TAXATION • 2

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TAXATION

AARP PRINCIPLES

Six broad principles guide AARP's evaluation of tax options:

Equity—Tax revenue sources should distribute the tax burden according to people's ability to pay and should, to the extent possible, achieve vertical and horizontal equity. Taxation should be progressive, and people with comparable incomes should be taxed at comparable rates.

Economic neutrality—Taxes should be as neutral as possible in their treatment of economic activity and should not unduly encourage behavior undertaken simply to avoid taxation. In addition taxes should not unduly hinder economic growth, induce inflation or discourage savings.

Administrative efficiency—Taxes should be as easy to collect and administer as possible, consistent with protection of individual liberties and privacy.

Revenue potential—Stable and reliable public policies and programs require adequate and consistent sources of revenue.

Impact on the budget—All tax measures should be weighed carefully against their impact on federal and/or state budgets and their potential to achieve desired goals.

Social and economic goals—A balance must be struck between relying on the tax system to address social and economic needs (through such measures as tax expenditures or earmarking revenue) and keeping the system free from tax expenditures that undermine equity.

EVALUATING TAX POLICIES

Background

Government at all levels (federal, state and local) relies on revenue derived from taxation to finance its operations, including its administrative, regulatory and service functions. There are many different types of tax, the most common being income, property, sales, property transfers, user-fee and excise taxes.

Different forms of taxation fall differently on individuals and corporations, depending on their economic status and their consumption habits. Progressive taxation affects those who can afford to pay more heavily than it does less affluent individuals. Regressive taxation, on the other hand, puts a greater relative burden on those who can less afford it.

Government at all levels can encourage certain behaviors and discourage others through its implementation of tax policy. For example, deferral of income tax on qualified retirement savings tends to encourage individuals to save in qualified retirement plans, just as tax deductions for employers' contributions to retirement savings for their employees tend to encourage employers to make such contributions. Similarly, lower tax rates in long-term capital gains, however defined, encourage capital investment. On the other hand special taxes on certain consumer items, such as alcohol and tobacco, may diminish consumption of such items. Tax deferrals, exemptions, deductions and credits are common tools, among others, by which governments extend tax preferences.

Proposals to reform the tax code, stimulate the economy, raise additional revenue for any purpose, or modify individual tax provisions should take into account the aforementioned principles, which also apply to corporate taxation.

Vertical equity means that tax burdens—the percentage of income paid in taxes—should increase with a measure of ability to pay, usually income. Vertical equity implies a progressive tax structure. Horizontal equity holds that those with equal resources should be taxed equally.

Tax policies that create economic distortions may encourage tax avoidance and hinder economic growth, induce inflation or discourage savings. However almost all taxes distort economic choices to some extent.

Administrative efficiency can help foster compliance and hold down costs to businesses and individuals.

The revenue yield from broad-based taxes, such as on income or consumption, is greater than the revenue yield from narrowly based taxes, such as levies on alcohol or tobacco.

FEDERAL & STATE POLICY

EVALUATING TAX POLICIES

The choice of revenue options should balance the principles of equity, economic neutrality, administrative efficiency, revenue potential, budget impact, and social and economic goals. Each of these principles is important, but the need to raise sufficient revenue is most critical in current conditions.

While the principles are generally applicable to the states, state budgets operate under a variety of different constraints. Therefore these tax principles should be tempered by the states' varying economic, historical and political conditions.

REVENUE SOURCES

Background

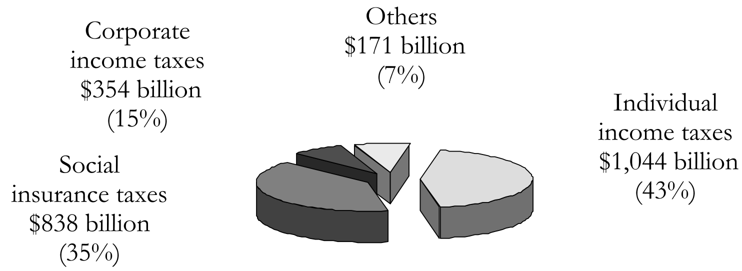
Federal, state and local governments rely on different revenue sources to finance their programs and activities.

Federal taxes—The federal government relies largely on income and payroll taxes for its revenue, with smaller amounts coming from excise taxes, the estate tax and miscellaneous sources (Figure 2-1). The individual income tax has accounted for a very stable percentage (41 percent to 50 percent) of federal revenues for more than 30 years. The corporate income tax, which accounted for more than 20 percent of federal revenues in the early 1960s, now accounts for only 15 percent. Excise, estate and gift taxes; customs fees; and other sources also contribute a declining share of total federal revenues. As a group these sources contributed about 17 percent of federal revenues in the 1960s but provide 7 percent today. On the other hand social insurance revenue as a portion of total federal revenues has been steadily increasing, from 17 percent in the early 1960s to 35 percent today.

Federal revenues have varied only between 17 percent and 20 percent of gross domestic product (GDP) for the past 40 years (Figure 2-2). In fiscal year (FY) 2004, however, total federal revenue fell to 16.3 percent of GDP, a lower share than at any point during the last four decades. Income tax receipts, as a share of GDP, similarly dropped to their lowest level in six decades. In FY 2005, total federal revenue rose back up to 17.5 percent of GDP; income tax revenue also increased slightly as a share of GDP.

Figure 2-1

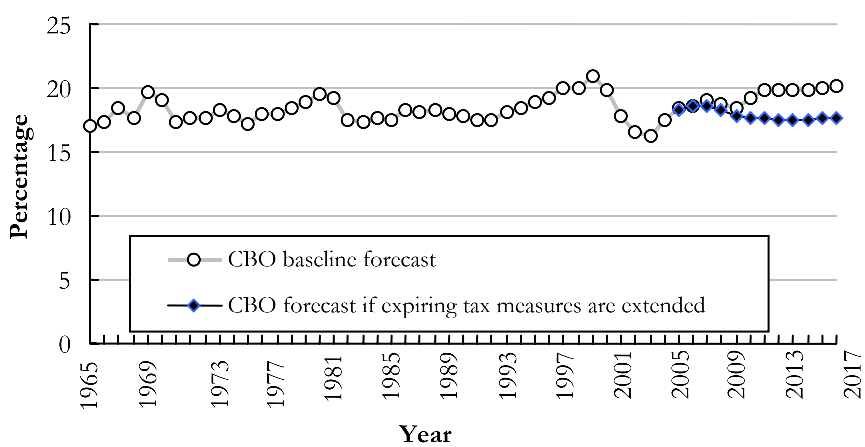
Distribution of Federal Revenue by Major Source, FY 2006



Source: Congressional Budget Office, *The Budget and Economic Outlook,* January 2007.
Prepared by AARP Public Policy Institute.

Figure 2-2

Federal Revenue as Percentage of GDP, 1965–2017



Source: Congressional Budget Office, *The Budget and Economic Outlook,* January 2007.
Prepared by AARP Public Policy Institute.

State and local taxes—For states and localities the largest source of tax revenue is the property tax, which accounted for 32 percent of state and local tax revenue in FY 2003. The second largest source of tax revenue is the general sales tax, which is now used in 45 states and accounted for about one-quarter of state and local tax revenue in FY 2003. The individual income tax, now used in some form by 43 states, is the third largest source, yielding 21 percent of state and local revenue in FY 2003. State fiscal experts advocate a balance among these "big three" revenue sources as a way of avoiding the severe revenue fluctuations of business cycles and limiting competition between neighboring states with disparate tax rates.

Other significant state and local revenue sources include:

- corporate income tax (used in 45 states);
- excise taxes on such products as motor fuels, alcohol and tobacco;
- public utilities taxes;
- severance taxes on the extraction of minerals;
- estate and inheritance taxes;
- licenses and user fees and charges;
- gaming; and
- a variety of miscellaneous revenue sources.

A large nontax source of state revenue is federal aid. In FY 2003 federal aid contributed 22 percent of state and local general revenue.

States also play a central role in local property taxation because they:

- prescribe assessment ratios and practices,
- establish tax-rate limits and property classifications,
- offer property tax relief through "circuit-breaker" programs (which limit the property tax burdens of certain groups and income levels), and
- offset property tax burdens by providing substantial aid to public education.

Income taxes are generally the most progressive of state taxes, i.e., people with higher income pay a higher proportion of income in taxes. Sales and excise taxes, however, are usually regressive, i.e., they take a higher proportion of income from low-income people than from high-income people. Property taxes are the most regressive and burdensome because they continue to increase as people age, even though income tends to decline in real terms.

States with a flat tax rate on a broad base of income sources (Colorado, Illinois, Indiana, Massachusetts, Michigan and Pennsylvania) have a more regressive tax structure than do states with graduated rates. When graduated tax rates are not politically feasible, states still can make their tax schemes more progressive by establishing higher standard deductions and personal exemptions indexed annually for inflation. States can also provide earned income tax credits to low-income residents.

In 1989 the US Supreme Court ruled in *Davis v Michigan* (409 S. Ct. 1500) that states could not discriminate against federal retirees by offering them smaller income tax exemptions on pensions than those offered to retired state and local workers. Most states resolved the issue by giving partial exemptions to both federal and state retirees but no exemption to private pensioners. Federal legislation enacted in 1995 and generally supported by AARP prohibited all states from taxing pension and other retirement distributions made to nonresidents after December 31, 1995, with the exception of distributions from certain nonqualified deferred compensation plans.

State income taxes are closely linked to the federal tax structure through state conformity with federal definitions of income and through provisions such as the deductibility of state income and local property taxes from federal tax liability. This linkage is generally desirable because it simplifies tax administration, enhances compliance and enforcement, and makes it easier for taxpayers to file their state returns. However whenever the federal government modifies its tax base, as it has several times over the past few years, it can create adjustment problems for states. For example, the Economic Growth and Tax Relief Reconciliation Act of 2001 phases out, between 2002 and 2005, the dollar-for-dollar credit that taxpayers can use against their federal estate tax liability for estate or inheritance taxes they paid to state governments (the federal estate tax itself phases out by 2010). This has created a dilemma for states that have a "pickup" tax, in which a state picks up a portion of the federal estate tax revenue without increasing total tax liability.

FEDERAL POLICY

REVENUE SOURCES

AARP supports the income tax as the preferred method of raising revenue at the federal level because it is the most progressive but recognizes that other sources, such as a consumption tax, may be needed to raise sufficient federal revenues.

STATE POLICY

REVENUE SOURCES

AARP supports the income tax as the preferred method of raising revenue at the state level because it is the most progressive.

States should not set inflexible ceilings on the amount of revenue they raise, or the sources from which they collect revenue, without adequate and public justification.

State income taxes should be enacted where none exist to increase equity and improve the balance among revenue sources.

States should modify income tax structures where possible to exempt from state tax rolls low-income people who pay no federal income tax.

Personal exemptions and standard deductions should be increased as a means of increasing the progressive effect of the income tax. States that conform to the federal tax code should also adopt other federal provisions, such as indexed rate brackets, personal exemptions and standard deductions.

Social Security cash benefits should be exempt from state income tax, at least to the extent they are under federal income tax.

At a minimum states with income taxes should allow credits for taxes paid by their residents to other states so that no taxpayer is subject to double taxation.

States should cautiously anticipate the effects of federal changes on state revenues and move carefully to respond.

INCOME TAX OPTIONS

Introduction

Several high-priority income tax issues are highlighted below because they deserve legislative attention. Each issue is discussed in a separate section.

INCOME TAX OPTIONS

Background

Tax Expenditures

The Congressional Budget Act of 1974 defines "tax expenditures" as "revenue losses attributable to provisions of the federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability." Such provisions are referred to as tax expenditures because they may be considered analogous to direct outlay programs when either can be used to accomplish budget policy objectives.

On balance, tax expenditures benefit higher-income people more than lower-income people (see Chapter 1, The Budget, for the largest spending entitlements). For example preferential treatment for capital gains, which largely benefits middle- and higher-income people, is the largest single tax expenditure and is expected to cost $740 billion over the five years starting in fiscal year 2004. The second largest tax expenditure, the exclusion for employer pension contributions and earnings, is expected to cost $568 billion over the same period. Third largest, the exclusion for employer contributions for health care, health insurance and long-term care insurance, is expected to cost $494 billion over the same period. While the Tax Reform Act of 1986 broadened the individual and corporate income tax bases, changes to the tax code in 1997, 2001 and 2003 created a large number of new tax expenditures, thus narrowing the tax base.

FEDERAL POLICY

INCOME TAX OPTIONS

Tax Expenditures

AARP supports efforts to broaden the tax base by limiting tax preferences (often referred to in a budgetary context as "tax expenditures") of dubious value.

The creation, limitation or elimination of tax expenditures warrants at least as much scrutiny as direct spending decisions.

The impact of any new tax expenditures should be monitored carefully to ensure that corporations and upper-income taxpayers bear their fair share of the overall tax burden, in accordance with progressive tax principles.

INCOME TAX OPTIONS

Background

Major Tax Packages of 2001 and 2003

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) was signed into law on June 7, 2001. The largest tax cut in 20 years, the new law was estimated to provide $1.35 trillion in tax reductions. The act:

- created a new 10 percent income tax bracket,
- reduced income tax rates,
- expanded the child credit,
- provided alternative minimum tax relief,
- provided marriage-penalty relief,
- gradually repeals the estate tax,
- expanded education tax incentives, and
- provided numerous pension and savings expansions, as well as other incentives.

Generally the majority of EGTRRA's provisions benefit all federal income taxpayers but favor upper-income taxpayers. One provision specifically targets midlife and older Americans: It allows catch-up contributions to retirement plans for certain individuals age 50 and older (for definition of "catch-up" contributions, see this chapter's section Income Tax Options—Individual Retirement Savings). Many of EGTRRA's provisions were to be phased in over several years, while others would not have taken effect for several years. Still others would have phased out after a few years, and all are scheduled to expire (or "sunset") in 2011 unless Congress votes to reauthorize them. This added complexity in the effective dates resulted from congressional efforts to minimize the cost of individual provisions and comply with the budget framework.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) accelerates many of EGTRRA's measures, and introduces some new changes. The $350 billion package:

- expanded the child credit to $1,000 for tax years 2003 to 2005,
- accelerated implementation of the EGTRRA provision expanding the lowest (10 percent and 15 percent) tax rates,
- accelerated implementation of EGTRRA's reductions in higher tax rates,
- accelerated EGTRRA's marriage-penalty relief,
- offered more generous depreciation methods to businesses,
- provided fiscal relief to states, and

- reduced capital gains and dividends tax rates to 15 percent for upper-bracket taxpayers for 2003 to 2008. For taxpayers in the 10 percent and 15 percent brackets, capital gains and dividends tax rates are reduced to 5 percent for 2003 through 2007 and to zero in 2008.

In 2004 Congress extended several EGTRRA and JGTRRA provisions that were scheduled to expire. Relief from the individual alternative minimum tax was extended one year; marriage penalty relief was extended for four years; the child credit was kept at $1,000 for another five years; and the expanded 10 percent bracket was extended for six years (the marriage penalty, depreciation and capital gains measures are discussed in more detail in the relevant sections of this chapter). The recent tax packages will have to be revisited at some point in the near future because many provisions sunset after 2010; some sunset much earlier (see Figure 2-3, where asterisks indicate the years for which the recent legislation is effective). The Pension Protection Act of 2006 made permanent many of the pension provisions of EGTRRA, including increases in allowable contributions to Individual Retirement Accounts and 401(k) plans and the establishment of catch-up contributions.

This complexity in expiration dates will make tax planning more difficult. Some legislators and the administration have expressed interest in removing the sunsets and making these measures permanent. Removing all the sunsets in the tax code (including the EGTRRA and JGTRRA provisions) would cause a revenue loss of $2.3 trillion over the next ten years. The costs of extending the sunsets would increase dramatically over time: in 2014 alone the revenue loss would be $430 billion, or 2.4 percent of the gross domestic product.

Figure 2-3

Sunsets of 2001–2004 Tax Legislation

Tax measure	2003	2004	2005	2006	2007	2008	2009	2010
Income tax rate reductions	*	*	*	*	*	*	*	*
Expanded 10% bracket	*	*	*	*	*	*	*	*
Marriage-penalty relief	*	*	*	*	*	*		
Lower dividend rates	*	*	*	*	*	*		
Lower capital gains rates	*	*	*	*	*	*		
Increased child credit	*	*	*	*	*	*	*	
Alternative minimum tax relief	*	*	*					

Source: Commerce Clearinghouse Incorporated, May 28, 2003.
Prepared by AARP Public Policy Institute.

Major Tax Packages of 2001 and 2003

Given the deterioration in the budget outlook and the need to fund national spending priorities, Congress must ensure an adequate revenue base.

New tax reductions, as well as new spending increases, should be offset by other revenue increases or spending reductions.

INCOME TAX OPTIONS

Background

Marriage Penalty

A married couple is generally treated as one tax unit who must pay tax on their total taxable income. The so-called marriage penalty causes some married couples to experience higher taxes than nonmarried couples with the same income. However the tax code generates both marriage penalties and marriage bonuses, and married couples generally receive a marriage bonus.

A marriage penalty is said to exist when the combined tax liability of a married couple filing a joint return is greater than the sum of the tax liabilities the two individuals would incur if they were not married. In the past this generally occurred because—among other reasons—the standard deduction and rate brackets for joint filers were less than twice the corresponding amounts for single filers or head-of-household filers. While the size of any marriage penalty or bonus depended on the individuals' income, number of dependents and itemized deductions, married couples whose incomes were split more evenly than a 70-30 ratio generally suffered a marriage penalty under prior law. The benefits from eliminating the marriage penalty tend to be concentrated among couples with moderate to high incomes.

From 2003 to 2008 the marriage penalty will be partially alleviated in three ways. First, the standard deduction for a married couple filing a joint return will be twice that for an unmarried individual filing a single return. Second, the size of the 15 percent income tax bracket for a married couple filing a joint return will increase to twice the size of the corresponding bracket for an unmarried individual filing a single return. Under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), both of these provisions would have taken effect starting in 2005. Implementation was accelerated by the Jobs and Growth Tax Relief Reconciliation Act of 2003, however, and in 2004 Congress extended marriage-penalty relief through 2008. Three, for married couples who file a joint return EGTRRA also adjusted the earned income tax credit (EITC) phase-out by adding $1,000 to the beginning and ending points for the years 2002 to 2004, and $2,000 for the years 2005 to 2007. Starting in 2008 the EITC phase-out beginning and ending points increase by $3,000, which is adjusted for inflation in subsequent years.

Despite the recently enacted changes, numerous marriage penalties and bonuses still exist, and it is essentially impossible to eliminate completely these penalties and bonuses in a progressive tax system. In fact before enactment of the new law, there were more than 60 marriage penalties embedded in the tax code.

FEDERAL POLICY

INCOME TAX OPTIONS

Marriage Penalty

Any further efforts to address the marriage penalty should be targeted to low- and moderate-income people, through methods that include adjusting the earned income tax credit.

INCOME TAX OPTIONS

Background

Individual Alternative Minimum Tax

The individual alternative minimum tax (AMT) was created in 1969 to prevent high-income taxpayers with large amounts of deductions from avoiding all income tax liability. Taxpayers pay the AMT to the extent it exceeds their regular tax liability. The AMT is levied at the rate of 26 percent on the first $175,000 of alternative minimum taxable income (AMTI) and at 28 percent above that amount. The AMT allows an exemption of $35,750 for single filers and heads of household ($49,000 for married couples filing jointly), which is phased out as AMTI increases above certain other income thresholds. The $175,000 break point, exemption levels and other threshold amounts are not indexed for inflation. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) increased these limits temporarily for tax years 2001 to 2004 (the exemption amount was increased by $2,000 for single taxpayers and by $4,000 for married taxpayers). In 2004 Congress extended the higher exemption amounts for another year. In 2006 Congress considered changes that would limit the number of people affected by the AMT, but it did not pass any legislation.

The AMT is poorly targeted at curbing tax shelters. In 2003 about 2.4 million taxpayers had an AMT liability, but more than 90 percent of these people were subject to the AMT not because of aggressive tax shelters but because they had dependent exemptions or standard or itemized deductions. Of the

2.4 million tax filers subject to the AMT in 2003, only 2,700 had an income over $1 million and paid income tax only because of the AMT; under the regular income tax, they would have had no tax liability. By 2010, 29 million taxpayers, or about one-third of all taxpayers, will have an AMT liability under current law (i.e., assuming that provisions of EGTRRA or the Jobs and Growth Tax Relief Reconciliation Act of 2003 are not extended). In addition many more taxpayers will have to calculate both regular tax liability and the AMT to be certain which they are required to pay. The projected expansion in the number of taxpayers affected by the AMT occurs because it is not indexed for inflation and the recent tax cuts reduced regular income tax liabilities.

Married couples, couples with many children, and residents of states with high property and income taxes are also more likely to become subject to the AMT.

Repealing the AMT would be expensive, reducing revenue by about $562 billion between 2005 and 2014 under current law (i.e., if the 2001 and 2003 tax cuts are allowed to expire), and by about $919 billion during the same period if the tax cuts are made permanent. When interest costs on the public debt are included, AMT repeal would cost $710 billion under current law between 2005 and 2014, and about $1.1 trillion during the same period if the 2001 and 2003 tax cuts are extended. Repealing the AMT would result in zero tax liability during 2010 (the last year that the 2001 and 2003 tax cuts are effective) for 77,300 taxpayers with adjusted gross incomes (AGIs) over $200,000, and for about 7,600 taxpayers with AGIs over $1 million. Some analysts argue that the AMT should be reformed but not repealed because it reduces the use of tax shelters.

AMT reform could be accomplished so as to have an almost neutral effect on total tax revenues. Various reform packages have been proposed that would accomplish this.

FEDERAL POLICY

INCOME TAX OPTIONS

Individual Alternative Minimum Tax

Congress should reform the individual alternative minimum tax (AMT) to prevent the number of AMT filers from increasing solely as the result of inflation and to simplify filing for many taxpayers; however, the large revenue loss should be offset by other equitable tax changes.

INCOME TAX OPTIONS

Background

Capital Gains

The Jobs and Growth Tax Relief Reconciliation Act of 2003 made some temporary changes to tax rates on capital gains. For the years 2003 to 2008 the top capital gains tax rate falls to 15 percent. For taxpayers in the lowest income tax brackets (10 percent and 15 percent), it falls to 5 percent during 2003 to 2007, and drops to zero in 2008. In 2009 all capital gains tax rates revert to 2002 levels.

The capital gains rates for 2002 (and those that start again in 2009) were established by the Taxpayer Relief Act of 1997 (TRA 1997). Under TRA 1997 the top long-term capital gains rate for the highest-income taxpayers was 20 percent on property held for more than one year. The tax rate was 18 percent for assets with holding periods beginning in 2001 and held for more than five years. In addition for taxpayers in the 15 percent income tax bracket, capital gains were taxed at 10 percent (8 percent for net capital gains on property held more than five years and properly taken into account beginning in 2001). To obtain the benefits of the new 18 percent and 8 percent rates, taxpayers could elect to treat any eligible assets held before 2001 as having been sold and reacquired. Gains, but not losses, resulting from this election had to be recognized.

TRA 1997 also permitted individuals in certain cases to exclude from taxable income up to $250,000 of gain ($500,000 for married couples filing a joint return) realized on the sale or exchange of property used as a principal residence. Among other rules, the taxpayers must have owned and used the property as their principal residence for at least two years during the five-year period ending on the date of sale or exchange.

While these lower rates and exclusions provided significant tax benefits, the changes also added complexity to the capital gains tax rules by lengthening and complicating the schedule used for filing capital gains taxes. In addition numerous rules apply with respect to qualifying property, depreciation recapture, and alternative minimum tax ramifications.

The capital gains rate differential may cause a return to many of the same tax-avoidance strategies that the Tax Reform Act of 1986 tried to eliminate. The most affluent are usually in the best position to engage in such strategies. For example if a high-income person borrows a large sum to purchase stock, the costs (interest on the borrowed funds) can be deducted at ordinary rates (the top ordinary rate for tax year 2003 was 35 percent), although profits (capital gains) are taxed at only 15 percent. If the interest costs and profits are each $50,000, the taxpayer has no economic gain, but the $17,500 in tax savings from deductions for interest payments is more than twice as great as the $7,500 in capital gains taxes. Thus, the tax code puts the taxpayer $10,000 ahead. Capital gains preferences overwhelmingly benefit those with incomes greater than $100,000, making the income tax less progressive.

The capital gains rate differential is only one of several preferences on capital gains income. Taxes are also deferred until gains are recognized, reducing the effective rate on capital gains in proportion to the length of time taxpayers hold assets yielding such gains.

Indexing capital gains to inflation is preferable to further lowering capital gains tax rates. It would provide a more precise adjustment for inflationary gains, although it would add more complexity to the tax code. On the other hand indexing capital gains without limiting other tax preferences would create an even larger tax advantage for capital gains and may create a heavy revenue loss over time.

Linking indexing to the taxation of capital gains at death would partially offset the revenue lost because of indexing, would treat different types of income more equally, and would improve tax fairness. Under present law property transferred at a person's death receives a basis equal to fair-market value (known as a "stepped-up" basis). As a result of the Economic Growth and Tax Relief Reconciliation Act, a modified carryover basis will be used when the estate tax is repealed in 2010: the basis will be equal to the lesser of the adjusted basis of the decedent or the fair-market value of the property on the date of the decedent's death (these issues are discussed in more detail below, under Other Revenue Options—Estate and Gift Taxes).

FEDERAL POLICY

INCOME TAX OPTIONS

Capital Gains

AARP supports the taxation of capital gains at the same effective rate as ordinary income and the elimination of the capital gains rate differential. Instead of a preferential capital gains rate, AARP supports indexing the basis of assets held for a substantial period (for example, ten years or longer). Individuals should not be taxed on the inflationary portion of gains from the sale of assets. Indexing also should be linked to the taxation of capital gains at death and should replace the stepped-up basis rule so that adjusted gains do not escape taxation completely.

Some protection should be provided against the unfair burdens of excessive record keeping and of establishing the cost basis.

For widow(er)s the time period to claim the couple's exclusion of capital gains, which is larger than the exclusion for single taxpayers from the sale of a house, should be extended to two years.

Congress should simplify the calculation of capital gains taxes by, for example, reducing both the number of holding periods and tax rates.

INCOME TAX OPTIONS

Background

Individual Retirement Savings

Individual retirement accounts—Tax incentives can play an important role in helping individuals save for retirement, as they already do in the private pension system. The contribution limit for individual retirement accounts (IRAs) was $2,000 in 2001. The Economic Growth and Tax Relief Recovery Act of 2001 (EGTRRA) increased this limit to $3,000 in 2002, to $4,000 in 2005, and to $5,000 in 2008, after which the limit will be adjusted for inflation in $500 increments. The Pension Protection Act of 2006 made these changes permanent. Contributions are deductible if the individual does not participate actively in a qualified retirement plan. For individuals who are active participants in a qualified retirement plan, 2005 contributions are deductible if adjusted gross income (AGI) is below $50,000 for single taxpayers and $70,000 for married taxpayers filing jointly. Above these AGI thresholds, the deduction for contributions is phased out.

The Taxpayer Relief Act of 1997 created another type of IRA, called the Roth IRA, for which single filers with AGIs below $110,000 and joint filers up to $160,000 are eligible. Contributions to Roth IRAs are nondeductible, but earnings grow tax free; distributions are generally tax free as well. Individuals with AGIs under $100,000 can, after making any necessary tax payments, roll over existing IRAs into Roth IRAs. The Tax Increase Prevention and Reconciliation Act of 2005 removed personal income restrictions on converting IRAs to Roth IRAs. IRAs that provide the tax exemption upon receipt at retirement (like the Roth IRA) rather than a deduction at the time of contribution (like the deductible IRA), or provisions that allow the exchange of a regular IRA for a Roth IRA, conceal the federal revenue loss by shifting it into the future.

"Catch-up" contributions to IRAs and 401(k)s—EGTRRA established catch-up limits for workers age 50 and older who contribute to an IRA, a 401(k) plan, or a Savings Incentive Match Plan for Employees, known as a SIMPLE plan. Beginning in 2002 older workers who contribute to an IRA became eligible to contribute an additional $500 to their IRAs each year from 2002 through 2005, and an additional $1,000 per year (unindexed) beginning in 2006. The 401(k) contribution limit for individuals age 50 and over rises by $1,000 in each year from 2002 to 2006 and thereafter; the contribution limit is indexed to inflation in $500 increments starting in 2007. SIMPLE plan catch-ups are 50 percent of those applicable to other plans. The Pension Protection Act of 2006 made these changes permanent.

Penalty-free IRA withdrawals—IRAs that offer penalty-free withdrawals for nonretirement purposes may undermine the purpose of encouraging savings for retirement. Current law allows the following exceptions to the 10 percent tax penalty for deductible IRA funds withdrawn prior to age 59½:

health insurance purchases by the unemployed, significant unreimbursed medical expenses, special cash distributions that are annuitized, higher education expenses, up to $10,000 in expenses for first-time home purchases, and the death or disability of the account holder. For Roth IRAs current law allows tax-free account distributions after five years if the owner is at least 59½ years old, disabled or deceased or uses the distribution for up to $10,000 in first-time home-buying expenses.

IRAs and retirement savings—Despite more than a decade of extensive research, questions exist as to whether IRAs are effective in increasing net savings, are well-targeted toward those needing retirement savings, and are the best use of federal budget resources. It has long been recognized that IRAs fail to provide a savings incentive for people who already save up to the maximum, because they establish a ceiling on contributions rather than a floor. Also, IRAs provide an incentive to shift savings to receive the tax benefit. At the same time those with lower incomes find it difficult to save at all. In 2003 only .55 percent of tax filers with AGIs below $15,000 contributed to an IRA, compared with 4.2 percent of taxpayers with AGIs above $50,000 and 4.8 percent of taxpayers with AGIs above $100,000. The number of taxpayers claiming IRA deductions peaked in 1985, at 16.2 million, and has fallen since; by 2002 only 3.5 million taxpayers, constituting 2.7 percent of all tax returns, claimed IRA deductions.

IRA distributions—With the exception of Roth IRAs, current law requires IRA owners to begin receiving distributions (and requires certain minimum distribution options) by April 1 following the year in which they reach age 70½, as a means of limiting tax avoidance on already tax-deferred accounts. But as longevity has increased, the years spent in retirement have also increased, subjecting retirees to a greater risk of exhausting their assets and highlighting the need to preserve retirement assets for longer lives or to pay for health or long-term care expenses. Mandatory distributions may also lock in investment losses.

Tax credits for qualified plan contributions (or the "saver's credit")—To encourage low- and middle-income workers to save for retirement, EGTRRA provides a temporary, nonrefundable tax credit for contributions made by eligible taxpayers to various savings plans. These plans include 401(k)s, 403(b)s, eligible deferred compensation arrangements of state and local governments, savings incentive match plans for employees (SIMPLE plans), simplified employee pensions (SEP plans), traditional IRAs, and Roth IRAs. The maximum annual contribution eligible for the credit is $2,000, and workers can claim a credit of as much as 50 percent of this amount (for a maximum credit of $1,000). The credit is available for taxpayers age 18 and over, other than full-time students or dependents, who have an AGI of up to $50,000 for married couples filing jointly, up to $37,500 for heads of households, and up to $25,000 for singles. The credit initially was available from 2002 through 2006. The Pension Protection Act of 2006 made these changes permanent.

To further target incentives to low-income workers, some have proposed making the tax credit refundable. Although 57 million taxpayers report incomes low enough to qualify for the credit, the inability to claim this as a refund means that only one-fifth of these taxpayers can benefit from the credit, and only about 64,000 can receive the maximum possible credit of $1,000 if they make the maximum contribution. Still others have proposed a government matching contribution or direct government transfers (see Chapter 3, Retirement Income, for additional information on tax incentives on retirement savings).

FEDERAL POLICY

INCOME TAX OPTIONS

Individual Retirement Savings

AARP supports adoption of progressive savings incentives. Tax incentives for retirement savings, such as refundable tax credits, should be established for those who are less likely to save (particularly those with lower to moderate incomes), kept at a reasonable cost, designed so that they promote new net savings, and promoted by educational efforts. Proposals to expand existing individual retirement accounts (IRAs) should be directed toward these goals.

IRA provisions that allow early withdrawal of funds for nonretirement purposes undermine the purpose of encouraging saving for retirement. Funds from retirement vehicles should not be easily available for nonretirement purposes.

Congress should raise the age at which mandatory IRA distributions must begin.

Congress should expand eligibility for the saver’s credit by raising income thresholds and making the saver’s credit refundable.

INCOME TAX OPTIONS

Background

Medical Expense Deduction

The Tax Reform Act of 1986 increased the medical expense deduction threshold from 5 percent to 7.5 percent of adjusted gross income. Older and sicker taxpayers who itemize their deductions bear the brunt of this increase because of their higher out-of-pocket expenses for medical care.

FEDERAL POLICY

INCOME TAX OPTIONS

Medical Expense Deduction

Congress should lower the medical expense deduction threshold of adjusted gross income for all taxpayers.

INCOME TAX OPTIONS

Background

Tax Incentives for Health Insurance

Tax incentives for health insurance are covered as part of a broader health policy strategy in Chapter 6, Health: Health Care Coverage—Private Health Insurance—Private-Market Regulation.

FEDERAL POLICY

INCOME TAX OPTIONS

Tax Incentives for Health Insurance

See Chapter 6, Health: Health Care Coverage—Private Health Insurance—Private-Market Regulation.

INCOME TAX OPTIONS

Background

Tax Incentives for Long-Term Care Insurance

Long-term care insurance tax incentives are covered as part of a broader long-term care strategy in Chapter 7, Long-Term Services and Supports: Financing Long-Term Services and Supports—Private Long-Term Care Insurance.

FEDERAL POLICY

INCOME TAX OPTIONS

Tax Incentives for Long-Term Care Insurance

See Chapter 7, Long-Term Services and Supports.

INCOME TAX OPTIONS

Background

Long-Term Care Tax Credit

The long-term care tax credit is covered as part of a broader long-term care strategy in Chapter 7, Long-Term Services and Supports.

FEDERAL POLICY

INCOME TAX OPTIONS

Long-Term Care Tax Credit

See Chapter 7, Long-Term Services and Supports.

INCOME TAX OPTIONS

Background

Tax-Exempt Interest

Currently tax-exempt interest is part of the income computation that determines the amount of Social Security benefits subject to income tax.

FEDERAL POLICY

INCOME TAX OPTIONS

Tax-Exempt Interest

The tax code should treat Social Security recipients the same as other taxpayers with respect to tax-exempt interest.

INCOME TAX OPTIONS

Background

Earned Income Tax Credit

The earned income tax credit (EITC) is an important federal effort to assist the working poor. Created in 1975 this refundable tax credit is intended to offset the burden of the Social Security payroll tax on low-income workers and to encourage low-income individuals to work. Almost 20 million working families and individuals claimed more than $32 billion through the EITC in 2004.

Taxpayers must file a tax return in order to claim the credit. The amount that eligible individuals may claim depends on their earned income and whether they have one, more than one or no qualifying children. The EITC is potentially available to any low-income worker with at least one qualifying child. Low-income workers with no dependents and who are between the ages of 25 and 64 may also qualify for the EITC.

Although highly successful the EITC program has been widely criticized for its complexity, which discourages participation, hinders compliance, increases administrative costs and engenders abuse.

The program also appears to be underutilized by eligible workers who are overwhelmed by the complex filing requirements or simply do not know about the program. The AARP Tax-Aide counseling program is an important resource available to help low-income workers claim the credit. The Tax-Aide program helped more than one million workers receive the credit last year.

Seventeen states now offer EITCs, which are supported by businesses as well as social service advocates. State EITCs can help reduce poverty among workers with children and complement welfare reform by helping low-wage workers support their families as they leave public assistance. However the design of the credit contributes to high marginal tax rates among taxpayers with incomes slightly above the poverty threshold.

FEDERAL POLICY

INCOME TAX OPTIONS

Earned Income Tax Credit

Congress should:

- extend the earned income tax credit (EITC) to low-income workers with no dependents, regardless of age, provided they are not dependents themselves;
- implement measures designed to reduce the complexity of the program; and
- provide the Internal Revenue Service (IRS) with the revenue necessary to fund education and counseling programs that would encourage eligible taxpayers to obtain the credit. The IRS should increase funding for tax aid programs to help low-income workers eligible to receive the credit.

STATE POLICY

INCOME TAX OPTIONS

Earned Income Tax Credit

When states are experiencing surpluses that allow them to cut taxes, they should at the same time enact or expand earned income tax credits (EITCs) so that low- and moderate-income workers and their families can also share in the tax benefits of prosperity.

States should allow working people of all ages who are not dependents to benefit from the state EITC, whether or not others are dependent on them, provided that income eligibility is determined based on the inclusion of adjusted gross income, tax-exempt interest and total Social Security benefits.

INCOME TAX OPTIONS

Background

Low-Income Housing Credit

The low-income housing credit is covered as part of a broader long-term care strategy in Chapter 8, Housing: Tax Incentives for Developing Low-Income Housing.

FEDERAL POLICY

INCOME TAX OPTIONS

Low-Income Housing Credit

See Chapter 8, Housing: Tax Incentives for Developing Low-Income Housing.

TAX REFORM

Introduction

Several factors have motivated proposals to reform the federal income tax system: the complexity of the existing income tax code, inadequate revenue raised by the existing system, a desire to eliminate the corporate income tax, a belief that the US savings rate is low because of the tax code, a concern for the international competitiveness of the economy's export sector, and public dissatisfaction with the existing tax system. Many proposals call for a consumption tax—such as a value-added tax, national retail sales tax or cash-flow consumption tax—to replace the existing individual and corporate income taxes.

Broad tax-reform discussions have reemerged because of several administration proposals that would move the current system closer to a consumption tax, a renewed interest in Congress in reform, and growing concern about the individual alternative minimum tax and the budget deficit. In January 2005 President Bush created the Advisory Panel on Federal Tax Reform to advise on options to reform the tax code in order to make it fairer, simpler and pro-growth, while not affecting revenue amounts or distribution relative to the 2005 tax code. In November 2005 the panel offered two proposals: income tax simplification and a "growth and investment" package, aspects of which are similar to a consumption tax.

TAX REFORM

Background

Consumption and Other Taxes

The base of a consumption tax is what people spend or consume in a given period, usually a calendar year. As classically defined the income tax base is what people consume plus any changes in their net wealth. The fundamental difference between an income tax and a consumption tax is that the former also taxes savings. Shifting from an income tax to a consumption tax has the added potential pitfall of taxing accumulated wealth that has already been taxed under the income tax.

Retail sales tax—The consumption tax most familiar to Americans is the retail sales tax. Retail establishments collect the tax on behalf of state and local governments but pass the tax burden directly along to consumers. The retail sales tax could also be imposed at the federal level.

Value-added tax—Many countries have adopted a consumption tax known as a value-added tax (VAT). This is a tax on businesses at each stage of production; it is levied on the difference between total sales and total purchases (including capital investment).

Gross receipts tax—A gross receipts tax is levied on the total gross receipts of a business at each stage of production. For instance the tax could be levied on the value of flour sold to a baker, on the value of the bread sold to a grocer, and then on the value of the bread sold to a consumer. A pure gross receipts tax would have no deductions for the cost of goods sold (cost of inputs), interest or other expenses, or taxes, and the tax would apply to all businesses including service providers. It might therefore be passed along in sales prices and result in taxes being levied on tax dollars already paid. Many European countries moved to value-added taxes to avoid this very feature.

Consumed-income (cash-flow) tax—A consumed-income, or cash-flow, tax measures consumption as the flow of income on a cash (as opposed to an accrual) basis minus additions to net wealth (i.e., savings). This approach, which is based on annual returns on individual finances, is progressive if exemptions, deductions and graduated rates are incorporated, something that neither the retail sales nor VAT taxes can accomplish as easily because they are based on individual transactions.

Flat taxes—Flat taxes can be either income or consumption taxes. Most recent flat tax proposals have taken the form of consumption taxes, whose structures most closely resemble VATs. Unlike VATs, however, the flat tax is divided into two taxes—one on individuals and one on businesses. Whereas a VAT is levied on wages by including them in a firm's value added, the flat tax subtracts wages from a firm's value added and taxes them at the individual level instead. This makes it possible to offer exemptions and/or multiple rates to offset the regressive nature of the flat tax. But if adopted broadly, flat taxes would eliminate most tax preferences, including the deductibility of mortgage interest, charitable contributions, and state and local taxes.

Business taxes—Most analysts have criticized the corporate income tax on neutrality grounds because corporate profits are taxed once at the firm level and again through the individual income tax, which requires tax payments on dividends distributed to stockholders. This double taxation of dividends leads businesses to avoid incorporating and paying dividends. Some reform proposals would integrate individual and corporate income taxes; others would broaden the tax base by reducing tax expenditures or equalizing the treatment of different income sources.

Structural tax reform should be evaluated against the principles discussed at the beginning of this chapter.

Equity—With regard to vertical equity, or the progressive nature of a tax, retail sales taxes and VATs, which are based on transactions, typically burden low-income people disproportionately. There is no effective administrative method of protecting them from the tax. Standard methods include exemptions for necessities or differential tax rates for different products, but these tend to be ineffective at targeting low-income people because the exemptions or rates apply to all income groups. Alternatively lawmakers may use the revenues to benefit lower-income people. In the context of a tax that is levied on both businesses and individuals, lawmakers may provide exemptions only for lower-income people, establish progressive tax rates, or establish income tax credits.

With regard to the equal treatment of taxpayers with equal incomes (horizontal equity), consumption taxes may create disparities if certain items are exempted from the tax base or different rates apply to different goods.

One concern regarding all consumption taxes is that subjecting existing savings (wealth) to a new consumption tax would constitute double taxation. Seniors could be taxed twice, once on income during their work years, and a second time during retirement as they spend down their savings to buy goods and services that would be subject to a consumption tax. It would be possible to exclude accumulated savings (as opposed to new savings from wages and salaries) from consumption taxes, although some economists argue that this would eliminate most of the economic gains from moving to a consumption tax. Without transition relief for existing assets, however, retirees would be able to buy less with their savings.

Economic neutrality—Any tax creates some inefficiencies by distorting people's normal behavior in the market. For example the income tax raises the cost of future consumption relative to current consumption. Consumption taxes create no incentive for present versus future consumption. However, about 80 percent of savings in the US economy already receives the treatment it would under a consumption tax, so the argument in favor of consumption taxes probably depends on other presumed advantages.

Administrative efficiency—The degree of administrative complexity depends greatly on the form of the tax. Credit-invoice method VATs have high administrative costs because they increase the number of taxpayers and require detailed record keeping. But a VAT that replaces the income tax (setting aside any transition rules) might not be any more costly to administer than the existing tax system. Advocates of flat-rate consumption taxes claim they are administratively simpler than the income tax. In general, complexity increases with the number of exemptions and tax rates.

Revenue potential—Because consumption is potentially as broad a base as income, broad consumption taxes can, in principle, raise nearly as much revenue as income taxes. Revenue amounts would depend on tax rates and exemptions (e.g., in such areas as housing, health care, food, employer-provided pensions and health insurance, and state and local government purchases). At the rates currently proposed most consumption tax reform plans would result in a significant loss of revenue.

Social and economic goals—Current income tax provisions encourage health insurance coverage, protection of low-wage workers, and home ownership, among other positive goals. A consumption tax could potentially remove these incentives. As a replacement for the income tax most transaction-type taxes, such as retail sales taxes and VATs, would make federal taxes far less progressive.

Consumption taxes also might impose heavy one-time burdens on accumulated savings. Additionally consumption taxes would treat more than 80 percent of US savings no differently than the income tax presently does.

FEDERAL POLICY

TAX REFORM

Consumption and Other Taxes

Tax reform should focus on making the income tax more equitable, neutral and efficient rather than on moving to another type of tax system. To that end comprehensive tax reform should:

- increase the system's capacity for raising adequate revenue;
- maintain ability to pay as the standard of tax equity—Tax reform should result in a distribution of tax burdens that is no less progressive than the current distribution of burdens under the individual and corporate income taxes;
- avoid negative impacts on important social goals such as retirement savings, health insurance coverage and home ownership;
- reduce distortions in the tax code;
- reduce the administrative record-keeping burden on American taxpayers;
- maintain the current amount of federal revenues as a percentage of the economy; and
- avoid excess burdens in the transition to a new tax system.

TAX REFORM

Background

State and Local Sales Taxes

Forty-five states and the District of Columbia tax retail sales or gross receipts. Only a handful of states have maximum local sales tax rates of 4 percent or greater: Alabama, Alaska, Arizona, Arkansas, Colorado, Georgia, Louisiana, Missouri, Nevada, New York, Oklahoma and Utah. In eleven states with a state sales tax there are no local sales taxes, and in 23 other states, local sales tax rates range from just above zero to less than 4 percent.

Taxes on consumption take a higher percentage of income from low-income people than they do from those with higher incomes. The adverse impact of the sales tax's regressive nature can be ameliorated by exempting certain necessities (in most states prescription drugs and food purchased for home preparation are exempt), by taxing services in addition to goods, and by offering sales tax credits to low-income residents. Any exemptions, however meritorious, narrow the tax base and so must be offset by higher taxes or additional taxes elsewhere.

Above all, sales taxes are complex and cumbersome to administer. State sales taxes are augmented by local sales taxes in thousands of localities, and both state and local sales tax systems are riddled with exceptions based on criteria that have no clear rationale (such as whether a beverage is purchased in a grocery or convenience store; whether it is served hot, cold or at room temperature; or whether it has more or less than 30 percent real fruit juice).

Eliminating tax exemptions for services has several advantages as a way of raising sales tax revenues:

- Services are an expanding part of the economy, so they cannot be ignored as an important source of needed revenue.
- Taxing goods but not services violates the principles of tax neutrality, because it biases consumer choices against the taxed goods, and fairness, since only some products are taxed. Moreover services and goods are sometimes close substitutes (such as repairing an appliance or buying an appliance, using a copy service or buying a copy machine).
- Because service consumption is greater among those with higher incomes, especially for professional services such as legal and accounting help, taxing services is probably more progressive than taxing goods. However, to avoid taxing services used in the production of goods or other services and thus "pyramiding" the tax (which means the paying of taxes on taxes), some exemptions would be necessary.

Currently sales taxes go uncollected on most consumer Internet and catalog sales. This is because the US Supreme Court has ruled that states can require out-of-state merchants to collect and remit sales tax only when the merchant has a physical presence, or "nexus," in the customer's state. Moreover consumers have generally failed to submit the sales tax voluntarily to their home states when the retailer has not already collected the tax. Traditional retailers argue that this situation confers an advantage on Internet and catalog retailers. Older people, minorities, and people with low incomes may pay the sales tax more frequently because they are less likely to have Internet access. States depend on sales tax collections for about 35 percent to 40 percent of state revenues, on average, and this proportion is considerably higher for states lacking a broad-based personal income tax. As ever greater volumes of merchandising and retail transactions occur electronically, the potential impact on state finances is dire. Loss of state sales tax revenue could adversely affect many state-provided services for seniors and low-income residents, and states might eventually be forced to seek additional revenues through property taxes, which weigh more heavily on seniors.

In 1998 Congress imposed a federal moratorium on new discriminatory Internet taxes (e.g., Internet access fees), although the moratorium does not affect states' ability to collect the sales tax under existing laws. The moratorium has been extended twice. Several (primarily antitax) groups have proposed abolishing the sales tax on Internet purchases altogether.

Partly in response to the threat that the lack of Internet sales taxes pose to their revenue base, states have joined in a project to streamline their sales tax systems and simplify merchants' tax collection duties. In October 2005 participating states launched the project by encouraging sellers to start collecting the tax voluntarily, with amnesty for past uncollected sales taxes. Under the program each participating state would determine a single state sales tax rate, with a second rate for limited activities (such as food purchases). Each local jurisdiction also would get one rate. Internet sellers would forward all state and local sales tax receipts to a central point within the state government. All jurisdictions would follow a common set of product definitions, although each jurisdiction would decide which products to tax. Internet companies would participate on a voluntary basis, and sellers' collection of sales and use taxes on remote sales would remain voluntary. Eighteen states have adopted conforming legislation.

STATE & LOCAL POLICY

TAX REFORM

State and Local Sales Taxes

Although state and local sales taxes are major revenue raisers, they are regressive and should not be the first choice for increasing tax revenues where they already exist.

Legislators should minimize the impact of sales taxes on low-income people. Exempting basic necessities and providing sales tax credits to low-income residents make sales taxes less regressive; such exemptions should have high priority.

States and localities should include in the tax base those services used primarily by individuals (but not those used primarily by businesses) and a provision to offset the regressive effects of the tax on low-income taxpayers.

The current nexus rules that allow states to require catalog and Internet merchants to collect sales taxes on certain out-of-state sales should not be scaled back. To the extent possible under current law, goods sold over the Internet and through catalogs should be subject to the same sales tax treatment as goods sold by traditional brick-and-mortar retailers.

STATE AND LOCAL REAL PROPERTY TAXATION

Background

The mainstay of local taxation is the property tax, which pays for most elementary and secondary public education, as well as many other local services. But using property taxes to pay for schools leads to disparities in educational quality among school districts according to respective property values. This means that people from poorer districts may face higher effective property tax rates than residents of wealthier communities yet receive inferior educational facilities and services.

The property tax is the single most burdensome tax for many low-income and older people. It affects older people directly as homeowners but also indirectly as renters, because landlords pass on at least part of any property tax increases in higher rents.

In response to rapidly rising property values in many parts of the country, property tax caps are being proposed to limit homeowners' increasing tax burdens. These caps are typically offered via referenda and voter initiatives, making it easy for backers to promise tax breaks without identifying the possible downside to such caps: a plunge in revenues to fund local spending priorities such as police and fire protection and schools. In many states voter approval is necessary to override property tax caps.

Forty-three states and the District of Columbia alleviate or shift property tax burdens through limits on assessed property values, property tax rates, property tax liabilities or property tax revenues on a jurisdiction-wide basis. The limits can apply to individual homeowners or local taxing districts, or they can be statewide. Some caps apply only to specific types of taxes, such as school property taxes.

Over time these caps can be extremely damaging because they erode local governments' revenue and reduce essential police, ambulance and fire protection services, as well as spending for schools, libraries and road maintenance. For example, in California, which enacted the first of such initiatives in 1978 (Proposition 13), the level of education quality has moved from among the nation's highest to the bottom third.

Limiting assessed property values can create inequities between existing and new property owners, in situations where fair-market property values increase faster than the annual property valuation for tax purposes. Property tax caps may also give tax breaks to many whose income is adequate to pay the tax; in resort areas such caps benefit wealthy out-of-state owners of vacation properties who do not otherwise contribute substantially to state and local coffers.

States reduce property tax burdens in a number of other ways, the most common of which are homestead exemptions and credits, circuit breakers, and property tax deferrals.

Homestead exemptions and credits—Homestead exemptions reduce the amount of assessed property value subject to taxation. They promote the socially desirable goal of homeownership by reducing the real estate tax burden. The exempt amount is generally the same for all owners regardless of age or other circumstance and applies only to homeowners. Homestead credit programs offer the same property tax credit to all eligible households (i.e., the credit does not change with income). Thirty-nine states and the District of Columbia provide homestead exemptions; of these, 16 limit the exemption to low- and middle-income people. Of the 16 states that provide homestead credits, seven limit credits to low- and middle-income people. Three states (Indiana, Massachusetts and Mississippi) offer some combination of homestead exemptions and homestead credits within the same program. In general homestead exemptions are less targeted than circuit breakers and generally create a cost to local, not state, governments, since they shrink the property tax base.

Circuit breakers—Circuit breakers (the term derives from the mechanism used to relieve an overloaded electrical circuit) usually ease the property tax burden of residents with low and low-middle incomes by setting a threshold (usually some percentage of income) below which residents will receive a property tax rebate. Thirty-four states and the District of Columbia now have circuit breakers, with provisions in seven of these jurisdictions strictly limited to older homeowners and/or renters. The remaining state circuit breakers apply to varying combinations of the blind, disabled, owners and renters. Of the 34 states that offer circuit breakers, five (Nebraska, New York, North Dakota, Ohio and Washington) offer homestead exemptions that act as circuit breakers (i.e., the value of the exemption decreases as income increases). Vermont offers either a homestead exemption or a tax credit, whichever is greater. The other states and the District of Columbia offer tax credits.

Property tax deferrals—Twenty-five states and the District of Columbia also offer property tax deferrals, often for those whose incomes are too low to afford payment, in exchange for some arrangement for the deferred taxes to be paid upon some event, such as the owner's death.

STATE & LOCAL POLICY

STATE AND LOCAL REAL PROPERTY TAXATION

States should broaden their methods of financing public education, thereby taking some of the burden off the regressive property tax and shifting it to less regressive taxes, which are better correlated with ability to pay.

To ensure equity in property taxation, assessors should use fair-market value as the starting basis for determining property values, so that owners of similar properties in the same area face the same property tax burden. Assessors should meet professional standards, and properties should be assessed annually, if possible, to help ensure that property taxes do not increase abruptly. The assessment appeals process should be easy to understand, appeals should be easy to file, and decisions should be reached within a reasonable time and in an equitable manner.

Property tax relief should be provided in an equitable manner to low- and moderate-income homeowners and renters. AARP supports circuit breakers rather than homestead exemptions (when the exemption amount is the same for all eligible homeowners) because they are more progressive. In addition in many cases circuit breakers are offered to renters as well as homeowners.

As a general rule arbitrary property tax caps should be avoided.

Voluntary property tax deferral programs should allow low-income homeowners to defer property taxes until change of ownership or death, especially when there is no other property tax relief program available or where tax burdens are high. Any interest charged for the deferral should be at fair and equitable rates.

Full-disclosure laws should require that localities inform taxpayers annually of the property tax rate required to maintain revenues at the same level as the prior year and identify new spending or revenue reductions that warrant any proposed tax increase. To be effective, localities need to make such disclosures prior to the date when they confirm annual financial decisions.

OTHER STATE REVENUE SOURCES

Background

States have other less significant taxes, such as estate or inheritance taxes, utilities taxes, and a variety of user fees, including road tolls and fees for vehicle registration, park entrance and various permits. User fees may have great potential in the infrastructure area, where increased road tolls, gasoline taxes, vehicle registration fees, utility hook-up fees and water charges could raise substantial revenue to be earmarked for the maintenance and repair of roadways and utility systems. States also may levy impact fees on developers of commercial, industrial or residential real estate projects to defray some of the public infrastructure costs such projects entail. User fees are based on the principle that people should pay according to the benefits they receive. This principle works best where an efficient market exists to help determine the "correct" price of the benefit. However these fees tend to fall relatively heavily on lower-income people. Because not all markets are efficient, user fees should also take into account people's ability to pay for the benefits.

STATE & LOCAL POLICY

OTHER STATE REVENUE SOURCES

States and localities should not enact tax cuts that could threaten vital spending programs when economic activity slows.

States should:

- allow tax-free transfers of property between spouses;
- rely on user fees only when they bear a direct relationship to the services received—Charges should take into account the limited ability of low-income people to afford necessary services; and
- consider requiring developers to bear their fair share of development costs by funding infrastructure improvements, paying impact fees, or contributing to housing construction.

States should not sell public assets if it would mean sacrificing valuable capital resources that serve important public purposes.

OTHER REVENUE OPTIONS

Introduction

The options discussed in the following sections are not all equally productive in their revenue yield but rank highly according to one or more of the principles discussed at the beginning of the chapter.

OTHER REVENUE OPTIONS

Background

Estate and Gift Taxes

The estate tax was enacted in 1916 and originally applied to estates of $50,000 or more. The purpose of the estate tax is to raise revenue and reduce the concentration of wealth. It was expected to produce federal revenue of about $25 billion in 2005.

The estate tax allows a credit or exemption under current law. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) gradually raises the exemption amount to $3.5 million in 2009 while phasing down the maximum tax rate on estates from 55 percent to 45 percent (Figure 2-4). In addition the estate tax does not apply to the transfer of property at death to a spouse or a charitable organization. Prior to EGTRRA the tax code provided several additional protections for small family-owned businesses and farms. Although some people were concerned about the burden of the estate tax on these entities, a recent study by the Congressional Research Service concluded that the estate tax applied to only about 2 percent of family farms and businesses; in addition most of these have sufficient liquid assets to pay the tax.

EGTRRA will eliminate the estate tax in 2010 and change the rules for valuing assets (Figure 2-4). The law, however, expires in 2011, and the estate and gift tax regimes will return to their 2001 exclusion amounts and rates unless Congress revisits this issue.

Figure 2-4

Estate and Gift Taxes, 2002–2011

Tax year	Estate and generation-skipping transfer tax (effective exclusion amount)	Lifetime gift exemption	Highest estate and gift tax rates
2002	$1 million	$1 million	50%
2003	$1 million	$1 million	49%
2004	$1.5 million	$1 million	48%
2005	$1.5 million	$1 million	47%
2006	$2 million	$1 million	46%
2007	$2 million	$1 million	45%
2008	$2 million	$1 million	45%
2009	$3.5 million	$1 million	45%
2010	Tax repealed	$1 million	35% for gift tax
2011	$1 million	$1 million	55%

Source: Joint Committee on Taxation, *Summary of Provisions Contained in the Conference Agreement for H.R. 1836, the Economic Growth and Tax Relief Reconciliation Act of 2001,* JCX-50-01, May 26, 2001.
Prepared by AARP Public Policy Institute.

The amount of money lost through permanent repeal of the estate tax over a period of 75 years would be equivalent to about 40 percent of the shortfall in the Social Security trust funds. When the estate tax repeal is fully phased in by 2010, it will benefit only about 54,000 estates (or about 2 percent), providing an average tax cut of about $800,000 per estate. Moreover one-half of the annual benefits will go to just 3,000 families, or the top one-tenth of 1 percent of families, who would receive an average tax cut of $7 million per family.

EGTRRA did not repeal the gift tax, although it reduced the top gift tax rate to equal the top individual income tax rate. Pressure may build to repeal the gift tax as well. Some business owners have legitimate reasons to transfer a family business to a child while they are still living.

Capital gains, which are subject to the income tax when realized, i.e., when assets are sold, are often unrealized before the death of the asset holder. Hence unrealized gains are often a significant component of assets that are passed on from generation to generation. To avoid taxing capital gains twice (first under the estate tax and a second time when heirs must pay income tax on the sale of the inherited asset), the estate tax provides that asset values are "stepped up" to their fair-market value at the time of death. One consequence of this is that inherited capital gains may completely escape taxation: The great majority of heirs are not subject to the estate tax (because of the generous exclusion) yet benefit from stepped-up basis valuation and therefore avoid income tax on the capital gains unrealized by the decedent.

In 2010, when the estate tax is scheduled to be repealed, capital gains on inherited assets will still be subject to the income tax (which provides preferential capital gains tax rates) when the assets are sold after the decedent's death. With the repeal of the estate tax it would no longer be necessary to protect capital gains from being taxed twice, therefore the valuation (or basis) of the inherited property will change from a stepped-up basis to a modified carryover basis. The latter is defined as the lesser of the decedent's adjusted tax basis or the fair-market value of the property at the time the asset holder dies. The modified carryover basis rule would allow each taxpayer an exemption of $1.3 million, as well as $3 million for gains on property transferred to a spouse.

The carryover basis rule could be very difficult to administer, because it requires individuals to maintain extensive records across generations. Such a requirement was included in the Tax Reform Act in 1976; however it was repealed before it took effect.

In the absence of an estate tax some have proposed indexing capital gains to inflation to ensure that the appreciation in value due to inflation isn't taxed. Conversely it has been argued that indexing capital gains to inflation is administratively complex.

EGTRRA also repealed as of 2005 the credit allowed under the federal estate tax for estate or inheritance taxes levied by the states. The act replaced this with a deduction for estate taxes paid to any state or the District of Columbia. In response a number of states eliminated their estate taxes. The resulting revenue loss to the states will be almost $5 billion in 2007.

FEDERAL POLICY

OTHER REVENUE OPTIONS

Estate and Gift Taxes

Congress should retain an estate tax as an important component of our tax structure because it helps reduce the concentration of wealth in our society and prevents large amounts of capital income from escaping tax entirely. In the absence of an estate tax capital gains should be indexed to inflation and taxed at death.

The estate tax should continue to affect only the largest transfers and protect surviving spouses and family farms and businesses from excessive burdens. Heirs should have some protection against the need to liquidate assets to pay taxes and against the unfair burdens of excessive record keeping and establishing the cost basis.

STATE POLICY

Estate and Gift Taxes

States that have or choose to enact estate taxes should consider the advisability of structuring them independently of the federal estate tax.

OTHER REVENUE OPTIONS

Background

Excise Taxes on Tobacco and Alcohol

Excise taxes are selective sales taxes on individual commodities, such as motor fuel, cigarettes and alcohol or on transactions such as home sales. These are important revenue sources for states: Taxes on motor fuel, alcoholic beverages and tobacco yielded 8.1 percent of total state tax collections (excluding federal aid) in fiscal year 2005. However such taxes are regressive (they take a higher percentage of income from low-income people) and violate neutrality (they single out individual commodities for taxation).

Nonetheless excise taxes serve a useful social purpose by discouraging the consumption of harmful commodities, such as tobacco, or by encouraging the conservation of commodities such as gasoline. The public also tends to object less to these taxes, in part because they can be avoided. The regressive nature of tobacco and alcohol taxes can be ameliorated if they can be used to finance programs such as health care for those with low incomes; gasoline taxes could be useful sources of revenue for investment in physical capital and infrastructure.

During the 1950s excise taxes raised about 14 percent of all federal revenue, a level that dropped to just under 3.7 percent by 2004. Such "sin taxes" on alcohol, beer, wine and tobacco products have not kept pace with inflation because they are based on units sold rather than price. Thus revenues do not increase automatically with prices. Although the Omnibus Budget Reconciliation Act of 1990 enacted large percentage increases in cigarette, beer and wine excise taxes, the act only partially restored the revenue base of these taxes.

Smoking is a public health problem. Tobacco use has been estimated to result in annual public and private health care expenditures of about $89 billion. To help finance expanded health insurance coverage for children, the Taxpayer Relief Act of 1997 increased cigarette taxes by ten cents per pack in 2000 and by an additional five cents per pack in 2002. In recent years lawmakers also have proposed increasing alcohol taxes because excess alcohol consumption contributes to rising health care costs. Some claim that increases in tobacco and alcohol taxes will discourage consumption, especially among the young, and thus will decrease related societal costs. Additional revenues could help fund health programs for low-income people.

Many states have recently boosted their tobacco and alcohol taxes substantially, so state taxes on these items are higher than ever.

Historically excise taxes are regressive when viewed in an annual accounting framework. Recent research suggests, however, that when viewed over the longer term, excise taxes may be more proportional. Because cigarette and alcohol consumption is discretionary, taxpayers can avoid the burden of higher excise taxes by lowering consumption. In addition the health-related costs associated with the consumption of these products have placed a strain on federal and state treasuries.

FEDERAL & STATE POLICY

OTHER REVENUE OPTIONS

Excise Taxes on Tobacco and Alcohol

Excise taxes on tobacco and alcohol should at least keep pace with inflation. Levying them on an ad valorem basis (i.e., on the value of the purchase) rather than a per-unit basis would automatically adjust excise taxes for inflation.

The revenue from increases in excise taxes on alcohol and tobacco should be used to supplement the funding of public health programs.

The revenue from increases in the gasoline tax should be used in part to restore the capital infrastructure.

OTHER REVENUE OPTIONS

Background

Taxing Employer-Provided Benefits

Employer-provided benefits, such as pensions, health insurance, group term life insurance, dependent care assistance, employee discounts, memberships in athletic facilities, and small gifts, are excluded from both taxable income and taxable wages. The exclusion of pension contributions and earnings from current taxable income has proven an important effective means of promoting retirement savings (see Chapter 3, Retirement Income), and in light of our nation's low savings rate, few people have suggested restricting the exclusion.

However lawmakers have often proposed limiting the exclusion for employer-provided health benefits. Many argue that this exception creates an incentive for more expensive coverage, offers no incentive for cost containment, and provides greater benefits to more affluent taxpayers. It also creates inequities between those who receive all of their compensation in wages and those who receive a large proportion of compensation in the form of health insurance or other nonwage benefits. A limit on the exclusion would still create an incentive for the purchase of health care coverage while yielding substantial income and payroll tax revenue. By 2003 self-employed people were able to exclude from taxable income 100 percent of their health insurance premiums.

FEDERAL & STATE POLICY

OTHER REVENUE OPTIONS

Taxing Employer-Provided Benefits

Lawmakers should maintain the tax-deferred status of employer-provided pensions as a critical way of promoting retirement savings.

The exemption for employer-provided health insurance is an important method of encouraging health insurance coverage. Limiting the health insurance exemption to amounts below some threshold would be desirable if the revenue derived from taxing the amount in excess of the threshold financed health insurance for low-income or uninsured families and individuals.

Limiting the exemptions for other employer-provided benefits, such as life insurance, tuition and parking, which are already subject to some limitations, are a desirable method of broadening the tax base and making the income tax more progressive.

OTHER REVENUE OPTIONS

Background

Energy and Environmental Taxes

A tax levied on the energy content of fuel measured in British thermal units (Btus) treats all forms of energy equally and does not create incentives to favor one form of energy over another. Because it is broader based, a Btu tax also would raise more revenue than would other taxes at the same tax rate. Unfortunately the Btu tax is administratively complex and difficult to understand. Other energy taxes, including levies on domestic or imported oil, on emissions of carbon dioxide generated from the burning of fossil fuels, and on the production of other pollutants, also would discourage consumption and presumably improve the environment. Nevertheless each has potential negative effects (see Chapter 10, Utilities: Telecommunications, Energy and Other Services, for a further discussion of utilities).

All of these taxes are borne by consumers and would be regressive unless they included some offsetting measures. Taxes on energy used in production would raise production costs and might slow economic growth, while taxes on foreign oil could raise objections from trading partners. Some energy taxes also have different urban-rural and regional effects (for example, heating oil taxes hurt those in the Northeast).

FEDERAL & STATE POLICY

OTHER REVENUE OPTIONS

Energy and Environmental Taxes

Some form of energy tax may be appropriate to raise revenues and promote energy conservation.

Increased energy taxes are undesirable unless they balance out regional effects and adequately protect low-income people against higher consumer costs. Potential safeguards could include increased federal funding of energy assistance and weatherization programs or reductions in other taxes.

OTHER REVENUE OPTIONS

Background

User Fees and Asset Sales

User fees are based on the principle that people should pay taxes according to the benefits they receive. Asset sales represent the privatization of government activity through the sale of public assets such as parks and open spaces. Such sales often effect short-term revenue gains but can result in longer-term revenue losses and reduced future public enjoyment of assets.

FEDERAL & STATE POLICY

OTHER REVENUE OPTIONS

User Fees and Asset Sales

User fees should not unfairly burden low-income people or unduly limit access to public services.

Public assets should not be sold to raise revenue if the sale would sacrifice valuable and efficient capital resources that serve important national and regional purposes and would harm the common interests of present and future generations.

OTHER REVENUE OPTIONS

Background

Taxing Government-Provided In-Kind Benefits

Under the Medicare program one-half of the contributions to Medicare Part A (Hospital Insurance) comes from employees; the other half, from their employers. Premiums from Medicare beneficiaries fund 25 percent of the cost of the Medicare Part B (Supplementary Medical Insurance, or SMI) program. The remainder comes from general revenue.

Several past reform proposals would have taxed some part of Medicare's insurance value. Unlike Social Security, Medicare is not cash income. In addition, aside from the issue of measuring the value of benefits accurately, taxing in-kind benefits would require people to make monetary payments on nonmonetary income.

FEDERAL POLICY

OTHER REVENUE OPTIONS

Taxing Government-Provided In-Kind Benefits

AARP opposes any attempt to tax the actuarial value of Medicare or the value of other in-kind benefits because it would set an undesirable precedent and could impose a serious hardship on those who otherwise would not pay income taxes.

TAXPAYER ASSISTANCE, COMPLIANCE AND IRS ADMINISTRATION

Background

Taxpayer assistance for older Americans—Older people, who face income changes at retirement, often have a difficult time understanding the tax laws' many reporting and record-keeping requirements. The Internal Revenue Service (IRS) has responded to this problem with the Tax Counseling for the Elderly program, enacted in 1978 to help older taxpayers prepare their federal returns. As part of this assistance the agency has developed the Older Americans Tax Guide (Publication 554), which provides an overview of the tax laws that apply to all taxpayers and highlights certain provisions that give special treatment to older Americans. In addition large-print tax forms are made available for easier reading and to help older and visually impaired Americans practice preparing their returns.

In recent years the IRS has stopped making tax forms and publications available in public libraries and other easily accessible places. In fact the IRS has begun charging taxpayers for some publications. Both of these actions limit the ability of taxpayers to handle their own filings.

Compliance—The tax gap, which is the amount of income tax owed but not paid, results from both intentional and unintentional noncompliance. In 2004 the IRS estimated a total tax gap of $310.6 billion for tax year 2001.

The tax gap for individual income taxpayers alone was estimated to be close to $196.3 billion in 2001. Noncompliance is more prevalent among high-income taxpayers, although it occurs in all income groups. The IRS Taxpayer Compliance Management Program found underreporting of income on two-thirds of all returns over $100,000, compared with one-third of returns below

$50,000. Because revenue lost through noncompliance must be made up elsewhere, noncompliance worsens an already uneven distribution of income.

The corporate tax gap was at least $32 billion in 2001. The number of corporations using tax shelters and other methods to reduce federal tax liability and hide debt has increased considerably over the past decade. Indeed over the past few years, the country saw numerous corporations come under investigation and/or restate their earnings due to accounting fraud or corporate scandals. In response the Sarbanes-Oxley Act of 2002 enacted broad accounting and corporate reforms, but problems still exist with respect to corporate tax shelters. One possible explanation for the tax gap is the continued aggressive use of tax "products" that have little or no economic purpose other than to reduce tax liability. Some estimates show that such shelters may reduce federal tax revenues by as much as $25 billion every year.

Tax simplification—Recent tax changes have not produced a simpler or more easily understood tax system. Indeed the Economic Growth and Tax Relief Reconciliation Act of 2001 and the Taxpayer Relief Act of 1997 have created a vastly more complex tax code. As the tax system grows more complex the compliance costs to individuals and businesses continue to rise. Nevertheless there are trade-offs between simplification and complexity, as the latter can lead to achieving other social policy goals.

Administration—IRS budget cuts and staff reductions have hindered enforcement. The IRS Oversight Board has concluded that "enforcement activities have dropped to a dangerous level, giving the impression that it is easy to get away with cheating." Between fiscal years 1992 and 2001, the IRS's workload (i.e., the number of returns) increased by 16 percent while its staff declined by 16 percent (field compliance personnel decreased by 28 percent). The individual audit rate fell from 2.15 percent in 1978 to .58 percent in 2001. The audit rate for corporate income tax returns fell from 3 percent in 1993 to less than 1 percent in 2001. Former IRS Commissioner Charles Rossotti stated in 2002 that because staff and resources are spread so thinly, 60 percent of identified tax debts are not collected and 75 percent of identified nonfilers are not pursued.

In 1997 the National Commission on Restructuring the Internal Revenue Service, established by Congress, made sweeping recommendations for improving the agency's structure, organization and management. The recommendations formed the basis of the Internal Revenue Service Restructuring and Reform Act of 1998. The law set goals for increasing taxpayers' use of electronic filing because electronic returns have far fewer errors and are easier to process than paper returns. Under the law 80 percent of all tax returns are to be filed electronically by 2007; the tax system is to be free of paper returns beginning in 2008. As a result the IRS in early 2001 unveiled its online Electronic Federal Tax Payment System.

The restructuring act also broadened taxpayer rights and protections in dealing with the IRS, including by shifting the burden of proof to the IRS, providing innocent-spouse relief, implementing several changes to the interest and penalty rules, and providing several new protections for taxpayers subject to an audit or a collection process.

Nevertheless some projects will take more time to complete, including the computer modernization project. The quality of phone service is still lacking, taxpayer notices are still confusing, the 80 percent goal for electronic filing by 2007 will be hard to achieve, and there has been a continued drop in audit and collection activities.

FEDERAL POLICY

TAXPAYER ASSISTANCE, COMPLIANCE AND IRS ADMINISTRATION

The Internal Revenue Service (IRS) should continue supporting the Tax Counseling for the Elderly program, including its counselor training program, which is particularly important in light of frequent tax code changes.

The IRS should increase its efforts to make tax forms, including electronic forms, publications and correspondence, more accessible and comprehensible. The tax forms should be written in a manner taxpayers will understand. If necessary the IRS printing budget should be increased to pay for large-type forms for vision-impaired taxpayers. The IRS should resume its previous practice of making forms and publications widely available in public places such as libraries and should not charge for individual taxpayer forms or assistance.

To avoid the need for low-income people to file tax returns, the threshold amount of interest income above which a person is required to file should be increased and methods should be explored for simplifying the recovery of withholding at the end of the year.

It is appropriate for the IRS to encourage taxpayers to file electronically, but the option to file tax returns by regular mail should always be maintained without penalty.

Based on the principle of equity, increasing compliance is a priority method of raising revenue.

The IRS should improve its taxpayer assistance programs, increase the audit rate, and raise penalties for noncompliance, yet preserve individual privacy and scrupulously protect the legitimate rights of taxpayers.

AARP supports adoption of measures that would curb the use of corporate tax shelters and tax havens. Such provisions can include requiring increased disclosure of corporate tax shelter activity, increasing the penalties related to understatements of income attributable to undisclosed transactions, imposing penalties on all parties associated with an illegal corporate tax shelter, and disallowing the use of tax benefits generated by a corporate tax shelter.

STATE POLICY

TAXPAYER ASSISTANCE, COMPLIANCE AND IRS ADMINISTRATION

States should help fund the Tax Counseling for the Elderly program, because it often helps taxpayers calculate and pay state income taxes.