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Tax Reform Details: An Example of Comprehensive Reform

I. Introduction and Summary

A previous report from Citizens for Tax Justice explains that tax reform should do more than simplify our tax system. It should also raise revenue, make our tax system more progressive, and reduce opportunities for corporations to shift profits and jobs offshore.[1] This report provides a concrete example of a comprehensive reform plan that would meet these goals.

Eliminating certain "tax expenditures" (subsidies provided through the tax code) for wealthy individuals is one path to raising substantial revenue in a progressive way and simplifying the tax code. Most importantly, tax reform should eliminate the lower personal income tax rates that currently exist for capital gains (profits from selling assets for more than they cost to purchase) and stock dividends. These forms of investment income, which mostly go to the rich, should be taxed at the same rates as the income from work and other types of income.

In addition, Congress could consolidate the top three income tax brackets (in which "ordinary" income is taxed at 33, 35 and 39.6 percent but capital gains and dividends are taxed at much lower rates) into one income tax bracket in which *all* income is taxed at a rate of 36 percent. This means some of the ordinary income going to wealthy individuals (ordinary income in the existing 33 and 35 percent brackets) would be taxed at a higher rate, while some of it (ordinary income in the 39.6 percent bracket) would be taxed at a lower rate. Most importantly, wealthy Americans would pay substantially more, on average, than they pay under current law because their capital gains and stock dividends would no longer be taxed at lower rates than other income.

Average Tax Changes for Different Income Groups in 2015 Under Combination of Tax Reforms Described (end capital gains preference, close business tax breaks, etc)

Income Group	Average Income	Min and Max Income for Group	Average Tax Change in Dollars	Average Tax Change as % of Income
Lowest 20%	$ 14,670	Less than $23,000	$ –10	–0.1%
Second 20%	$ 29,680	$23,000–38,000	–20	–0.1%
Middle 20%	$ 47,530	$38,000–60,000	80	0.2%
Fourth 20%	$ 78,670	$60,000–102,000	370	0.5%
Next 15%	$ 137,190	$102,000–206,000	1,380	1.0%
Next 4%	$ 298,360	$206,000–533,000	5,940	2.0%
Top 1%	$ 1,664,500	$533,000–or more	71,860	4.3%
ALL	$ 82,000		$ 1,240	1.5%

Tax changes include impacts of changing tax provisions affecting individuals (calculated by the Institute on Taxation and Economic Policy (ITEP) tax model) and changing tax provisions affecting businesses (based on the Joint Committee on Taxation's estimates of Senator Wyden's tax reform proposal and calculations by ITEP).

The top personal income tax rate would be set at 36 percent to address concerns that taxing capital gains at the current top "ordinary" rate of 39.6 percent would discourage asset sales. The net impact of this change would be to raise $76 billion in 2015 alone.

To further counteract possible behavioral responses to higher tax rates on capital gains (i.e., in order to stop people with assets from getting around the tax increase on capital gains), Congress should also end the rule allowing capital gains held at death to escape taxation.

To further enhance progressivity and further simplify taxes for more people, tax reform can also include an increase in the standard deduction that most taxpayers subtract from their income to calculate their taxable income. This report analyzes the impact of increasing the standard deduction by $2,200 for singles and by twice that amount for

Revenue Impact of Tax Reforms in 2015, in Billions of Dollars

Tax Reforms for Individuals	
Eliminate preferential rates for capital gains and stock dividends, tax capital gains at death, and replace top three brackets with one 36% bracket.	76
Increase the standard deduction by $2,200 for singles, $4,400 for married couples, and $2,900 for heads of household.	–34
Repeal "backdoor" income taxes: PEP, Pease, AMT.	–44
Enact President Obama's proposed 28 percent rule.	39
Subtotal for Tax Reforms for Individuals	**37**
Tax Reforms Affecting Businesses (excluding temporary revenue changes)	
Repeal deferral (include active income of offshore subsidiaries in Subpart F income, per-country foreign tax credit).	67
Repeal accelerated depreciation (depreciation of equipment in excess of alternative depreciation system).	30
Index corporate interest deduction for inflation.	19
Repeal deduction for domestic production activities (Sec. 199).	16
Other business provisions in Wyden legislation.	16
Subtotal for Tax Reforms Affecting Businesses	**148**
TOTAL PERMANENT REVENUE IMPACT	**185**
Temporary Impacts of Tax Reforms Affecting Businesses	
Repeal deferral	18
Repeal accelerated depreciation	20
Subtotal for Temporary Impacts of Tax Reforms Affecting Businesses	**38**

Revenue Impact of Corporate Income Tax Rate Reductions in 2015, in Billions of Dollars, Assuming Other Reforms Described Are Also Enacted

Corporate Income Tax Rates (including interactions with other provisions)	
35 percent (no change)	**—**
32 percent	**–51**
30 percent	**–85**

Sources: Institute on Taxation and Economic Policy (ITEP) tax model, for individual tax changes; Joint Committee on Taxation and calculations by ITEP for business tax changes.

married couples. This would reduce the revenue savings from the reforms already described by $34 billion, down to a net of plus $42 billion in 2015.

Some politicians believe that to enhance simplicity, tax reform should eliminate "backdoor" income taxes like the Alternative Minimum Tax and limits on personal exemptions and itemized deductions — but this would reduce the revenue savings from the reforms described so far by $44 billion in 2015. On the other hand, Congress could replace these backdoor income taxes with one, President Obama's proposed "28 percent rule," which would offset most of this cost. This would result in a simpler tax code than the one we have now. Each of these steps is explained in detail in this report.

Annual Revenue Raised from Tax Reforms Described, in Billions of Dollars

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	**2014-2023**
changes for individuals	$ 36	$ 37	$ 40	$ 43	$ 46	$ 48	$ 51	$ 54	$ 57	$ 61	**$ 473**
changes for businesses	$ 82	$ 148	$ 159	$ 164	$ 168	$ 165	$ 162	$ 157	$ 156	$ 152	**$ 1,514**
total change excluding temporary effects	**$ 117**	**$ 185**	**$ 199**	**$ 207**	**$ 214**	**$ 214**	**$ 213**	**$ 211**	**$ 213**	**$ 213**	**$ 1,987**
temporary change in first decade	$ 17	$ 38	$ 49	$ 53	$ 55	$ 52	$ 48	$ 42	$ 38	$ 35	**$ 426**

Sources: Institute on Taxation and Economic Policy (ITEP) tax model for individual tax changes; Joint Committee on Taxation and calculations by ITEP for business tax changes.

Eliminating major tax expenditures for businesses is another path to raising substantial revenue in a progressive way. A recent tax reform proposal from Senator Ron Wyden of Oregon includes several provisions to end tax expenditures for businesses, and if Congress simply enacted these (without the tax rate reductions that Wyden's plan also includes) these provisions would collectively raise $148 billion in 2015. (This figure excludes temporary revenue increases that result from shifts in the timing of tax payments.) This would require Congress to eliminate some enormous business tax breaks, like the rule allowing American corporations to "defer" paying U.S. taxes on their offshore profits, which encourages corporations to shift profits and jobs offshore.

Many lawmakers propose to combine such business tax reforms with a reduction in the corporate income tax rate, but this would significantly reduce the amount of revenue that can be raised. Each percentage point reduction in the corporate income tax rate would reduce the revenue gain from adopting the Wyden reforms by about $17 billion a year.

As this report explains, business tax increases are progressive tax increases because they are generally borne by the owners of business assets, who are disproportionately wealthy.

If Congress enacted the reforms described in this report, they would collectively raise revenue by $185 billion in 2015 alone and by almost $2 trillion over a decade. This figure excludes over $400 billion in temporary revenue that would appear in the first decade due to shifts in the timing of business tax payments. Because it is temporary,

this revenue cannot be used to fund anything permanent but instead could be used to fund a temporary increase in federal investments in infrastructure or some other short-term increase in public investments.

This report provides details on each of the reforms described here as well as estimates generated by the Institute on Taxation and Economic Policy's microsimulation model and from other sources. The final section of this report provides details on how these figures were estimated.

II. Tax Reforms Affecting Individuals

Ending Personal Income Tax Breaks for Capital Gains and Stock Dividends

Very generally, the federal personal income tax allows taxpayers to subtract from their income deductions (some people "itemize" their deductions but most low- and middle-income people use the "standard deduction") and "personal exemptions" for each family member to calculate their taxable income.

If the taxpayer has taxable income (and not everyone does), it is taxed at progressive income tax rates. For taxable income that takes the form of "ordinary" income (including the wages that most of us depend on for income), the rates start at 10 percent and climb as high as 39.6 percent. But there are lower, preferential tax rates for taxable income that takes the form of capital gains (the profits made from selling assets for more than they cost to purchase) or corporate stock dividends.

Under current law, a person whose income takes the form of capital gains (which they might receive whenever they sell stocks or other assets) or stock dividends can therefore pay lower personal income taxes than a person who receives the same amount of income from work.

The preferential income tax rates for capital gains and stock dividends can also create situations in which very wealthy individuals pay lower effective tax rates (pay a lower percentage of total income in taxes) than some middle-income people. This phenomenon became well-known when the billionaire investor Warren Buffett revealed that he pays a lower effective tax rate than his secretary.

Personal Income Tax Rate Brackets in 2013 Under Current Law and Proposed Reform

Taxable income floor for each filing status, applicable ordinary income tax rate and preferential income tax rate.

Filing Status				Current Law Tax Rates		Proposed Tax Rates
Married Filing Jointly (married couples with or without children)	Single (unmarried people without children)	Head of Household (unmarried people with children)	Married Filing Separately (rarely used)	"Ordinary" Rates (for most types of income)	Preferential Rates (for capital gains and dividends)	Rates for All Income ("ordinary" and capital gains and dividends)
$0	$0	$0	$0	10%	0%	10%
$17,850	$8,925	$12,750	$8,925	15%	0%	15%
$72,500	$36,250	$48,600	$36,250	25%	15%	25%
$146,400	$87,850	$125,450	$73,200	28%	15%	28%
$223,050	$183,250	$203,150	$111,525	33%	15%	36%
$398,350	$398,350	$398,350	$199,175	35%	15%	
$450,000	$400,000	$425,000	$225,000	39.6%	20%	

The Congressional Budget Office recently estimated that 68 percent of the benefits of the preferential rates for capital gains and dividends will go to the richest one percent of Americans this year.[2] This is because over two-thirds of capital gains income and over one-third of dividends are received by the richest one percent of Americans, and also because the difference between the preferential tax rates and the ordinary tax rates is greater for people in the highest income tax brackets. (The difference between the capital gains and dividends rates and the "ordinary" rates are about 20 percentage points in the top two income tax brackets, but less for all other income tax brackets.)

Eliminating the preferential income tax rates will greatly simplify the tax code in addition to making it fairer. The income tax preference for capital gains creates an incentive for individuals to devise various schemes to disguise other types of income as long-term capital gains income to benefit from the lower tax rate. This is true despite the great effort that drafters of the tax code have put towards preventing these abuses. Hundreds of pages of the tax code and regulations are devoted to defining what is or is not a capital gain, and many other sections of the code (sections related to the Alternative Minimum Tax, incentive stock options, distributions from corporations, and

A Small Number of Middle-Income Americans Would Face a Tax Increase if Capital Gains and Dividends Are Taxed at "Ordinary" Rates

Most low- and middle-income Americans do not benefit from the preferential personal income tax rates on capital gains and stock dividends. The Congressional Budget Office recently estimated that in 2013, the middle fifth of Americans received just two percent of the benefits of these preferential rates, and the share of the benefits going to the poorest two-fifths of Americans rounded to zero percent.*

While many people in these income groups have some sort of investments, most are not affected by the preferential rates. For example, most stock owned by middle-income people is in 401(k) plans, Individual Retirement Accounts (IRAs) or other similar retirement savings vehicles. Taxes on these investments are deferred until retirement, at which point they are taxed as "ordinary income," meaning they don't benefit from the tax cuts for capital gains and dividends.

However, there is a small number of low- and middle-income taxpayers who do have capital gains and dividend income that would be taxed at higher rates under this plan. (For some of these taxpayers this would be mitigated by the provision of this plan that would increase the standard deduction by $2,200 for singles and $4,400 for married couples.)

The resulting tax increase on some low- and middle-income people is acceptable for two reasons. First, it is simply unfair for a person whose income takes the form of capital gains and dividends to pay lower taxes than someone who has the *same* amount of income, but in the form of wages. This is true whether these two people have a small income or a large income.

Second, there is no way around this tax increase if one of the goals of tax reform is to simplify the tax system. Preserving a system of separate rates for different types of income — at any income level — would make impossible the simplification that politicians and the people who elect them claim to want.

* Congressional Budget Office, "The Distribution of Major Tax Expenditures in the Individual Income Tax System," May 29, 2013. http://cbo.gov/publication/43768

many others) have language distinguishing how capital gains should be treated. Most of this would, of course, be unnecessary if all income was simply taxed at the same rates under the personal income tax, because then no one would engage in schemes to disguise other types of income as capital gains.

Eliminating the preferential rates for capital gains and dividends is not a radical idea. It was part of the Tax Reform Act of 1986, which was signed into law by President Ronald Reagan, and which resulted in all personal income being taxed at the same set of rates. Under that law, the top personal income tax rate was 28 percent, which was far too low to raise enough revenue to meet the obligations that the federal government faces today. But the tax reform plan described in this report would provide the same type of simplification and increased fairness that the 1986 law did.

The Congressional Research Service (CRS) and the Congressional Joint Committee on Taxation (JCT) are currently in disagreement over how much revenue can be raised from increasing tax rates on capital gains from their current levels. Both believe that the revenue raised would be reduced somewhat by behavioral responses of taxpayers. In other words, both CRS and JCT believe that taxpayers would respond to increased tax rates on capital gains by changing their behavior by reducing asset sales to avoid a tax increase. (A previous CTJ report explains that CRS seems to have more realistic assumptions, and thus finds that more revenue can be raised from higher rates on capital gains than does JCT.)[3]

To counteract these behavioral responses, Congress should end the rule allowing capital gains income to escape personal income taxes at death. Ultimately, this current rule is a key way that people with assets can avoid paying taxes on capital gains. We assume that changing the rule so that capital gains are now taxed at death will counteract those behavioral responses (i.e., will prevent people with assets from getting around the higher tax rates on capital gains).

Any appreciation of an asset that takes place while it is owned by a taxpayer is capital gains income that the taxpayer must pay income taxes on when he or she sells the asset. But if the taxpayer dies before selling such an asset, that appreciation is never subject to the personal income tax under the current rule. People who inherit appreciated assets pay personal income taxes only on any appreciation of the assets that takes place after they inherit them, and only if they sell the assets.

This means that a considerable amount of capital gains income never gets taxed. It also means that some people could (at least in theory) respond to a higher personal income tax rate on capital gains by deciding to hold onto more assets until they die and bequeath them to their heirs. This behavioral response can largely be blocked by changing the rule so that capital gains income is taxed upon a taxpayer's death.

Replacing Three "Backdoor" Taxes (the AMT, PEP and Pease) with One (the "28 percent rule")

There are some provisions that we can think of as "backdoor" income taxes, provisions that Congress has enacted over the years to increase taxes on well-off Americans without increasing the regular tax rates applying to taxable income.

The most well-known of these back-door taxes is the Alternative Minimum Tax (AMT). The AMT was enacted in 1969 and is a backstop tax meant to ensure that well-off Americans pay at least some minimal amount of income taxes no matter how many deductions and other breaks they use to reduce their income taxes under the regular rules. Under current law, the vast majority of the AMT is paid by the richest five percent of Americans.

Two other backdoor taxes are the personal exemption phase-out (PEP) and the limit on itemized deductions that is often called "Pease," after the Congressman who proposed the idea. Under current law, PEP and Pease only affect taxpayers with adjusted gross income (AGI) above $250,000 (above $300,000 if married) in 2013. These thresholds are adjusted annually.

There is much talk in the media and in Congress about the complexity caused by provisions like the AMT, PEP and Pease. While these provisions certainly make tax filing more complicated for some people, the effect is likely exaggerated because most people with incomes high enough to be affected file their taxes using software or through an accountant.

Eliminating the backdoor taxes in effect today would be costly. Assuming Congress takes the steps described so far in this report (consolidating the top three personal income tax brackets into a 36 percent bracket, eliminating preferential rates for capital gains and dividends and taxing capital gains at death), repealing PEP, Pease and the AMT would reduce revenue by $44 billion in 2015.

If lawmakers nonetheless want to repeal PEP, Pease and the AMT, they have two options. Lawmakers could reform the individual tax expenditures (like the various itemized deductions) that wealthy people use to lower their tax bills so that these backdoor taxes are not needed. Or, lawmakers could repeal these backdoor taxes and replace them with one backdoor tax. This would at result in a tax system that is simpler than the one we have now.

One option for a new backdoor tax to replace the existing three is President Obama's proposed "28 percent rule," which would limit the tax savings for high-income taxpayers from itemized deductions and certain other deductions and exclusions to 28 cents for each dollar deducted or excluded.

Like other backdoor taxes, the 28 percent rule is a way of limiting tax expenditures for the wealthy. The term "tax expenditures" refers to provisions that are government

subsidies provided through the tax code. As such, these tax expenditures have the same effect as direct spending subsidies, because the Treasury ends up with less revenue and some individual or group receives money. But tax expenditures are sometimes not recognized as spending programs because they are implemented through the tax code.

Some tax expenditures subsidize particular activities, like donating to charity or borrowing to purchase a home, but subsidize these activities at higher rates for high-income people than for low- and middle-income people. Currently, a high-income person in the 39.6 percent income tax bracket saves almost 40 cents for each dollar of deductions or exclusions. A middle-income person might be in the 15 percent income tax bracket and therefore save only 15 cents for each dollar of deductions or exclusions. Under the tax reforms described in this report, the highest personal income tax rate would be 36 percent rather than the current 39.6 percent. That means a wealthy person would save 36 cents for each dollar of deductions and exclusions if there was no provision to limit them (no backdoor tax).

The 28 percent rule would limit the savings for each dollar of deductions and exclusions to 28 cents. This could affect people with taxable income in an income tax bracket higher than the 28 percent bracket (and people who *would* have taxable income in a higher bracket if not for their deductions and exclusions).[4]

If Congress took the steps already described in this report, enacting the 28 percent rule would increase revenue by $39 billion in 2015, meaning it would offset most of the cost of repealing PEP, Pease and the AMT.

Replacing the existing three backdoor income taxes with one (the 28 percent rule) would therefore prevent a large reduction in revenue and could be a reasonable part of a larger tax plan that raises revenue.

III. Tax Reforms Affecting Businesses

Reform of tax provisions affecting corporations and other businesses is another path to raising revenue. Most of the business tax expenditures discussed in this section benefit corporations that pay the corporate income tax as well as “pass-through” businesses, which are businesses that are taxed under the personal income tax (businesses whose profits are “passed on” to their owners and taxed as their personal income.)

Many politicians, including President Obama, have expressed a contrary idea, the idea that business tax reform should be “revenue-neutral.” In other words, they call for eliminating or reducing certain business tax expenditures, but using all of the revenue savings to offset a reduction in the corporate income tax rate.

The idea that the corporate income tax rate should be reduced is based on several misunderstandings about the tax. One is about the corporate income tax rate. While

the *statutory* federal corporate income tax rate, at 35 percent, is relatively high compared to that of other countries, the *effective* federal corporate income tax rate (the percentage of profits actually paid in federal income taxes) is much lower for most corporations. A CTJ report found that the average effective federal corporate income tax rate for the Fortune 500 companies that had been consistently profitable for three years was just 18.5 percent, about half of the statutory rate. The same CTJ report found that of those corporations studied that had significant offshore profits, two-thirds paid a higher effective income tax rate in the foreign countries where they did business than they paid in the U.S.[5]

Another misunderstanding is about how corporate profits are taxed. Some argue that it is actually better policy to allow most corporations to avoid the corporate income tax because the profits of corporations are taxed a second time after they are paid out as stock dividends to individuals who must then pay personal income taxes on them. One of several problems with this argument is that two-thirds of stock dividends paid by corporations go to tax-exempt entities, meaning they are not subject to any personal income taxes.[6]

The approach analyzed in this report assumes that Congress enacts the provisions of Senator Ron Wyden's recent tax reform legislation that close business tax expenditures, without also enacting the reduction in the corporate income tax rate included in that legislation. The most significant provisions are described below.

Ending the Rule Allowing American Corporations to "Defer" Paying U.S. Taxes on their Offshore Profits

One of the very largest tax expenditures, one that only benefits corporations, is so-called "deferral." This is the rule allowing American corporations to "defer" paying U.S. taxes on the profits of their offshore subsidiaries until those profits are "repatriated." That's another way of saying Americans corporations are allowed to delay paying U.S. taxes on their offshore profits until those offshore profits are brought to the U.S. A corporation can go years without paying U.S. taxes on those profits, and may *never* pay U.S. taxes on those profits.

This creates two terrible incentives for American corporations. First, in some situations it encourages them to shift their operations and jobs to a country with lower taxes. Second, it encourages them to use accounting gimmicks to disguise their U.S. profits as foreign profits generated by a subsidiary company in some other country that has much lower taxes or that doesn't tax these profits at all.

The countries that have extremely low taxes or no taxes on profits are known as tax havens. And the subsidiary company in the tax haven that is claimed to make all these profits is often nothing more than a post office box.

The corporate income tax has rules that are supposed to limit this practice of artificially shifting profits (on paper) to offshore tax havens. For example, American

corporations are not allowed to defer U.S. taxes on "passive income," which refers to certain types of income that Congress considers too easy to shift around from one country to another. And there are "transfer pricing" rules, which require that a U.S. corporation and its offshore subsidiary (which are really two parts of the same company) deal with each other at "arm's length" when there is a transaction of some sort between them. In other words, if a U.S. corporation is transferring, say, a patent to its offshore subsidiary, it's supposed to pretend that the subsidiary is an unrelated company and charge it a fair market price for the patent. And if the subsidiary wants to allow the U.S. corporation to use the patent, it must charge royalties at a fair market price.

These rules are failing to prevent abuses of deferral. The IRS cannot easily identify a fair market price for (for example) a patent for a brand new invention, particularly when there is no similar transaction in the marketplace for the IRS to look to for comparison. American corporations are therefore able to transfer patents to subsidiaries in Bermuda or the Cayman Islands at very low prices and then pay inflated royalties to these subsidiaries for the use of those patents — and then claim to the IRS that they have no U.S. profits as a result.

Recent data from the Congressional Research Service (CRS) confirms that this sort of corporate tax dodging involving offshore tax havens is happening on a massive scale. Luxembourg and Bermuda serve as two examples of tax havens. CRS recently found that the profits that American corporations claim (to the IRS) to have earned through their subsidiaries in Luxembourg in 2008 equaled 208 percent of that country's gross domestic product (GDP). That's another way of saying American corporations claim to have earnings in Luxembourg that are twice as large as that nation's entire economy, which is obviously impossible. The profits that American corporations claimed to have earned through subsidiaries in Bermuda equaled 1,000 percent of that tiny country's economy.[7] It is clear that most of the profits American corporations claim are earned by their subsidiaries in these tax havens are not the result of any real business activity there.

The most straight forward solution is to repeal deferral. This would mean that all the profits of American corporations are subject to the U.S. corporate income tax whether they are domestic profits or foreign profits generated by offshore subsidiaries. There would be no incentive for an American corporation to move its operations offshore or to make its U.S. profits appear to be generated in an offshore tax haven.

American corporations would continue to receive a credit against their U.S. taxes for corporate taxes paid to any foreign government (the foreign tax credit), just as they do now, to prevent double-taxation. For example, imagine an American corporation has a subsidiary in another country and pays a corporate tax of 20 percent of the profits it earns there to that country's government. Under the current rules, the American corporation can indefinitely defer paying any U.S. tax on those profits by keeping them in the foreign country. (And characterizing these profits as "offshore" may be largely an

Treasury Department's Distribution of Corporate Income Tax	
Lowest 20%	1.1%
Second 20%	3.2%
Middle 20%	6.6%
Fourth 20%	12.0%
Next 15%	18.0%
Next 4%	15.0%
Top 1%	43.0%
ALL	100.0%

Source: Treasury Dept., 2012.

accounting matter.) When it does "repatriate" those profits (bring them to the U.S.) it receives a credit for the 20 percent it already paid to the foreign government and then pays the difference between the U.S. corporate income tax rate of 35 percent and the rate of 20 percent paid to the foreign government, which comes to a 15 percent rate paid to the U.S.

If Congress repeals deferral, the American corporation would still receive the foreign tax credit and still only pay 15 percent to the U.S. government. The only difference is that the company would be required to pay that tax the same year the profits are earned regardless of whether or not the profits are brought back to the U.S.

In other words, the total tax due the year the profits are earned would be the same, 35 percent, regardless of whether those profits were generated in the U.S. or in another

Who Pays the Corporate Income Tax?

All taxes must ultimately be paid by someone, and the corporate income tax is no different. It is directly paid by corporations, but those tax payments mean that corporations have fewer profits to pay out as dividends to stock holders. This affects the value of corporate stocks and, indirectly, the value of all business investment. The corporate income tax is therefore ultimately paid primarily by the owners of corporate stocks and other business assets. Because ownership of these assets is concentrated in the hands of the wealthy, this makes the corporate income tax a progressive tax.

Some analysts who are critical of the corporate income tax claim that it is ultimately paid by labor (by workers) because it pushes investment outside the U.S., which results in lower employment and depressed wages for American workers. But no one has paid more attention to the corporate income tax than those who manage corporations, and they have spent noticeable resources lobbying Congress to lower the corporate income tax. They would not bother doing this if they did not believe their shareholders (who they are accountable to) were the people ultimately affected by the tax.

Further, most tax analysts and government agencies who have examined the issue have concluded that the vast majority of the corporate income tax is paid by capital (the owners of corporate stocks and other business assets) rather than labor (the American workers). For example, a 2012 report from the U.S. Treasury Department concludes that 82 percent of the corporate income tax is borne by capital and just 18 percent is borne by labor.*

The table in the top left corner of this page illustrates how that Treasury report concluded the corporate income tax is distributed among different income groups. The distribution estimates in the table on page one assume that the corporate income tax increases that result from this tax reform plan are distributed in the same way, as are the tax increases that result for "pass-through" businesses, which likely have a similar effect.

As the table illustrates, some of the increase in taxes on businesses that results from this plan is paid by low- and middle-income people. (This is partially mitigated by the increase in the standard deduction by $2,200 for singles and $4,400 for married couples.) The business tax increases that result from this plan are nonetheless progressive because they are mainly paid by the wealthy.

* Julie-Anne Cronin, Emily Y. Lin, Laura Power, and Michael Cooper, "Distributing the Corporate Income Tax: Revised U.S. Treasury Methodology," Treasury Department, 2012. http://www.treasury.gov/resource-center/tax-policy/tax-

country. There would therefore be no incentive for an American corporation to make its U.S. profits appear to be generated in an offshore tax haven.

As already explained, part of the revenue raised during the first decade after deferral is repealed is really just a timing shift in tax payments. This is because some of the offshore profits for which U.S. taxes are deferred under current law would have eventually been brought to the U.S. and subject to U.S. taxes. But a great deal of the revenue raised comes from U.S. taxes paid on profits that would not have been brought to the U.S. under the current rules and from shifting to a system that no longer provides incentives for corporations to shift profits or operations offshore.

Ending Accelerated Depreciation

Businesses are allowed to deduct from their taxable income the expenses of running the business, so that what's taxed is net profit. Businesses can also deduct the costs of purchases of machinery, software, buildings and so forth, but since these capital investments don't lose value right away, these deductions are taken over time. The basic idea behind depreciation is that when a company makes a capital purchase of a piece of equipment, it can deduct the cost of that equipment over the period of time in which the equipment is thought to wear out.

Accelerated depreciation allows a company to take these deductions more quickly — sometimes far more quickly — than the equipment actually wears out. The deductions for the cost of the capital purchase are thus taken earlier, which makes them bigger and more valuable. Accelerated depreciation was first introduced in the 1950s, and then greatly expanded in the 1970s and 1980s. The rules were so generous that many large corporations were able to avoid taxes entirely. This resulted in a public outcry that led to the Tax Reform Act of 1986, which curtailed, but did not eliminate, special tax breaks for capital purchases.

Combined with rules allowing corporations to deduct interest expenses, accelerated depreciation can result in a very low, or even negative, tax rate on profits from particular investments. A corporation can borrow money to purchase equipment or a building, deduct the interest expenses on the debt and quickly deduct the cost of the equipment or building thanks to accelerated depreciation. The total deductions can then be more than the profits generated by the investment.

A report from the Congressional Research Service reviews efforts to quantify the impact of depreciation breaks and explains that "the studies concluded that accelerated depreciation in general is a relatively ineffective tool for stimulating the economy."[8]

One might argue that some depreciation breaks are more effective than others. For example, the breaks studied most closely by CRS are temporary increases in depreciation breaks ("bonus depreciation") because these temporary provisions make possible before-and-after comparisons. But CRS analysts have also concluded that the

permanent depreciation breaks likely have even *less* of an impact on economic growth because there is no requirement that they be used before any particular deadline.[9]

Nonetheless, many members of Congress and even many tax analysts seem committed to the (false) idea that depreciation breaks are necessary to spur domestic investment. If lawmakers do not want to repeal accelerated depreciation, then they would have very little leeway to reduce the corporate income tax rate at all without losing an unacceptable amount of revenue.

If lawmakers wanted to take a more limited approach, they could opt to curb the worst abuses of accelerated depreciation by barring it for leveraged investments. This would end the situations in which the combination of depreciation breaks and interest deductions provide a negative effective tax rate for a given investment. A strong corporate AMT, which was enacted as part of the Tax Reform Act of 1986 but rendered toothless during the 1990s, would also have the effect of limiting the most egregious uses of depreciation breaks.

IV: How We Estimate the Revenue Impacts of Potential Tax Reforms

Citizens for Tax Justice's affiliated research organization, the Institute on Taxation and Economic Policy (ITEP), used its microsimulation tax model to estimate the impact of the potential tax reforms described here that directly affect individuals' taxes. ITEP's tax model is similar to those used by the Congressional Joint Committee on Taxation and the Treasury Department.[10] The one provision directly affecting individuals that was not modeled is the proposal to tax accumulated capital gains at death (repealing the rule that allows these capital gains to go untaxed). We make the conservative assumption that the only revenue impact of this proposal would be to counteract the behavioral effects that would otherwise reduce the revenue gained from taxing capital gains at the same rates as other income.

The provisions affecting business taxes are calculated based on the estimates provided by the Joint Committee on Taxation (JCT) of the impacts of Senator Ron Wyden's Bipartisan Tax Fairness and Simplification Act of 2010.[11] JCT's estimates separate the impacts of eliminating business tax expenditures, reducing the corporate income tax rate, and the interaction between the two. This allows us to calculate the revenue impact of enacting these provisions without a reduction in the corporate tax rate and also with smaller corporate tax rate reductions than Senator Wyden proposed. We adjust the revenue estimates of the business tax provisions for each year based on more recent JCT revenue estimates to account for the later time period we examine (2014 through 2023) and to account for the greater corporate profits that JCT now predicts during the coming decade.

For JCT's figures showing how much revenue is raised by eliminating business tax expenditures, we separate out certain revenue that appears in the first decade but is unlikely to be maintained in the future. This is because this portion of revenue would

come from shifts in the timing of tax payments rather than permanent increases in taxes. The figures on page two present permanent revenue increases separately from the revenue increases that would be temporary.

One example of a timing shift is the provision repealing accelerated depreciation. A recent report from the Center on Budget and Policy Priorities explains that the revenue raised from repealing accelerated depreciation would be much larger in the first decade than in later decades, because part of the revenue increase represents a change in the timing of tax payments. (Ending accelerated depreciation would mean that businesses must write off the costs of equipment over the period of time it actually wears out, which is typically longer, meaning they must wait longer to take deductions for these investments.) [12] That report explains that ending accelerated depreciation would raise only about 60 percent as much in later decades as it would raise in the first decade after enactment. We therefore count only 60 percent of the revenue raised in the first decade from ending accelerated depreciation as permanent revenue.

Another example is the provision repealing the rule allowing American corporations to defer paying U.S. taxes on their offshore profits until those profits are brought to the U.S. Some of those profits would eventually be brought to the U.S. and thus subject to U.S. taxes even under the current rules, which means that some of the revenue raised from ending deferral is simply a shift in the timing of tax payments. JCT's figures indicate that the amount of revenue raised from ending deferral declines by about 3 percent each year. This implies that during the second decade after this plan is enacted, the provision ending deferral would raise only 79 percent of the amount it would raise in the first decade. We therefore count only 79 percent of the revenue raised from this provision in the first decade as permanent revenue.

The table on page 1 illustrates the distributional impacts of the average tax decreases and tax increases for each income group resulting from this tax plan in 2015 (assuming that the plan goes into effect starting in 2014). These estimates include impacts of changes to individuals' taxes as well as 80 percent of the net tax increases on businesses (the other 20 percent is assumed to be paid by people outside the U.S.). In determining which income groups ultimately pay what fraction of the corporate income tax and personal income taxes paid by businesses, we assume the distribution estimated in a recent report by the Treasury Department which found that the richest one percent pay 43 percent of the corporate tax and the richest five percent pay 58 percent of it.[13]

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[1] Citizens for Tax Justice, "Tax Reform Goals: Raise Revenue, Enhance Fairness, End Offshore Shelters," September 23, 2013.
http://www.ctj.org/ctjreports/2013/09/tax_reform_goals_raise_revenue_enhance_fairness_end_offshore_shelters.php

[2] Congressional Budget Office, "The Distribution of Major Tax Expenditures in the Individual Income Tax System," May 29, 2013. http://cbo.gov/publication/43768

[3] See the appendix of Citizens for Tax Justice, "Policy Options to Raise Revenue," March 8, 2012. http://ctj.org/ctjreports/2012/03/policy_options_to_raise_revenue.php

[4] President Obama initially presented his proposal to limit certain tax expenditures in his first budget plan in 2009, and included it in subsequent budget and deficit-reduction plans each year after that. The original proposal applied only to itemized deductions. The President later expanded the proposal to limit the value of certain "above-the-line" deductions (which can be claimed by taxpayers who do not itemize), such as the deduction for health insurance for the self-employed and the deduction for contributions to individual retirement accounts (IRA). Most recently, the proposal was also expanded to include certain tax exclusions, such as the exclusion for interest on state and local bonds and the exclusion for employer-provided health care. Exclusions provide the same sort of benefit as deductions, the only difference being that they are not counted as part of a taxpayer's income in the first place (and therefore do not need to be deducted). This expanded version of the 28 percent rule is included in the tax reform plan described in this report.

[5] Citizens for Tax Justice, "Corporate Taxpayers & Corporate Tax Dodgers, 2008-2010," November 3, 2011. http://ctj.org/corporatetaxdodgers/

[6] Citizens for Tax Justice, "Fact Sheet: Why We Need the Corporate Income Tax," June 10, 2013. http://ctj.org/ctjreports/2013/06/fact_sheet_why_we_need_the_corporate_income_tax.php#.Ui4Nt3-6nXQ

[7] Mark P. Keightley, "An Analysis of Where American Companies Report Profits: Indications of Profit Shifting," Congressional Research Service, January 18, 2013.

[8] Gary Guenther, "Section 179 and Bonus Depreciation Expensing Allowances: Current Law, Legislative Proposals in the 112th Congress, and Economic Effects," Congressional Research Service, September 10, 2012. http://www.fas.org/sgp/crs/misc/RL31852.pdf

[9] Statement of Jane G. Gravelle, Senior Specialist in Economic Policy, Congressional Research Service, before the Committee on Finance, United States Senate, March 6, 2012, on Tax Reform Options: Incentives for Capital Investment and Manufacturing, pages 5-6. http://www.finance.senate.gov/imo/media/doc/Testimony%20of%20Jane%20Gravelle.pdf

[10] See the overview and detailed description of ITEP's tax model. http://www.itep.org/about/itep_tax_model_simple.php

[11] Joint Committee on Taxation, "Estimated Revenue Effects of S. 3018, the "Bipartisan Tax Fairness and Simplification Act of 2010," November 2, 2010. http://www.wyden.senate.gov/download/joint-committee-on-taxation-estimated-score-of-the-bipartisan-tax-fairness-and-simplification-act-of-2010

[12] Chye-Ching Huang, Chuck Marr, and Nathaniel Frentz, "Timing Gimmicks Pose Threat to Fiscally Responsible Tax Reform," Center on Budget and Policy Priorities, July 24, 2013. http://www.cbpp.org/cms/index.cfm?fa=view&id=3994

[13] Julie-Anne Cronin, Emily Y. Lin, Laura Power, and Michael Cooper, "Distributing the Corporate Income Tax: Revised U.S. Treasury Methodology," Treasury Department, page 25. http://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/OTA-T2012-05-Distributing-the-Corporate-Income-Tax-Methodology-May-2012.pdf