CTJ Citizens for Tax Justice

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# Answers to Your Tax Day Questions

## Part 1: President's Obama's Budget, Taxes, and the Economy

1. **Question:** Does President Obama plan on raising our taxes?

**Answer**: President Obama proposed tax cuts for more than 95 percent of Americans in his budget proposal. He would allow the Bush tax cuts for the richest 2.5 percent of taxpayers to expire as they are scheduled to at the end of 2010.[1]

This means that the very richest few will pay taxes at rates in place during the Clinton years while everyone gets to keep the tax cuts enacted by President Bush as well as additional tax cuts for low- and middle-income families enacted as part of the economic recovery legislation.

2. **Question:** How will reducing tax breaks for the highest income households affect the economy?

**Answer:** It will help the economy because it will provide revenue needed to make investments in health care, education, transportation and other things families and businesses need to be prosperous.

There is no evidence that the tax rates in place during the Clinton years hurt the economy. Real median household income grew during the Clinton years, but fell in the Bush years. The poverty rate declined under Clinton, but increased during the Bush years. Unemployment, which fell under Clinton, rose under Bush. And all this happened even before the collapse of the financial sector at the end of Bush's presidency and the deep downturn that followed.

3. **Question:** Well, there might be cyclical downturns and upturns in the economy that no one can control, but don't tax cuts help us climb out of downturns a little faster?

**Answer:** Not if they're Bush's tax cuts for the rich.

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[1] Citizens for Tax Justice, "Only 2.5 Percent of Taxpayers Would Lose Some of the Bush Income tax Cuts Under Obama's Tax Plan: State-by-State Figures," October 23, 2008. http://www.ctj.org/pdf/obamathreshold.pdf.

President Reagan and President George W. Bush both enacted “supply-side” tax cuts, meaning tax cuts that primarily benefitted the wealthy investor class. Research shows that the recovery from recessions has been weaker following the high-income tax cuts of President Reagan and President George W. Bush than the recovery following the high-income tax *hikes* enacted under President Clinton.[2]

4. **Question:** How will President Obama’s proposed tax policies affect small businesses?

**Answer:** Very few small businesses would be subject to higher taxes than they are today.

An individual business owner would be subject to higher rates only if his *taxable* income exceeded $250,000—that’s after deducting all business costs and expenses, and his itemized deductions. If he reinvests the money into his business by purchasing equipment or building a plant, most, if not all, of that expense is immediately deductible.

5. **Question:** What about the President’s proposal to limit deductions for rich people?

**Answer:** Currently rich people benefit from itemized deductions much more than middle-income people (even if they claim the same amount in deductions). The President proposed to somewhat limit those benefits for the richest 2.5 percent and use the revenue to help fund health care reform, but neither the House nor the Senate included this change in their recent budget resolutions.

If a millionaire and a middle-class person claim the same amount in itemized deductions on their federal income tax form, the millionaire receives a much greater benefit. That’s because a deduction saves you the amount of money deducted times the marginal income tax rate that applies to someone at your level of taxable income. If you are in the 10 percent income tax bracket, then each dollar of itemized deductions saves you 10 cents. If you are lucky enough to be in the 35 percent income tax bracket, each dollar of itemized deductions saves you 35 cents. President Obama proposed that the richest taxpayers be allowed to get no more than 28 cents for each dollar of itemized deductions they claim — which is still more than most of us can enjoy.

6. **Question:** Why do some people say that charities will be hurt by the proposal to limit the benefits of itemized deductions for the rich?

**Answer:** One of the deductions affected would be the deduction for charitable giving, but this proposed change would have very little impact on charities because the vast majority of

[2] Michael Ettlinger and John Irons, "Take a Walk on the Supply Side: Tax Cuts on Profits, Savings, and the Wealthy Fail to Spur Economic Growth," Center for American Progress and the Economic Policy Institute, September 12, 2008. http://www.americanprogress.org/issues/2008/09/pdf/supply_side.pdf

charitable giving does *not* come from individuals in the top two income tax brackets. A recent Center on Budget report estimated that charitable giving would decrease by only 1.9%.[3] What's more, most beneficiaries of charity are likely to come out far ahead if the additional revenues are invested in expanding and improving our health care system.

## Part 2: Taxes and Income Distribution

1. **Question**: Are the rich shouldering too much of the tax burden?

**Answer**: No, because the share of total taxes paid by the rich is not very different from the share of total income received by the rich.

If you look at just federal individual income taxes, the rich do pay a higher share of their income in taxes than do poor and middle-income people. That's a feature of a progressive tax, and helps keep taxes down for the vast majority of us. Unfortunately, when you include other federal taxes (like payroll taxes), and state and local taxes (including sales and property tax), almost everyone contributes to paying the cost of public services in amounts proportional to their income. A new report from Citizens for Tax Justice finds, for example, that the richest one percent receives 22.2 percent of the total income in the U.S. and pays 23 percent of total federal, state and local taxes.[4]

2. **Question**: The top income tax rate is 35 percent and President Obama wants to allow it to revert to 39.6 percent after 2010. Does this mean that if I become financially successful, the federal government will take well over a third of what I make in taxes?

**Answer**: No. Most wealthy Americans are taxed at rates far lower than this.

This is because of the various deductions, credits and loopholes they use, and particularly because much of their income is taxed at the special low rates for income from investments (income that takes the form of capital gains and dividends).

You don't have to take our word for it. The IRS recently found that the richest 400 Americans in 2006 had an effective income tax rate of just 17.2 percent of their reported income, far lower than the top statutory rate of 35 percent.[5] The real effective income tax rate for this group is probably even less because the IRS makes no attempt to account for all the unreported income these taxpayers receive.

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[3] Paul N. Van de Water, "Proposal to Cap Deductions for High-Income Households Would Reduce Charitable Contributions by Only 1.9 Percent," March 31, 2009. http://www.cbpp.org/cms/index.cfm?fa=view&id=2700

[4] Citizens for Tax Justice, "Is 'Tax Day' Too Burdensome for the Rich? The U.S. Tax System Is Not as Progressive as You Think," April 13, 2009. http://www.ctj.org/pdf/taxday2009.pdf

[5] Citizens for Tax Justice, "Do the Rich Really Pay Over a Third of Their Income in Federal Income Taxes?" April 10, 2009. http://www.ctj.org/pdf/irstop400.pdf

3. **Question:** Why does President Obama propose tax credits for people who don't pay income taxes (the credits would cause some people to have negative tax liability, meaning they actually get money from the IRS rather than paying)?

**Answer**: Over a third of taxpayers do not earn enough to owe any federal income taxes, but everyone who works pays federal payroll taxes. These people are not helped by a cut in the federal income tax — unless it takes the form of a refundable credit that helps offset payroll taxes.[6]

The refundable tax credits that the President and Congressional leaders created and expanded in the economic recovery package help some families who pay federal payroll taxes but earn too little to owe any income taxes. These credits are only available for people with earnings, and virtually everyone with earnings pays federal payroll taxes. The refund checks families receive from the IRS as a result of the refundable income tax credits are largely a way to offset the impact of those payroll taxes.

## Part 3: The Estate Tax

1. **Question**: Even if I don't pay a lot in federal taxes right now, is the government going to eventually tax my wealth when I die?

**Answer**: Only if you're one of the richest people in America.

Only 0.7 percent of deaths in 2006 resulted in estate tax liability.[7] (That's the most recent year for which the IRS has released estate tax data.) This year even fewer deaths will result in estate tax liability because the amount of assets that are exempt from the tax increased in 2009. Under the rules in effect this year, a married couple can pass on $7 million to their heirs without one penny of it being affected by the estate tax. With this higher exemption, only about two-tenths of one percent of estates are estimated to be subject to the estate tax. If you're lucky enough to have an estate bigger than that, then it might be taxed, but if it consists of a family business then the tax can be paid in installments over 14 years. And you can leave an unlimited amount to your surviving spouse or to charity without paying any estate tax.

President George W. Bush signed a law that gradually phases out the estate tax, raising the exemptions and lowering the rates over a course of years until the estate tax disappears altogether in 2010. But like all the Bush tax cuts, this change expires at the end of 2010,

[6] Citizens for Tax Justice, "Claims that Stimulus Tax Cuts Go to 'People Who Don't Pay Taxes' Are Intentionally Misleading," January 29, 2009. http://www.ctj.org/pdf/refundablecredits.pdf

[7] Citizens for Tax Justice, "Latest State-by-State Data Show Why Obama Should Scale Back His Proposal to Cut the Estate Tax," December 3, 2008. http://www.ctj.org/pdf/estatetax20081203.pdf

meaning that the estate tax rules scheduled under President Clinton go back into effect in 2011 if Congress does nothing. President Obama proposes to make permanent the 2009 rules.

2. **Question:** But we've heard over and over again that small businesses and family farms are hurt by the estate tax.

**Answer:** According to an analysis by the Tax Policy Center cited in the *New York Times* on April 8, only 100 small businesses and family farms nationwide would owe any estate tax in 2011, and almost all of them can handle the taxes without having to sell any business assets.

Despite that fact, you have probably heard over and over again that the estate tax devastates small businesses and family farms. That story is told by opponents of the estate tax because small businesses are a lot more sympathetic than large businesses and multimillion dollar estates. But don't be misled — keeping the estate tax at the 2009 level will cost more than $250 billion over 10 years, and an even bigger cut passed in the Senate would cost another $90 billion more.

## Part 4: Tax Havens

1. **Question:** What are "tax havens" and why are some people in an uproar over them?

**Answer:** Tax havens are countries where bank secrecy laws forbid the disclosure of information about financial institutions' customers and they often also have low or non-existent income taxes. When an individual or corporation transfers income or assets to one of these countries, they can often evade U.S. taxes because the IRS cannot tax income that it does not know about. Typically, these schemes are available to high-income Americans and American corporations but not to ordinary people like us.

2. **Question:** What does it matter to me if someone else is hiding their income from the IRS?

**Answer:** The use of tax havens to evade income taxes is estimated to cost somewhere around $100 billion a year. That's a lot of money that could go to education, health care or other investments that we need but instead is lost because some wealthy people are willing to cheat on their taxes to avoid paying their fair share.

3. **Question:** Shouldn't I be able to invest my money wherever I want? What does the U.S. government care if I put my money in some bank in a foreign country without telling anyone?

**Answer:** Nobody's telling you where to invest, but U.S. citizens are obligated to pay taxes on their worldwide income, no matter where it is earned or where they live. If income is also taxed in another country, the U.S. grants a foreign tax credit against your U.S. income tax to avoid double taxation. But income shifted to tax havens is not taxed by *any* government.

4. **Question:** Do corporations use tax havens?

**Answer:** U.S. corporations have even *more* opportunities than individual citizens and residents to avoid taxes through the use of tax havens.

Unlike U.S. people, U.S. corporations often get to “defer” U.S. taxes on their foreign income indefinitely. This “deferral” often looks more like an exemption from U.S. taxes and is a significant advantage for any corporate income earned abroad — or made to look like it is earned abroad.

The result is that income earned in the U.S. is often disguised through various schemes as corporate income earned in, say, the Cayman Islands, so that the taxes on this income can be “deferred,” which really means “*not paid*.”

President Obama has proposed to reform both “deferral” of taxes on foreign income and the international enforcement of U.S. tax laws. The administration projects that these steps can save $210 billion over ten years.

5. **Question:** Are the President and his friends just complaining because people are putting their money in countries with lower tax rates?

**Answer:** No, lower (or zero) tax rates are not the reason people shift their investments to tax havens, since they still owe U.S. taxes on their income wherever it is earned. Instead, people use tax havens because their bank secrecy laws make it easy for unscrupulous Americans to cheat on their taxes.

On the corporate side, most of the assets and income shifted to tax havens are only “investments” on paper. For example, a lot of companies that claim to have subsidiaries in tax havens have nothing but a post office box in the tax haven country and they are genuinely making all of their money in the U.S. There are 18,800 companies registered at the “Ugland House” a five-story building in the Cayman Islands, but *not one* of the registered companies actually has a real business in the Caymans.

6. **Question:** Is it common for corporations to use tax havens to avoid taxes?

**Answer:** Yes. A January 2009 Government Accounting Office (GAO) report disclosed that the 83 of the largest 100 U.S. publicly-traded companies had subsidiaries in countries considered tax havens. Citigroup has 427 subsidiaries located in tax havens, with 90 of those in the Cayman Islands alone. The pharmaceutical giant Pfizer has 80 tax haven subsidiaries and Marathon Oil has 76. Enron had 881 foreign subsidiaries with 692 of them located in the Cayman Islands. The GAO Report notes that the existence of a subsidiary in a tax haven does not necessarily mean that it was intended to be used to reduce the companies’ federal income tax liabilities, but most companies would be hard-pressed to come up with a non-tax reason for having subsidiaries in these tiny countries.

## Part 5: Tax Protestor Arguments

1. **Question**: I heard that federal income taxes aren't really legal. Is that true?

**Answer**: You heard that from a radical anti-tax activist who wants the courts to accept outrageous legal theories. Or worse, you heard that from someone who is trying to sell you a bogus tax scheme.

Two arguments about the legality of the federal income tax are raised by tax protestors. The first is that federal income taxes are unconstitutional because the 16th Amendment was not properly ratified, or because Ohio was not properly a state at the time of ratification. Ohio's status as a state was confirmed in 1953 retroactive to 1803, and even without Ohio, enough states ratified the 16th Amendment. The second argument is that the 16th Amendment does not authorize a direct non-apportioned federal income tax on U.S. citizens, but the U.S. Supreme Court has explicitly held that it does.[8]

2. **Question**: Is it true that the Internal Revenue Service is not an agency of the United States, and may even be illegal?

**Answer**: Tax protestors argue that the IRS is illegal because it was created by an act of the Treasury Department rather than by Congress. However, Congress had expressly delegated to Treasury full authority to administer and enforce the internal revenue laws and to create an agency to enforce them.

3. **Question**: Isn't filing an income tax return "voluntary" and doesn't that mean I don't have a legal obligation to file a return?

**Answer**: "Voluntary" refers to our system where taxpayers initially complete their returns and determine their tax, rather than having the government do it. Protestors often cite a Supreme Court decision stating "our system of taxation is based upon voluntary assessment and payment" and point to the IRS Form 1040 instructions that state that the tax system is voluntary. "Voluntary" here means self-assessed, it doesn't mean optional. The requirement to file a return is squarely in the internal revenue law.[9]

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[8] In United States v. Collins, 920 F.2d 619, 629 (10th Cir. 1990), cert. denied, 500 U.S. 920 (1991), the court cited to Brushaber v. Union Pac. R.R., 240 U.S. 1, 12-19 (1916), and noted that the U.S. Supreme Court has recognized that the "sixteenth amendment authorizes a direct nonapportioned tax upon United States citizens throughout the nation." See also Internal Revenue Service Revenue Ruling 2005-19, 2005-1 C.B. 819.

[9] Internal Revenue Code Section 6011. 26 U.S.C. 6011. See also Internal Revenue Service Revenue Ruling 2007-20, 2007-14 I.R.B. 863.

4. **Question:** Are salary and wages "income"? I heard that compensation isn't legally taxable.

**Answer**: The income tax code says that gross income is "all income, from whatever source derived."[10] Anyone who says that doesn't include wages is wrong.[11]

5. **Question:** Do the tax protestors actually believe all the nonsense they're promoting?

**Answer**: While some might be true believers, many so-called tax protestors do not believe any of it but are rather trying to sell you a bogus product.

They want taxpayers to buy their "Pay No Taxes" book[12] or their "Tax Termination Package,"[13] which are schemes that they claim will get you out of paying your income taxes. They are based on legal arguments that have never been held to be legitimate by a U.S. Court. They are, pure and simple, scams. The courts have not only rejected these arguments as "without merit," they have imposed fines, penalties, and prison sentences for the promoters.[14] Taxpayers should avoid these schemes.[15]

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[10] Internal Revenue Code Section 61. 26 U.S.C. 61.

[11] Internal Revenue Service Revenue Ruling 2007-19, 2007-14 I.R.B. 843.

[12] Alexander Hamilton, Pay No Taxes, www.paynotaxes.org

[13] Offered for $39.95 at www.givemeliberty.org until stopped by a federal injunction.

[14] There are other bogus income tax avoidance schemes, like the "Claiming the Slavery Reparation Tax Credit Guide" which tells African-American taxpayers (for a fee) how to claim a tax credit that has never existed. See Internal Revenue Service News Release IR-2002-08, Slavery Reparation Scams Surge, IRS Urges Taxpayers Not To File False Claims, January 24, 2002, available at http://www.irs.gov/pub/irs-news/ir-02-08.pdf

[15] For information about tax protestor arguments in general, see Internal Revenue Service, "The Truth about Frivolous Tax Arguments," February 9, 2009.
http://www.irs.gov/taxpros/article/0,,id=159932,00.html#_Toc153765517