CRS Report, “Raising the Tax Rates on High-Income Taxpayers: Pros and Cons”

[Note: Checkpoint subscribers can view the full-text Congressional Research Service report by clicking the link in the online version of this article on today’s Newsstand tab.]

A recent Congressional Research Service (CRS) report examines the pros and cons of raising the tax rates on high-income taxpayers. Specifically, it focuses on the debate over whether the top two marginal tax rates should be permitted to rise back to their 2001 levels—from the current 33% back to 36%, and from the current 35% back to 39.6%. In looking at this issue, the report takes into account the relationship between the top tax rates on ordinary income, the tax rate on capital gains and dividends, and the alternative minimum tax (AMT).

Background. The Bush tax cuts, including reduced tax rates, reduction of the marriage penalty, repeal of the personal exemption phaseout and limitation on itemized deductions, reduced tax rates on long-term capital gains and qualified dividends, and expanded tax credits, are set to expire in 2010. Beginning in 2011, absent Congressional action, many of the individual income tax rules will revert back to where they were in 2000.

President Obama has promised that he would not raise taxes on single taxpayers with income below $200,000, or married couples with income below $250,000. In its budget proposal for FY2011, the Administration proposed to extend the middle-class portion of the Bush tax cuts, but to allow several provisions favoring upper-income taxpayers to expire.

Some members of Congress favor permanently extending the entire package of Bush tax cuts. Others favor extending all of the cuts, but only temporarily.

Choices facing Congress. When Congress returns, it faces these decisions:

- whether to permit some or all of the Bush tax cuts to expire as scheduled on Dec. 31, 2010;

- whether to extend some or all of the tax cuts and, if they are extended, whether temporarily or permanently; and

- whether to modify some of the tax provisions before extending them.

Budgetary considerations. The report notes that the Bush tax cuts were initially enacted at a time of projected budget surpluses. Now, the nation is faced with very large current and projected federal budget deficits and national debt. The net 10-year cost of extending the Bush tax cuts is estimated to be $3.7 trillion. The president's proposal to raise taxes on upper-income taxpayers would reduce the cost to $3.0 trillion.

Differing views. Some Democrats support the Administration's proposal to permanently extend some, but not all, of the cuts. Other Democrats favor extending all of the cuts, but only temporarily. In general, Republican members of Congress favor permanently extending the entire package of Bush tax cuts.

Possible compromises. One compromise would be to extend some or all of the Bush tax cuts temporarily. Another compromise would be to extend only those Bush tax cuts thought to stimulate the economy the most, and to permit the other tax cuts to expire to help reduce the deficit. The Administration's proposal is in this middle ground, extending some of the Bush tax cuts, but not others. However, its proposed changes in the tax code would be permanent.

Interplay with AMT. Cuts in the regular income tax can make more taxpayers subject to the AMT. If the AMT exemption amounts are not raised for 2011 and beyond, the tax savings from extending the Bush

tax cuts could be offset by an AMT liability for most high-income taxpayers and many middle-income taxpayers. Permitting the top two marginal tax rates to rise could mean that some high-income taxpayers would no longer be subject to the AMT.

> **Observation:** Many taxpayers face increased AMT liability for 2010 because AMT exemption amounts have decreased and fewer credits can offset AMT than during last year. Congressional leaders, however, have vowed that a patch is forthcoming for 2010 (see article "**Taxwriters assure IRS that 2010 AMT patch will be enacted"** that appeared in yesterday's Newsstand e-mail for details).

Administration's upper-income proposals. In addition to letting the top two income tax rates rise back to 36% and 39.6%, the Administration would also reinstate the limits on itemized deductions for high-income taxpayers, reinstate the limits on personal exemptions for high-income taxpayers, and raise the maximum tax rate on capital gains and dividends from 15% to 20% for upper-income taxpayers. Under the Administration's proposal, 97% of taxpayers would experience no increase in their income taxes.

JCT comparison. The CRS study notes that the Joint Committee on Taxation (JCT) has estimated the reduction in taxes, by specially defined income categories, of two alternative approaches for extending the Bush tax cuts. One approximates the Administration proposal; the other approximates the Republican proposal.

Under both proposals, the average tax cut per return is larger, the higher the income category. On average, taxpayers in the eight income categories under $200,000 would receive a lower tax cut under the Republican proposal than the Administration proposal.

In contrast, taxpayers in the three income categories above $200,000 would receive a larger tax cut under the Republican proposal than the Administration proposal. For example, the average tax cut per return is estimated to be $97,486 higher under the Republican proposal for the $1 million and over category.

Arguments for letting the top rates rise. Arguments for raising the tax rates on high-income taxpayers start with the need to raise additional revenue and to signal the beginning of an effort to reduce the deficit. Some warn that if the lower tax rates for the two highest rate brackets are extended even temporarily (say in the interest of buttressing the present weak economy), those lower rates are more likely to be extended in the future.

In addition to having the highest incomes, taxpayers in the top rate brackets received the largest tax reductions from the Bush tax cuts. Consequently, they are seen as the group that can best afford to give back some of the tax cut.

To help stimulate the economy, a tax cut needs to be spent, not saved. But empirical evidence suggests that the rich are less likely to spend their tax savings.

Raising the marginal tax rates for the top two brackets is not expected to cause much reduction in work effort by high-income taxpayers.

Arguments against allowing the top rates to rise. Arguments against raising the tax rates on high-income taxpayers start with the bad timing of raising taxes in the midst of a weak economy. Higher tax rates on ordinary income would encourage high earners to convert some of their pay into lower-taxed forms of compensation. Higher tax rates in the top brackets are seen as a negative incentive for small business growth, investment, and employment. However, the report notes that the link between small business and employment or job creation is open to debate. Many small businesses are sole proprietorships with no employees, or only one or two employees. In general, higher tax rates increase tax evasion and economic distortions.

Tax rates on capital gains and dividends. The Republican proposal includes extending the 15% rate on capital gains and qualified dividends for taxpayers in the regular marginal tax rate brackets of 25% and above (the 25%, 28%, 33%, and 35% rate brackets), and extending the 0% capital gains and qualified dividends rate for taxpayers in the 10% and 15% rate brackets for regular income. The Administration's proposal would permanently extend the current capital gains and dividends tax rates of 15% and 0% for middle-class taxpayers—defined as taxpayers with adjusted gross income (AGI) below $200,000 for single individuals and below $250,000 for married couples filing jointly. But the Administration proposal would permanently raise the tax rate on capital gains and dividends from 15% to 20% for single taxpayers with AGI over $200,000 and married joint filers with AGI over $250,000.

Extending the current lower tax rates for qualified dividends is projected to cost over twice as much as extending the same lower tax rates for capital gains.

The lower tax rates on capital gains and dividends favor high-income taxpayers: they are the ones most likely to receive income from capital gains and dividends.

In contrast, taxable interest is the main source of investment income for taxpayers with AGI under $100,000. These taxpayers are at a disadvantage in a system that taxes interest at ordinary income rates, but dividends and capital gains at a 15% or zero rate. Furthermore, people who purchase stocks in traditional tax-deferred retirement accounts do not receive the advantage of lower tax rates on capital gains and dividends.

Conclusion. These are the difficult choices facing lawmakers. What choices will be made and when remain to be seen. Stay tuned.