephen J. Entin Fellow in Economics, Tax Foundation

Representative Ralph Norman (SC-05)**Question 1**

Nearly 95% of businesses in South Carolina employ less than 100 people, small business optimism continues to remain well below the 50-year historical average for the 17th consecutive month. Concurrently, President Biden has proposed over \$1.8 trillion in tax hikes on main street businesses.

What impact will these unprecedented increases have on the livelihood of small business owners, employees, and the general economy?

President Biden has targeted businesses of all sizes with a variety of tax increases. In his most recent budget, the president proposes to raise the corporate tax rate by one-third, from 21 percent to 28 percent, which would be directly paid by C corporations, more than 99 percent of which employ fewer than 500 employees.¹ High corporate taxes reduce the incentive to invest by reducing the after-tax return on investment, limit the growth of corporations by cutting into retained earnings, and reduce business start-up rates.² Fewer businesses and slower business growth mean fewer job opportunities and slower wage growth. This is why research finds, among major tax types, the corporate tax is the most economically destructive way to raise revenue.³

Most small businesses are structured as pass-through entities, such as partnerships and S corporations, so their profits face the individual income tax, not the corporate tax, when owners report profits on their individual tax returns. President Biden would raise taxes on pass-through businesses in several ways. By raising the top individual income tax rate to 39.6 percent, adding another 1.2 percentage points to the Medicare tax on wages, and expanding the base of the net investment income tax (NIIT) to include all pass-through business income while raising the rate to 5

¹ Alex Durante, "Many Small Businesses Could be Impacted by Biden Corporate Tax Proposals," Tax Foundation, May 11, 2021, <https://taxfoundation.org/biden-corporate-tax-small-business/>.

² Ibid.

³ William McBride, "What Is the Evidence on Taxes and Growth," Tax Foundation, Dec. 18, 2012, <https://www.taxfoundation.org/what-evidence-taxes-and-growth/>; Alex Durante, "Reviewing Recent Evidence of the Effect of Taxes on Economic Growth," Tax Foundation, May 21, 2021, <https://taxfoundation.org/reviewing-recent-evidence-effect-taxes-economic-growth/>; Åsa Johansson, Christopher Heady, Jens Arnold, Bert Brys, and Laura Vartiä, "Taxation and Economic Growth," OECD, Jul. 3, 2008, https://www.oecd-ilibrary.org/economics/taxation-and-economic-growth_241216205486.

percent, the president's proposals would effectively result in a federal top income tax rate of about 44 percent. When combined with state income taxes, many taxpayers would face top rates over 50 percent.⁴ As with the corporate tax, high marginal income tax rates on pass-through businesses will lead to less investment, slower economic growth, and fewer opportunities for workers.⁵

Primarily due to these and other tax hikes on corporate and pass-through businesses, we find that the president's budget proposals would reduce the size of the economy as measured by GDP by 1.3 percent in the long run, reduce wages by 1.0 percent, and eliminate 335,000 jobs.⁶

Question 2

Specifically, the President has advocated for eliminating the small business deduction, which over 19 million small businesses utilize to reduce tax liabilities by up to \$159 million.

Mr. Pomerleau and Mr. McBride: How would this hinder innovation within the marketplace?

What about economic growth and living standards?

The Section 199A deduction allows individual taxpayers to exclude up to 20 percent of their income from pass-through businesses, though it is subject to several complicated limitations that prevent many taxpayers with higher income from using it, and it is set to expire under current law at the end of 2025. The provision temporarily lowers marginal income tax rates that apply to pass-through business income, and as such reduces the cost of capital and encourages investment. These pro-growth features are diminished by the provision's complex limitations and looming expiration. If made permanent, we find the Section 199A deduction would increase GDP by 0.2 percent, raise wages by 0.1 percent and add 58,000 jobs.⁷ However, there are more effective ways to boost investment in a simpler and more neutral manner, such as by allowing businesses of all types to immediately deduct the full cost of investment (expensing).⁸

4 Erica York, Garrett Watson, and Alex Durante, "Biden's FY 2024 Budget Would Result in More Than \$4.5 Trillion in Gross Tax Increases," Tax Foundation, Mar. 9, 2023, <https://taxfoundation.org/biden-budget-taxes/>.

5 Timothy Vermeer, "The Impact of Individual Income Tax Changes on Economic Growth," Tax Foundation, Jun. 14, 2022, <https://taxfoundation.org/income-taxes-affect-economy/>; Robert Carroll, "The Excess Burden of Taxes and the Economic Cost of High Tax Rates," Tax Foundation, August 2009, <https://files.taxfoundation.org/legacy/docs/sr170.pdf>; Martin Feldstein, "Tax Avoidance and the Deadweight Loss of the Income Tax," *The Review of Economics and Statistics* 81:4 (November 1999): 674-680, <https://www.jstor.org/stable/2646716>.

6 Garrett Watson et al., "Details and Analysis of President Biden's Fiscal Year 2024 Budget Proposal," Tax Foundation, Mar. 23, 2023, <https://taxfoundation.org/biden-budget-tax-proposals-analysis/>.

7 Tax Foundation, "Options Guide 2.0: Option 10," Apr. 19, 2021, <https://taxfoundation.org/tax-reform-options/?option=10>.

8 Stephen J. Entin, "Expensing of Machinery and Equipment Should be Made Permanent," Tax Foundation, May 30, 2023, <https://taxfoundation.org/permanent-expensing-machinery-equipment/>.

Question 3

Do you think the \$80 billion provided to the IRS in the “so-called” Inflation Reduction Act help small businesses?

Will the addition of 87,000 new IRS agents help small businesses become more successful?

To the extent the additional funding for the IRS leads to more assistance and customer service for taxpayers, then it can help small businesses and others comply with the law in a timely manner. However, most of the additional funding is for more enforcement, which will lead to more audits of small businesses and other taxpayers. The general downside to this approach is that it does not address the underlying problem with the tax code that drives non-compliance, high compliance costs for taxpayers, and high administrative costs for the IRS, which is the excessive complexity of the law. The tax code is now about 4 million words and counting, with each successive Congress and administration adding to the complexity and compliance burden.⁹ Americans spend more than 6.5 billion hours trying to comply with the tax code every year, at a cost of about \$313 billion in lost productivity, and most of that cost is incurred by businesses.¹⁰ Lawmakers should focus on ways to simplify the code for business owners and all taxpayers, which can be achieved incrementally through reforms such as expensing and more holistically through fundamental tax reform as discussed in my written testimony.

9 William McBride, “Testimony: The Costs and Complexity of the Federal Tax Code Demand Reform,” Tax Foundation, Apr. 18, 2023, <https://taxfoundation.org/federal-tax-complexity-costs-reform/>.

10 Scott Hodge, “The Tax Compliance Cost of IRS Regulations,” Tax Foundation, Aug. 23, 2022, <https://taxfoundation.org/tax-compliance-costs-irs-regulations/>.

Committee on the Budget Hearing
Reigniting American Growth and Prosperity Series:
Incentivizing Economic Excellence Through Tax Policy

Questions for the Record

June 22, 2023

Kyle Pomerleau, Senior Fellow on Tax Policy, American Enterprise Institute

Representative Ralph Norman (SC-05)

Nearly 95% of businesses in South Carolina employ less than 100 people, small business optimism continues to remain well below the 50-year historical average for the 17th consecutive month. Concurrently, President Biden has proposed over \$1.8 trillion in tax hikes on main street businesses.

- **What impact will these unprecedented increases have on livelihood of small business owners, employees, and the general economy?**

In his most recent budget, President Joe Biden proposed more than \$4 trillion in tax increases. A handful of these tax increases would raise individual income taxes and would fall on what are called “pass through” businesses. These businesses include Sole Proprietorships, S Corporations, and Partnerships.

The major tax increases that will impact pass-through businesses are:

1. Strengthen limitation on losses for noncorporate taxpayers.
2. Apply the net investment income tax to pass-through business income of high-income taxpayers.
3. Increase the net investment income tax rate and additional Medicare tax rate for high-income taxpayers.
4. Increase the top marginal income tax rate for high-income earners.
5. Impose a minimum income tax on the wealthiest taxpayers.

Altogether, these tax increases would raise \$1.4 trillion over ten years. However, not all the new revenue would come from pass-through businesses and their owners.

In isolation, these provisions would raise marginal tax rates on new investment. This would increase the cost of investment in the United States and would, ultimately, reduce labor productivity, wages, and output.

However, the extent to which these tax increases penalize investment and growth depend heavily on what Congress does with bonus depreciation. If lawmakers extend 100 percent bonus depreciation, these rate increases would have a much smaller impact on investment incentives than if lawmakers allow bonus depreciation to phase out as currently scheduled.

Regardless of bonus depreciation, the additional limits on losses would penalize investment. The ability to deduct losses is an important component of a well-functioning income tax system. Businesses that invest in risky investments or those that may not pay off for several years need to be able to carry forward and deduct losses incurred before an investment provides returns. Without this ability, this type of investment would face high effective tax rates. Further strengthening this limitation doubles down on a poor TCJA policy.

Specifically, the President has advocated for eliminating the small business deduction, which over 19 million small businesses utilize to reduce tax liabilities by up to \$159 million.

- **Mr. Pomerleau and Mr. McBride: How would this hinder innovation within the marketplace?**
- **What about economic growth and living standards?**

Biden's most recent budget does not call for repealing Section 199A, the 20 percent deduction for qualified business income. However, he has proposed scaling it back for households with more than \$400,000 in adjusted gross income and Biden does suggest, in his budget, he would like to work with Congress to address the pending expiration of the individual provisions of the TCJA, which includes Section 199A.

Section 199A reduces the effective statutory tax rate on business income. At a 37 percent top tax rate, a 20 percent deduction reduces the top tax rate on business income to 29.6 percent. All else equal, this would reduce the cost of new investment and would result in higher output in the long run. However, there are a few issues to consider:

- The provision is currently temporary. Thus, the long-run impact of this provision on growth, investment, and government revenue is zero. Lawmakers would need to extend this provision for it to have an impact on the long-run size of the economy.
- The impact 199A has on new investment depends on whether lawmakers also extend bonus depreciation or expand it. If an asset is expensed, the effective marginal tax rate is zero regardless of the statutory tax rate. Thus, 199A would have no effect on equity-financed investment in the presence of expensing. In contrast, 199A would reduce the burden on new investment if bonus depreciation is allowed to expire.
- Furthermore, 199A may actually raise the tax burden on debt-financed investment. This is because the tax value of deductible interest depends on the rate at which it can be deducted. For example, the interest deduction is worth \$0.37 per dollar of interest at a 37 percent rate but falls to \$0.296 at a 29.6% rate. Thus, businesses that use debt for a large share of investment may face a higher cost of capital under 199A.
- Lastly, 199A introduces new distortions. Under 199A business income is taxed at a lower statutory tax rate than wage income. As a result, it encourages wasteful tax planning to redefine wages as business income. In addition, 199A also discourages companies from incorporating. This is because 199A increases the tax advantage of remaining a pass-through and forgoing converting to a C corporation. Ideally, a tax code should be neutral across business forms.

Do you think the \$80 billion provided to the IRS in the “so-called” Inflation Reduction Act help small businesses? Will the addition of 87,000 new IRS agents help small businesses become more successful?

The Inflation Reduction Act included \$80 billion in additional funding for the IRS over the next ten years. The funding is meant to help the IRS increase tax enforcement, customer services, and improve IT, among other things. More recently, lawmakers reduced the amount of funding the IRS will receive by about \$21 billion as part of debt ceiling deal.

It is still early, so there is a degree of uncertainty, but there could be a few potential implications for small business. First, more enforcement means higher compliance costs for businesses. Businesses subject to audits will need to spend additional time complying with the tax code. Second, higher tax burdens. Businesses that are currently evading taxes will likely need to pay more to avoid being audited by better-equipped IRS. Third, businesses may face some reduced compliance costs if the additional funding improves customer services.

Committee on the Budget Hearing

**Reigniting American Growth and Prosperity Series:
Incentivizing Economic Excellence Through Tax Policy**

Questions for the Record

June 22, 2023

Kevin Kuhlman, Vice President, Government Relations, National Federation of Independent Business

Representative Ralph Norman (SC-05)

Nearly 95% of businesses in South Carolina employ less than 100 people, small business optimism continues to remain well below the 50-year historical average for the 17th consecutive month. Concurrently, President Biden has proposed over \$1.8 trillion in tax hikes on main street businesses.

What impact will these unprecedented increases have on livelihood of small business owners, employees, and the general economy?

- Small business optimism remains well below historical averages, as you mentioned. Small business optimism was at and near record highs in late 2019 and early 2020 (before the pandemic) because the environment was focused on tax and regulatory relief. Businesses were investing in expansion, increasing wages and benefits, and hiring employees.

Tax increase proposals will continue to keep optimism and plans to hire and expand depressed. Thankfully, none of these proposals were included in the recent debt limit deal. At the hearing, I showed a petition with over 21,000 signatures of small business owners throughout the country who opposed the tax increases proposed in President Biden's Budget Request. If the tax increase proposals were implemented, small business owners would be forced to make cuts to pay the increased tax burden, and the local community and national economy would suffer consequences.

Do you think the \$80 billion provided to the IRS in the “so-called” Inflation Reduction Act help small businesses?

- The majority of the \$80 billion in funding to the IRS is focused on increased enforcement, which is concerning for small business owners. Tax compliance is complicated and more than 90% use a tax professional to prepare and submit their taxes. Among this group, “compliance” and “complexity” were the two dominant factors leading business owners to use a professional. Despite the high proportion of business owners enlisting the help of a tax professional, most respondents indicated a persistent administrative burden associated with preparing and paying their taxes.

At the same time, small businesses have not received adequate customer service from the IRS. In a recent NFIB Research Center survey, members were asked about their interactions with the IRS. Of the members who attempted to contact the IRS for information related to their businesses in the last 12 months, 64% reported that the experience was not helpful at all. Thus, NFIB supported H.R. 23, the *Family and Small Business Taxpayer Protection Act*, which repealed the enforcement funding and required a focus on compliance assistance.

IRS Commissioner Peter Werfel did testify at his confirmation hearing that the IRS would look to reduce paperwork burdens on small businesses, which is an area of common interest.

Will the addition of 87,000 new IRS agents help small businesses become more successful?

- No, the addition of tens of thousands of new IRS agents will not help small businesses become more successful. Instead, the IRS should focus on improving outreach and compliance assistance efforts, as well as reducing paperwork burdens. There are two examples of recent IRS enforcement that illustrate problems for small business owners – one I characterize as “shotgun enforcement” and another I characterize as “sledgehammer enforcement.”

“Shotgun enforcement” occurred when the IRS originally enforced the employer mandate from the Affordable Care Act. They sent out over 30,000 enforcement letter (226J letters) saying businesses were in violation of the employer mandate and needed to respond within 30 days. While the IRS did not characterize this as an audit, it certainly felt like an audit for small business owners, who had to spend time and money responding to the letters. More than 90% of the letters did not have penalties after responses, but small business owners were panicked.

“Sledgehammer enforcement” occurred when the IRS issues excessive penalties. The Supreme Court recently sided with taxpayers in *Alexandru Bittner v. United States of America*. The government fined Alexandru Bittner \$2.72 million for failure to file annual reports instead of the maximum \$10,000 per annual report. The Court reversed the lower court’s decision and protected small businesses by concluding that the failure to file a statutorily required financial report was one violation with one penalty, instead of a violation for each account not reported with multiplying penalties. NFIB filed an amicus brief in the case. The case questioned the *Bank Secrecy Act* and whether a violation under the Act is the failure to file an annual Report of Foreign Bank and Financial Accounts, or whether there is a separate violation for each individual account that was not reported. This example is relevant because beginning next year, more than 32 million small businesses will have to file reports containing personally identifiable information (beneficial ownership information reports) to Treasury (FinCEN specifically) or will face up to \$10,000 in penalties and up to 2 years in prison. These reports can be used for tax enforcement purposes. NFIB is very concerned about “sledgehammer enforcement” of this requirement, of which few small businesses are even aware.

Committee on the Budget Hearing

**Reigniting American Growth and Prosperity Series:
Incentivizing Economic Excellence Through Tax Policy**

Questions for the Record

June 22, 2023

The Honorable Mark Mazur, Former Assistant Secretary for Tax Policy, U.S. Department of the Treasury

Representative Ralph Norman (SC-05)

Nearly 95% of businesses in South Carolina employ less than 100 people, small business optimism continues to remain well below the 50-year historical average for the 17th consecutive month. Concurrently, President Biden has proposed over \$1.8 trillion in tax hikes on main street businesses. What impact will these unprecedented increases have on livelihood of small business owners, employees, and the general economy?

As we discussed during the hearing, one of the prime goals of tax policy is revenue adequacy, defined as raising the revenue necessary to support the public goods and services provided by the Federal government. The consistently large Federal budget deficits of the past two decades indicates that additional revenues are required to make progress on our fiscal policy situation. As I understand it, the revenues that the Biden Administration's budget proposes to raise would cover the new initiatives proposed in the Budget and also make a contribution to reducing our Nation's long-term budget deficits, improving the overall fiscal situation of the Federal government. Also, my understanding is that the proposed revenue increases are designed to be borne by households with annual incomes over \$400,000 and by corporations. These are most likely to be taxpayers with the greatest ability to bear a modest increase in their tax burdens. If the entire set of Biden Administration budget proposals were enacted by Congress, I would expect the overall effect on the economy to be modest in the short and longer run, as positive and negative effects would largely offset each other. Similarly, the expected effects on the vast majority of small business owners and employee would also be quite modest.

