

TaxWatch


**TAX
FOUNDATION**
SPRING 2013

Untangling the Mess

**Pro-
Growth
Reform
In North
Carolina**

**Wiping
the Slate
Clean?**

Social Engineering With the Tax Code

**Corporate
Taxes: No Place
to Hide**

**Reform: Nine
States Forward,
Six States Back**

**The Future of
Sales Taxes
and the Internet**

**Congressman
Ron Kind on US
Business Climate**

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Message from the President



“Managing vast social programs is not a function the IRS is designed to perform”

Peter Principle at Work at the IRS

In his 1969 best-selling book, *The Peter Principle: Why Things Always Go Wrong*, Dr. Laurence Peter taught us that people will often be promoted to the level of their incompetence.

What’s true for people is true for institutions, and the Internal Revenue Service is a classic case of the Peter Principle at work—it is an institution that has been given tasks far beyond its core competence.

Even before the Affordable Care Act (Obamacare) grafted more than forty new tax provisions to the tax code and effectively paired the IRS with Health and Human Services to manage one-sixth of the nation’s economy, the relentless growth of credits and deductions over the past twenty years has made the IRS a super-agency, engaged in policies as unrelated as delivering welfare benefits to subsidizing the manufacture of energy-efficient refrigerators.

Although the IRS’s annual budget may be relatively small, it is essentially controlling vastly more budgetary resources than any Cabinet-level agency. The more than 170 different tax deductions and credits in the code have a total budgetary cost exceeding \$1.1 trillion—roughly \$1 trillion of those preferences are targeted to individuals, while the remaining \$100 billion benefit businesses.

These tax provisions were enacted to achieve all manner of social and economic objectives, such as encouraging people to buy hybrid vehicles, turn corn into gasoline, buy a home, replace the home’s windows, adopt children, put them in daycare, and help them go to college, all while saving for your own retirement, and the list goes on.

Managing vast social programs is not a function the IRS is designed to perform, nor is it a function that it does very well. The IRS Inspector General has found vast amounts of fraud and erroneous payments in virtually all of the tax credit programs under the IRS’s jurisdiction. For example, the Earned Income Tax Credit program alone has a fraud and error rate upwards of 28 percent—equal to \$13 billion per year in improper payments—and investigators found that 362 prisoners or under-age tax filers erroneously claimed the Residential Energy Credits on their tax returns.

When you combine the Peter Principle with the culture of a regulatory agency that views its “clients” with suspicion, it creates a toxic brew that leads to the Tea Party scandal. The IRS is not equipped to determine what a “political organization” is—after all, it has seven definitions of a “dependent child”—and yet that is what Congress and the Supreme Court have required it to do.

The IRS says it needs more money and resources to meet these tasks. But the real solution is to overhaul the tax code and return the IRS to its core mission of simply collecting tax revenues.

Sincerely,



Scott A. Hodge, President

TaxWatch

SUMMER 2013

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The Tax Foundation is an independent, nonpartisan and nonprofit research institution founded in 1937 to educate taxpayers, policymakers and the courts on sensible tax policy. Our economic and policy analysis is guided by fundamental tax principles that should serve as touchstones for sensible tax policy everywhere.

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IRS scandal highlights need for tax code reform



North Carolina changes its tax code for the better



Congressman Ron Kind discusses the importance of tax reform for small businesses

Marriage and the Federal Income Tax

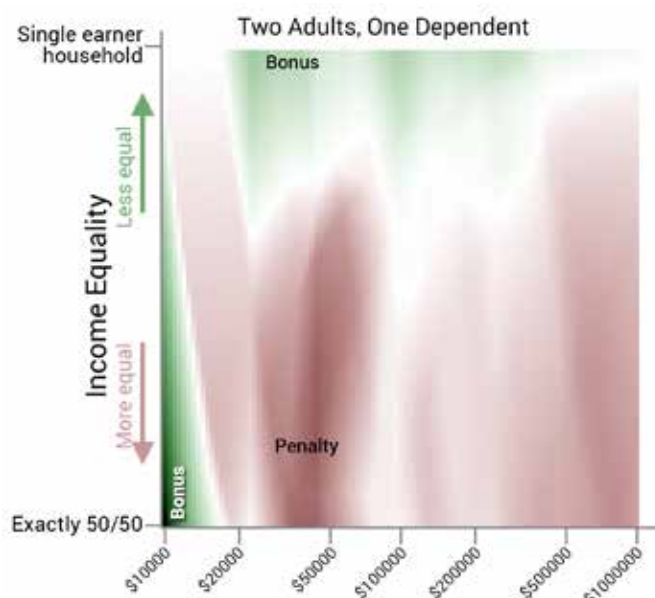
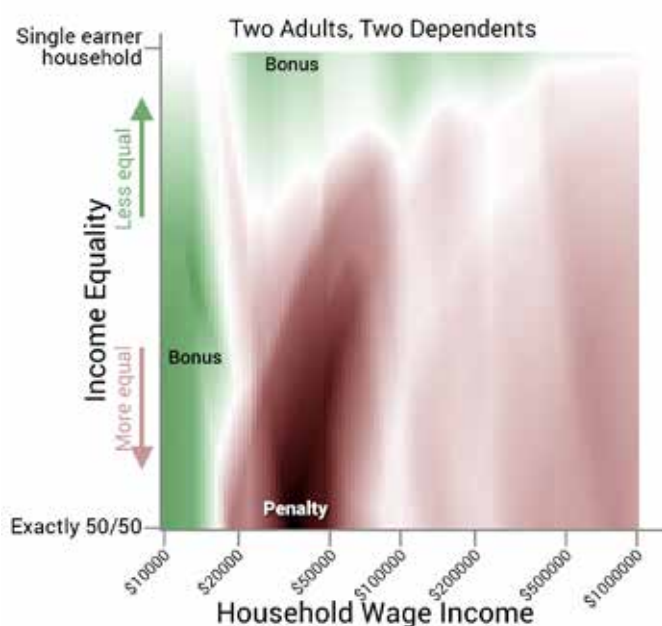
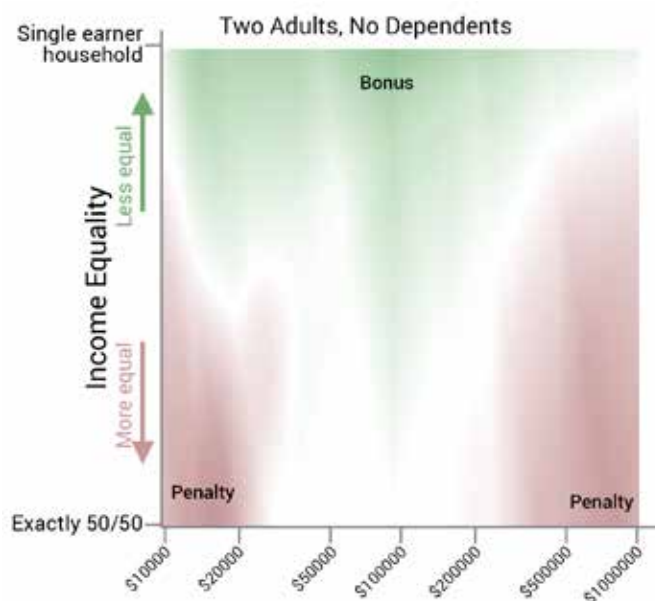
By Nick Kasprak

The end of DOMA brings with it significant tax changes for same-sex couples. Federal law grants benefits to married couples in many areas, but the federal income tax does not always reward marriage—while it allows couples to combine their incomes, the tax brackets that apply to joint filers aren't necessarily widened enough to prevent them from paying a higher tax rate (particularly at the upper income levels).

Credits, deductions, and other structural elements of the tax code add to the confusion. Two large tax credits—the child tax credit and the earned income tax credit—are far from marriage neutral. The child credit begins to phase out at \$75,000 in income for single filers but only \$110,000 for joint filers. The earned income tax credit has its own complicated structure that can cause very large penalties or bonuses, depending on the exact circumstances. For a long time, the standard deduction for married filers was only two-thirds greater than the amount for single filers. This was fixed by the Bush tax cuts, but the disparity threatened to return as recently as last year when congressional gridlock threatened to push the country over the “fiscal cliff.”

The charts on the right show tax penalties and bonuses for a variety of families. The top of each chart represents a household where one spouse earns all the income; households where both spouses earn the same salary are at the bottom. Combined household income increases from ten thousand dollars to one million dollars from left to right. Generally, single-earner households get a tax bonus and dual-earner households pay a penalty, but it's far from a simple pattern. Same-sex couples have much to celebrate with the end of DOMA, but they shouldn't necessarily count on a big refund check from Uncle Sam next year. **TW**

18% of income tax bonus marriage neutral 11% of income tax penalty



Be Careful How You Wipe the Slate Clean

By Scott Hodge

As momentum builds in Washington to reform the tax code, we hear a lot of well-intentioned lawmakers say that eliminating all of the loopholes in the tax code (“wiping the slate clean”) while lowering tax rates is key to spurring economic growth.

If only it were that simple.

The problem is that not every tax deduction is a loophole or is harmful. Indeed, some tax deductions help define the tax base and determine what taxable income is. Eliminating these preferences—even while cutting tax rates—can actually increase taxpayers’ effective tax rates and consequently slow economic growth.

To illustrate the point, we used the Tax Foundation’s Dynamic Macroeconomic Tax Model to simulate the effects of cutting the corporate tax rate to 25 percent from its current level of 35 percent, as well as the same corporate rate cut financed by eliminating nearly every corporate tax preference.

The results of this simulation are shown in the chart below. Cutting the corporate rate by itself produces huge economic benefits. Over

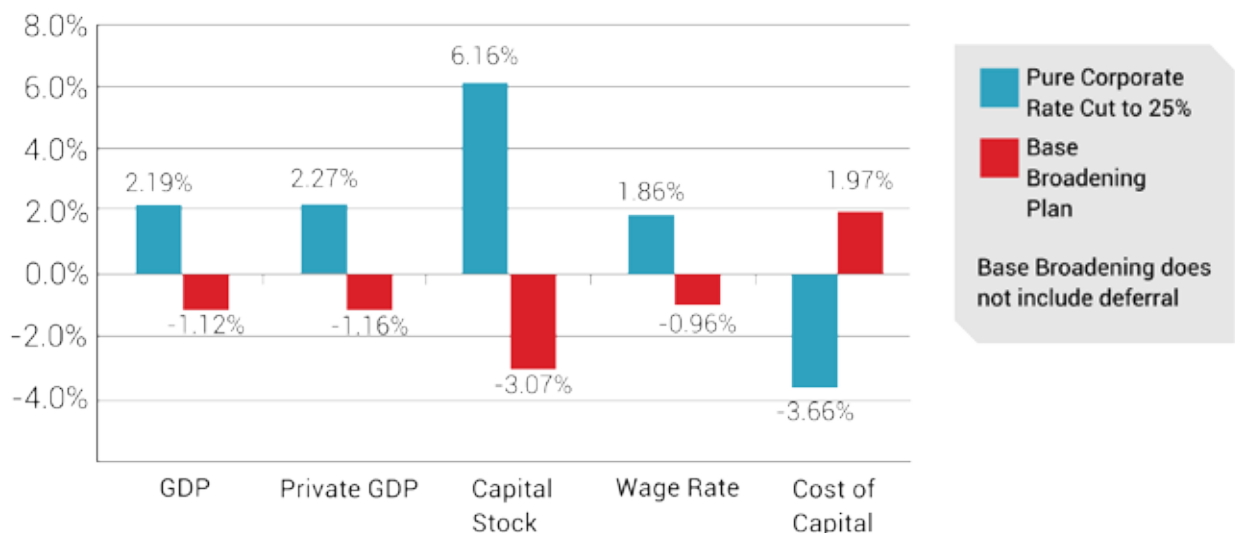
time, about five to ten years, the rate cut would boost GDP by more than 2 percent, boost the capital stock by 6 percent, increase wages by nearly 2 percent, and lower the cost of capital by nearly 4 percent.

By contrast, the same rate cut combined with repealing most corporate deductions turns out to be harmful for the economy. GDP falls by over 1 percent, the capital stock drops by 3 percent, wages by 1 percent, and the cost of capital increases by roughly 2 percent.

Why? Because many of the preferences in the corporate tax code in particular—such as accelerated depreciation and the R&D tax credit—lower the cost of capital by allowing businesses to recover their investment costs faster. Repealing these preferences boosts the cost of capital investments which, in turn, leads to slower economic growth—even with a lower tax rate.

We all want a simpler tax code with fewer loopholes and deductions. And we all want lower tax rates. But we must be selective in how we wipe the slate clean or we risk undermining the benefits of a lower tax rate. **TW**

Base Broadening Could Negate the Growth Effects of a Pure Corporate Rate Cut



IRS My Case: Stop Social Manipulation

By Philip Hammersley & Joseph Henchman

The recent IRS scandal should remind us that the tax code desperately needs reform. At the end of the day, some IRS officials may lose their jobs and policymakers may call for more oversight. While those actions should happen, we should also tackle the underlying problem: the tax code is being used to manipulate social behavior. Until the tax code is free of social agendas, we will continue to see the tax code used to target and punish dissenting opinions.

Tax policy has long been used to achieve allegedly desirable social ends. Our tax code subsidizes “good” behavior, like buying green energy, having children, owning a home, pursuing higher education, paying state taxes, giving to charity, and saving for retirement. Our tax code conversely punishes “bad” behavior, like purchasing alcohol or tobacco, withdrawing savings early, making too much money, not buying health insurance, and even laying in a tanning bed.

Using the tax code to target certain groups or industries, instead of just to raise revenue, is not a new development but it does give the IRS dangerous amounts of discretion. In the IRS’s 2011 Annual Report to Congress, they explain that their goal is to “train more IRS personnel to use market segmentation techniques to paint [a] useful portrait of taxpayer groups” and “disburse social benefits to target populations.” Through their regulations, audits, and tax court rulings, our nation’s tax collectors have immense power to target or reward certain groups.

“Using the tax code to manipulate social behavior flatly contradicts the principles of sound tax policy.”

Despite its widespread acceptance, using the tax code to manipulate social behavior flatly contradicts the principles of sound tax policy. The best tax system is one that is simple, neutral, transparent, and stable. Using the tax code to achieve social goals erodes all four of these principles. Once you begin using tax incentives to encourage certain behavior, lobbyists will carve out special exemptions for their organizations. Special interest groups will convince policy makers that their cause helps achieve a social good and thus deserves tax incentives. The result is uneven and complex tax rates.

Although proponents of using the tax code for social ends want it to be used for good, they overlook that it starts a huge political struggle over what is “good” and “bad.” Shifting political coalitions say they are promoting social welfare but it should be no surprise if their tax ideas also help their friends and punish their enemies.

The recent IRS scandal exemplifies how susceptible the tax code is to abuse. Self-serving officials utilize the tax code to target and stifle certain political organizations by withholding tax privileges and performing selective audits. While this behavior may come as a shock to some, picking winners and losers in the tax code is done routinely through uneven tax incentives. The current scandal is simply another iteration of the more fundamental practice of using the tax code for social engineering purposes.

Taxes should be used to collect revenue, not to conduct social policy. Only when we achieve this will the scandals cease. As tax reform takes center stage over the upcoming months, we hope that politicians stop using the tax code to sculpt their ideal society and instead move toward a simpler and more transparent system. **TW**

Federal Tax Reform: Hurry Up and Wait

By Andrew Lundeen

In his speech at the Tax Foundation Annual Dinner last November, Chairman Dave Camp (R-MI) of the House Ways and Means Committee vowed that he will present a tax reform bill this year.

“Tax reform is more necessary now than it was in 1986,” Chairman Camp said. “And that is why the Ways and Means Committee will write, act on, and pass comprehensive tax reform legislation in 2013.”

In February, he restated this intention: “Fixing our tax code is one of my highest legislative priorities for this Congress,” Chairman Camp said. “It’s time we shift the balance of power from the tax collector to the taxpayer.”

It appears both parties in Congress recognize the need for reform. Chairman Max Baucus (D-MT) and Ranking Member Orrin Hatch (R-UT) of the Senate Finance Committee released a letter in June stating the urgency of tax reform. “The complexity, inefficiency and unfairness of the tax code are acting as a brake on our economy. We cannot afford to be complacent,” the letter said.

Though Congress recognizes the urgency, progress toward comprehensive, federal tax reform has so far been slow. Both the Ways and Means Committee and the Senate Finance Committee have spent this session gathering information. The Ways and Means Committee accepted wide-ranging commentary on corporate and individual reform in the spring and has held numerous hearings on ways to improve the code.


Since early March, the Senate Finance Committee has met weekly to discuss a series of topics and more recently moved to begin a “zero-based” approach, placing every tax expenditure on the table.

Throughout the process, the Tax Foundation has continued to present pro-growth proposals and defend against tax policy that would stifle job creation and harm economic growth.

While Chairman Camp intends to stay true to his word and move a reform bill out of committee by the end of 2013, the passage of comprehensive tax reform through both houses is likely to stretch into next year and perhaps longer. This is not necessarily bad if the result is good policy—something Chairman Camp believes to be worth the wait.

“Tax reform wasn’t something to be finished in a matter of days and weeks, as some might suggest we do today,” Chairman Camp said. “Instead, it came about in the same manner as so many other things that have true meaning and lasting value—methodically, meticulously and as the result of work on both sides of the aisle.”

TW

 Read more at taxfoundation.org/tax-topics/federal-taxes

Tax Foundation University: Helping the Hill with Economics

By Andrew Lundeen



Dr. Matthew Slaughter, Associate Dean of the Tusk School of Business at Dartmouth University, discusses international economics with congressional staffers.

This year the Tax Foundation kicked off a new educational program, Tax Foundation University. Tax Foundation University's first course, Economic Theory and Application to Public Policy, is a graduate-level lecture series geared toward senior congressional staffers from all parts of the political spectrum.


The program provides staffers the opportunity to build upon their education in economics or, in some cases, formally develop their knowledge of economics for the first time, providing the theoretical basis for the policy decisions they make every day.

The course consists of ten lectures presented by leading economists and professors from top universities around the country. Some of the experts teaching include the author of the course textbook, Dr. Russell Sobel; Dr. Matthew Slaughter, Associate Dean of the Tusk School of Business at Dartmouth University; and leading monetary economist Dr. Lawrence White.

With a diverse group of talented lecturers, the course covers topics that range from the foundations of modern economic thought to international economics, from government finance to fundamental tax reform. The Tax Foundation's very own Stephen Entin, who was Deputy Assistant Treasury Secretary under President Ronald Reagan, developed the curriculum for the program.

Congressional staff members that successfully complete the program receive a Certificate of Economics from Tax Foundation University.

All of the lectures from the Tax Foundation University summer congressional series will be available to view online for free this fall. [TW](#)

 Read more about
Tax Foundation University at
taxfoundation.org/tfu

No Place to Hide: U.S. Companies Pay Billions in Taxes Abroad

By Kyle Pomerleau

In May, a hearing in the Senate about Apple's tax planning strategies ignited a debate over whether corporations are paying their fair share in corporate taxes. Indeed, many reports insinuated that corporations are shifting their profits overseas in order to avoid any taxes on their income. While it is undoubtedly true that U.S. multinational firms use tax planning techniques to minimize the taxes they pay on their foreign earnings, IRS data shows that the subsidiaries of U.S. multinationals paid more than \$100 billion in income taxes to foreign tax authorities on roughly \$413 billion in taxable income in 2009. Averaged across some ninety countries, U.S. companies paid an effective tax rate of 25 percent on that income. So while many criticize U.S. companies for "avoiding" taxes on their foreign earnings, it's a fact that these companies pay a substantial amount of tax throughout the world. [TW](#)



US Companies paid an effective tax rate of
25% on their Foreign Earnings in 2009

 Read more at taxfoundation.org/tax-topics/federal-taxes

The Road to Tax Reform in North Carolina

44th Ranked State for Taxes Makes a Change

By Elizabeth Malm

State lawmakers across the U.S. have always sought out Tax Foundation experts to weigh in on proposed policy changes, and the legislative session in North Carolina this year was no exception. Our staff wrote extensively on the ongoing legislative process, delivered expert testimony, and provided live coverage of the tax reform debate, just to name a few.

Our work in the Tar Heel State began in January when we published *North Carolina Tax Reform Options: A Guide to Fair, Simple, Pro-Growth Reform*, a book outlining four possible comprehensive tax reform plans the state could implement to improve its business tax climate. The book gave an in-depth analysis of the existing state tax system and discussed the many ways it could be improved to create an environment that is more welcoming to businesses and make North Carolina stand out from its neighbors.

A few months later, I traveled to Raleigh to debate Jared Bernstein of the Center on Budget and Policy Priorities on the future of North Carolina tax reform before a crowd over 100 people. The online audience, watching via live stream, was even larger. Mr. Bernstein and I discussed the implications of income tax cuts, how the antiquated sales tax could be improved, and the need to close the

targeted carve-outs for special interests that riddle the North Carolina tax code. Though we had disagreements, the debate was lively and explored many of the issues that are central to any tax reform discussion.

After the state Senate debuted their sweeping tax reform proposal in May that would comprehensively overhaul income, sales, and business taxes, we developed a tax calculator that would help North Carolina residents see how their tax liabilities would change under the Senate's plan. The calculator showed how sales and income tax burdens would be different relative to the existing tax system. This important informational tool was used by the public, media, legislators and their staff, and even opponents of the Senate's proposal.

In June, state economist Scott Drenkard traveled to the General Assembly to deliver testimony before the Senate Finance committee, where he spoke on the relationship between taxes and economic growth, the benefits of corporate income tax and estate tax repeal, and how lawmakers could ideally reform the income and sales taxes. He also discussed our *State Business Tax Climate Index* and how various reform plans would improve state scores. The *Index*

annually compares the states' tax systems on over 100 variables that impact business and acts as a guide for tax reformers aiming to make their state tax code more conducive to business investment.

As the debate rages on, we haven't missed a beat. As of July 17, both the House and Senate passed the legislation. It now awaits Governor Pat McCrory's signature. Regardless of the final outcome, it's clear that the Tax Foundation team's commentary and tax policy analysis is well-respected among state lawmakers and the public alike. [TW](#)

TIMELINE

The Tax Foundation publishes its report, *North Carolina Tax Reform Options: A Guide to Fair, Simple, Pro-Growth Reform*. The book describes various ways lawmakers could change state tax laws to make it more inviting to business and conducive to economic growth and expansion.

In early May, economist Elizabeth Malm debates Jared Bernstein of the Center on Budget and Policy Priorities on what the ideal tax reform in the Tar Heel State would embody. Topics include the costs and benefits of income vs. consumption taxation, regressivity of various tax types, and tax loopholes.



JANUARY

FEBRUARY

MARCH

APRIL

How Does the Tar Heel State Stack Up?

Where will the tax reform proposals land North Carolina on our State Business Tax Climate Index?

Current Tax System

44th

House Reform Plan

19th

Senate Reform Plan

13th

Impressive Media Presence for Tax Foundation in North Carolina

By Elizabeth Malm

Not only have we been sought out for information by some of the largest North Carolina newspapers this year, we've also been noted in the national news on the tax debate in the Tar Heel state. From the *Charlotte Observer* to the *News Record*, from the *Washington Post* to *Bloomberg Businessweek*, each have looked to the Tax Foundation for comment on what's happening in the North Carolina General Assembly. Our North Carolina analysis has been mentioned more than 450 times since January alone, and those citations come from all over the country.

That strong media presence has covered a wide range of media. Our staff appeared on *News14 Carolina*, the state's only statewide news channel, on both of our visits to Raleigh. Jared Bernstein, former economic adviser to Vice President Joe Biden, and I discussed the Senate's tax overhaul proposal. Our state economist Scott Drenkard described ideal tax reform on *Capital Tonight*, a show covering state politics.

We also tried something new this legislative session to further our web presence. We live Tweeted and live blogged any and all committee or

floor debate we could access, all from our offices in Washington, D.C. The coverage was followed by North Carolina residents, legislators and their staffers, and journalists reporting on the tax reform process. Tar Heel taxpayers and interested parties turned to us time and time again for accurate reporting of the legislative debate. This North Carolina analysis wasn't just followed by state residents, either. Our Tax Policy Blog, where we've provided the most coverage, has had nearly 600,000 unique hits since the beginning of 2013. In just the last month, we had over 87,000—meaning our North Carolina analysis has reached readers nationwide.

Our use of both traditional and nontraditional media has not only helped us advance the tax reform discussion in North Carolina, but also shown the nation the exciting tax reform that's happening in the Tar Heel state. We've made it clear that our reliable, objective coverage and expert analysis is the best source for what's happening in the state tax world. [TW](#)

After the introduction of the NC Fair Tax Act, Tax Foundation programmer Nick Kasprack develops a detailed tax calculator that allows North Carolina taxpayers to estimate their change in tax liability under the Act. It outlines changes to both income and sales tax burden relative to the current tax system.

Economist Scott Drenkard testifies before North Carolina Senate Finance Committee about the effects of the tax reform proposal. He outlines how the changes to the North Carolina tax code would improve the state's business tax climate, as reflected by our annual *State Business Tax Climate Index*.



In mid-July, the North Carolina General Assembly passes a tax reform bill which lowers individual and corporate income taxes, abolishes the estate tax, and modestly broadens the sales tax base. The legislation is sent to Governor Pat McCrory for his expected signature.

MAY

JUNE

JULY

For Tax Reform, Nine States Forward and Six States Back

By Joseph Henchman

This Fourth of July, our small state policy team of three took a day off to enjoy BBQ, pools, and fireworks. Believe it or not, it was the first day all year—weekends included—that at least one of us wasn't writing or speaking for better tax policy in the states. We wrote about or testified in every state listed below, and you can find all that online at www.TaxFoundation.org/state.

We're still hard at work but we want to share some of this year's state tax victories:

- Wisconsin approved a tax reduction that drops income tax rates, improves business treatment of net operating losses, and pares back targeted tax credits. We especially thank Rep. Dale Kooyenga, who solicited a lot of input from us and others as he put together this impressive tax package that is now law.
- New Mexico approved a significant business tax reduction, dropping the corporate rate over time from 7.6 percent to 5.9 percent and tightening a jobs tax credit. Gov. Susana Martinez worked with a heavily Democratic legislature to get it through, along with new laws that give taxpayers ninety days (instead of thirty days) to contest tax bills and let taxpayers seek refunds up to three years after (instead of one year after).
- Indiana repealed its death tax, is cutting its corporate income tax, and will even be cutting its second-lowest-in-the-nation individual income tax a little bit. Gov. Pence and his staff worked hard for budget constraint and to return money to taxpayers, and they should be commended.
- Arizona is transforming its awful local sales tax system with a new law limiting the proliferation of different tax rules by local governments, and working to ensure that retailers facing a state audit don't have to deal with local audits as well.
- Texas made some modifications to their awful margin tax. They didn't repeal it, but they did extend a \$1 million exemption for small business and they lowered the rate from 1.0 percent to 0.95 percent. Next year, Nevada votes on a margin tax, and we're reminding everyone that Texas is successful in spite of the margin tax, not because of it.
- Kansas addressed their structural deficit a bit this year, matching significant income tax rate cuts with some base broadening by limiting some income tax carve outs.
- Nebraska didn't pass tax reform this year, but a new commission will be investigating options. The Tax Foundation and the state's Platte Institute are jointly preparing recommendations that will help the commission in its work.
- Massachusetts rejected an income tax increase, although they did hike some other taxes.
- Even the District of Columbia is cutting its sales tax from 6 percent to 5.75 percent, below neighboring Maryland and even northern Virginia, which just hiked theirs from 5 percent to 6 percent.
- We honored Colorado, Illinois, Pennsylvania, Utah, and Virginia this year for their commitment to tax information transparency online during tax filing season. People think we pick on Illinois sometimes, so we're glad we could give them some good news. We hope we can honor a lot more states next year.

There were of course disappointments. Pennsylvania looks set to hike business taxes. Ohio passed a disappointing package that boosted the gross receipts tax, added a problematic carve out for pass-through businesses, and hiked the sales tax. Residents of Maryland, Minnesota, and California face higher income taxes. Virginia's new transportation taxes are a mess. We didn't let any of those go without a fight, but we think the good outweighs the bad.

Keep an eye out for more research this fall that helps the cause of sensible tax policy, including our *2014 State Business Tax Climate Index*. **TW**


States' Revenue Surge a Temporary Boon

By Joseph Henchman

State income tax revenues in the first quarter of 2013 soared 17 percent over 2012, according to a new collection of data released by the Rockefeller Institute. While about half of that increase is due to California's hefty income tax hike, excluding California still means an average 9 percent growth in state income taxes. By contrast, sales taxes grew 6 percent and corporate taxes 3.5 percent.

Why the spring "surge" in state income tax revenue? Part of it is the improving economy, but a big culprit is the increase in federal capital gains taxes. In late 2012, it became clear that capital gains taxes would go up for 2013 and indeed they did (from 15 percent to 20 or 23.8 percent). Lots of people "accelerated" their capital gains realizations—sold stuff in 2012—to make sure that they paid 2012 tax rates rather than future, higher tax rates. Taxpayers paid those taxes this spring, leading to a huge revenue boost for the federal government (knocking hundreds of billions of dollars off the 2013 budget deficit), a boost which flows through to the states.

All good news, right? So long as we understand that if acceleration is indeed the cause, much of the boost is temporary. One-time sales of capital gains are exactly that: one time. CBO's report on this unnerved us a bit because it shows the spring's tax revenues as an upward trend rather than a spike. States should be careful not to make that same assumption. **TW**

 For state-by-state data, visit <http://taxfoundation.org/blog/states-see-spring-surge-income-tax-revenues>.

Virginia Has a Sheep Tax, It Raises \$8,000 Per Year

By Scott W. Drenkard

While digging through Virginia's Annual Reports by the Department of Taxation, we had a few chuckles due to some of the taxes in the category of "Other Funds Revenues." In case you were wondering, Virginia has an excise tax on eggs that collects \$1.8 million per year, an excise tax on peanuts that collected just \$172,000 in 2012, and a tax on soft drinks that collected \$191,000 in 2012. But the most peculiar thing in this report is the line item that simply reads "Sheep" and collected \$9,000 in FY 2011 and \$8,000 in FY 2012.

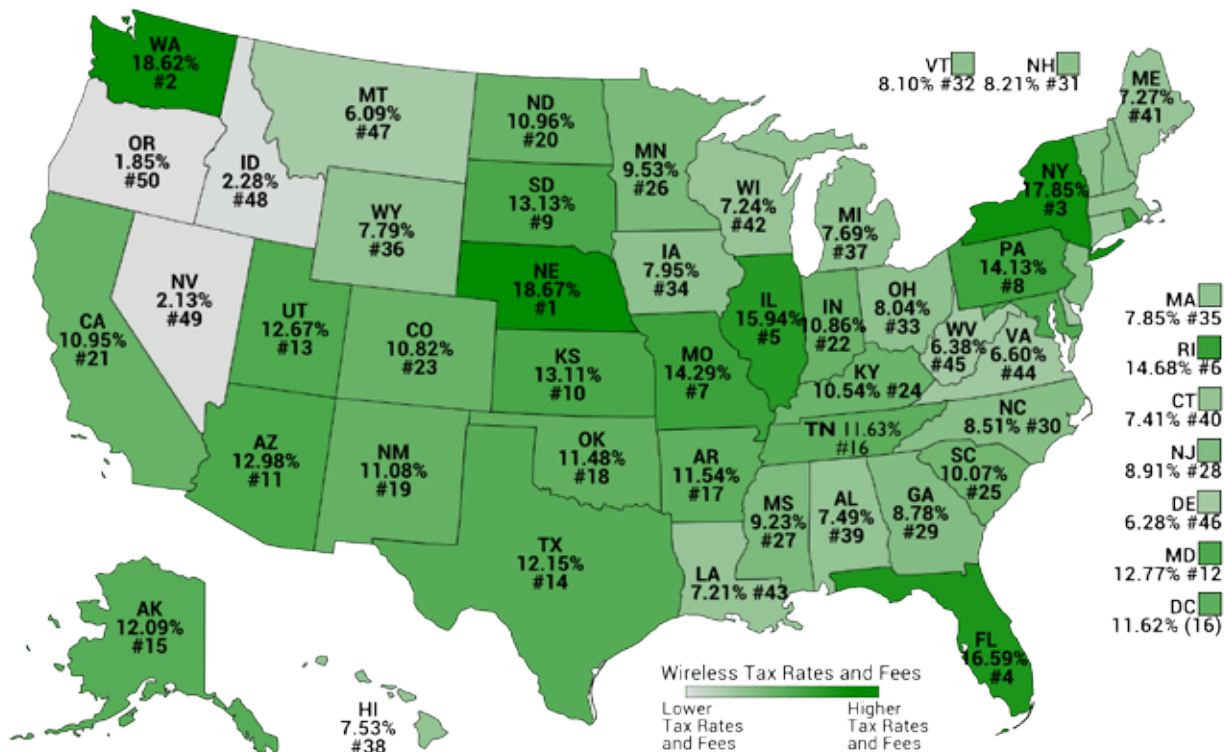
Turns out that there is a sheep assessment in Virginia, and every sheep or lamb sold is subject to a \$0.50 excise tax. This is all detailed on form SH-1. This levy is actually filed quarterly by sheep handlers. Really, the only redeeming feature about this levy is that if you're buying your sheep for the express purpose of resale in the next ten days, it doesn't apply. That's a good thing, because we wouldn't want any sheep tax pyramiding.

The money goes to the Sheep Industry Board, which is "responsible for the promotion and economic development of the sheep industry in the Commonwealth." Some elements of this board seem reasonable, and this assessment aims to be like a user fee in that some of the money is dedicated to protecting against coyote attacks on sheep. However, it's not immediately clear to me that coyote protection is a goal that requires forcing everyone in the industry to "buy in" in the form of a state-administered levy. I'd bet some farmers do just fine protecting their stock against coyotes with good fences.



I realize that these line items are relatively small peas, and they probably don't represent the worst example of government mismanagement of tax dollars. But then again, it's important to balance this minimal collection of \$8,000 per year with the compliance cost of filing these assessments every quarter. I'd anticipate it's probably pretty tiring to fill out these forms. It is, after all, counting sheep. [TW](#)

State and Local Taxes and Fees on Wireless Services



Source: Scott Mackey, *Wireless Taxes and Fees Continue Growth Trend* in State Tax Notes (Oct. 29, 2012).

Note: The federal rate on wireless service is 5.82 percent.

America Online: The Future of Internet Sales Taxes

By Joseph Henchman

On May 6, the U.S. Senate approved the Marketplace Fairness Act (S. 336 and H.R. 684) by a vote of 69 to 27. The bill would give each state the power to collect sales taxes from out-of-state retailers that have no physical presence in the state. While the bill's prospects in the House of Representatives remain uncertain, it is the latest of a series of efforts to expand state sales tax collection authority.

The story of Internet sales taxes actually begins in 1787, when the Framers proposed the U.S. Constitution to replace the Articles of Confederation. One of the driving forces was the recent experience of states imposing trade barriers, tariffs, and punitive taxes on each other. As states did serious damage to the country and each other, the central government had no power to stop them. The new Constitution included several provisions permitting the feds to limit state tax powers when they harm the national economy: the Tonnage Clause, the Privileges & Immunities Clause, and the Commerce Clause.

So bitter was this experience of unlimited state tax powers that for most of the first two centuries of our country, states could not tax interstate commerce at all. State power to tax ended at their borders, just as state services generally end at their borders.

This began to break down in the 1950s and 1960s as more multistate and multinational companies began engaging in interstate commerce. Just because a company sells across state lines, went the thinking, that didn't mean they shouldn't pay their fair share of supporting local services where they have property and employees. In 1977, the Supreme Court formally abandoned the old prohibition on all state taxation of interstate commerce, replacing it with a rule that states could impose non-discriminatory, fairly apportioned, service-related taxes on businesses with substantial presence ("nexus") in the state.

Nexus means physical presence in the state, as the Supreme Court has ruled on multiple occasions. If a company has property or employees in the state, you can subject to them to taxes and tax collection obligations. If they don't, the state can't. Otherwise, the Supreme Court explained, states could impose the compliance burdens of thousands of tax jurisdictions on every seller in the country with no democratic recourse.

States obviously dislike this rule; they prefer to have unlimited tax authority. Some sought to change the rule, setting up the Streamlined Sales Tax Project (SSTP) to bring some rationality to the country's 9,600 sales tax jurisdictions, multiple audits and forms, inconsistent definitions, and badly designed administrative procedures. While they achieved some notable successes on uniformity, SSTP remains hamstrung by most states refusing to join and their own failure to tackle simplification.


Some states tried to openly defy the Supreme Court, passing laws that expanded nexus beyond strict physical presence. Arkansas, California, Colorado, Connecticut, Georgia, Illinois, Maine, Minnesota, New York, North Carolina, Rhode Island, and West Virginia have passed variations on so-called "Amazon tax" laws that require collection by retailers even if they have no property or employees in the state. (The laws usually claim that commission-based website referrers are the equivalent of in-state employees.) Most of the laws have generated zero revenue, with the Illinois law in particular causing an outbound flight of

Internet companies. The Colorado and Illinois laws have been declared unconstitutional by the courts, while the New York law has survived a facial challenge.

Enter the Marketplace Fairness Act. While the law ends the physical presence requirement for sales taxes, it does require states to designate one entity in each state for sales tax collection, auditing, and filing. Each state must provide free calculation software to retailers, a rates database, a database containing information about the taxability of different products, liability waiver for errors dependent on the state, and notification when the rate changes. The bill is missing common definitions for products, notification when the base changes, a blended sales tax rate option for each state, and, crucially, an enforcement mechanism. The bill exempts sellers with less than \$1 million in annual online sales.

Is this tradeoff worth it? Big box retailers think so, as they must collect sales tax from their customers while their online competitors do not. States hungry for more revenue also think so (although new experience in California and New York shows the standard estimates of "lost revenue" are off by 80 percent!). Some scholars pitch alternatives to the MFA, including a national Internet sales tax or "origin-based" taxation (taxing sales based on where the seller is located). Consumers, who technically owe their home state a "use tax" for goods upon which sales tax has not been paid, generally don't know they are supposed to pay or don't want to.

We've been working to educate policymakers, the media, business owners, and taxpayers about this issue and the proposed alternatives. As the Internet grows as a share of commerce, pressure to expand state tax authority will grow with it. We want to make sure that state powers remain limited and clearly defined and avoid doing damage to our national economy. [TW](#)

 For more information about internet sales taxes, visit www.TaxFoundation.org/nexus.

IRS Exceeds Powers with Tax Preparer Regulations

By Joseph Henchman

On May 24, we filed a brief against the IRS along with seven independent tax preparers in the U.S. Court of Appeals for the District of Columbia Circuit. The case involves new regulations that require paid tax preparers to register with the IRS, pay significant fees, and pay for certified continuing education (larger preparers with other professional credentials are exempt from some of these requirements).

Our brief makes three main arguments:

- Preparing a tax return is not the same thing as arguing in front of the tax court, as was argued by former IRS commissioners who support the regulatory scheme. The IRS has the power to regulate who argues in front of tax court.
- The regulations are poorly targeted for their stated goal of deterring tax preparer fraud and are in fact arbitrary and capricious under relevant case law.
- The enactment of the regulations did not comply with notice and comment requirements, violating transparency.

The regulations were struck down by the lower court, but the IRS appealed. We argue that the appeals court should agree with the lower court. The case, *Loving v. IRS*, was brought by the Institute for Justice and several "mom and pop" tax preparers. [TW](#)

Maryland Residents Soaked by Rain Tax

By Austin John

Broyhill Family Foundation Intern

This summer, Maryland's new "rain tax" took effect. In April, Governor Martin O'Malley signed a new law that enacted a "storm water management fee" on 10 of 24 local jurisdictions within the state. The bill was passed in response to a decree by the Environmental Protection Agency (EPA) which identified mandatory reductions in nitrogen, phosphorus, and sediment that damage the Chesapeake Bay. These pollutants are primarily found in drainage run-off and fertilizers.

Maryland, New York, Pennsylvania, Virginia, West Virginia, and the District of Columbia must comply with these new environmental standards, but each jurisdiction is free to find its own way to fund the relief efforts. Maryland is the only state that has instituted a levy to meet the EPA's standards.

While a "tax" is a charge levied with the purpose of generating revenue, a "fee" is a charge levied for the purpose of recovering costs incurred in providing a service to the payer. So while the legislature has taken to calling this levy a fee, it is rightly categorized as a tax, because the revenue goes toward drainage systems, which everyone in the general public benefits from—not just payers of the levy.

What's more, the tax is convoluted and disorganized. It is levied annually on the amount of "impervious surface" on a property. According to Maryland's state legislature, an impervious surface includes any area that prevents drainage from being absorbed into the ground. This means any roofing, driveways, or parking lots are subject to this tax. The rationale is: the more covered area, the more you pay.

An interesting twist here is that the ten local jurisdictions that will levy the tax have been given total autonomy on deciding rates. Several local legislators have used this as an opportunity to push back against it, including Anne Arundel County Executive Laura Neuman, who vetoed her county's legislation that would have charged an additional \$85 on single-family homes, \$34 on condos, and \$170 on rural houses (her veto has since been overridden). Frederick County chose to send a message to the state government by charging just a penny for the storm water management fee. Carroll County commissioners voted not to enact the tax. Instead, the county will provide the necessary money through grants and county funding. [TW](#)

Minnesota: Land of 10,000 Taxes?

By Philip Hammersley

Minnesota Governor Mark Dayton (DFL) recently signed legislation increasing income and cigarette taxes in the Gopher State. The legislature hopes to raise nearly \$2.1 billion in revenue from the tax hikes in order to close the budget deficit and fund new spending projects. The average Minnesotan currently pays 10.79 percent of his income in state and local taxes. This tax burden makes Minnesota the 7th highest taxed state in the nation. With these new tax hikes signed into law, no relief is in sight.

The Land of 10,000 Lakes currently taxes top income earners at a rate of 7.85 percent. The increase creates a new bracket for single filers making over \$150,000 and married couples making over \$250,000. These taxpayers face a rate of 9.85 percent, making Minnesota's income tax the fourth-highest state income tax rate in the nation. Progressive taxes, like Minnesota's, discourage investment and diminish other factors that lead to economic growth. Higher progressive tax rates further distort the economy and discourage income producing activity.

State cigarette taxes will increase \$1.60 a pack under the new legislation, bringing Minnesota's cigarette tax to a total of \$2.83 per pack. The tax, which took effect on July 1, is expected to drive tobacco sales to surrounding states. Minnesota's neighbors have comparatively lower cigarette taxes: North Dakota's is 44 cents per pack, South Dakota's is \$1.53 per pack, and Iowa's is \$1.36 a pack.

The cigarette taxes will harm small businesses and likely will not generate the expected revenue. As consumers cross state lines where tobacco prices are cheaper, Minnesotan businesses will lose customers and the state will lose out on tax revenue. Higher cigarette taxes also increase illicit activity, such as tobacco smuggling. Furthermore, cigarette taxes tend to be regressive. The brunt of the \$400 million revenue increase will largely be felt by lower income taxpayers.

Other tax increases are currently being phased in as well: higher gift taxes, taxes on audio and video internet downloads, and a "wheelage" tax, which charges people for each vehicle they have.

What will all the revenue be spent on? Policymakers intend to close Minnesota's budget deficit and then use further revenue to fund early-education programs and other economic development projects. Such projects include plans to build a new football stadium for the Minnesota Vikings and an expansion to the Mayo Clinic.

Minnesota's tax burden is one of the highest in the nation. These tax increases will only further burden Minnesotans and discourage economic productivity. [TW](#)

Staff Developments



Michael Vogler has been promoted to Vice President of Development, stepping into the shoes left by Carter DeWitt, who is returning to Florida. Michael has a B.A. in Political Science from the University of Rochester and a M.S. in Education from Shenandoah University. Prior to coming to the Tax Foundation, Michael worked in consulting, sales, and business develop-

ment in both Los Angeles and Washington, DC. He also taught as a public high school teacher in Loudoun County, VA where he taught American Government, Ancient World History, World Religions, Geography, and International Relations.

Michael started at the Tax Foundation in 2010 as Manager of Corporate and Government Relations. He excelled in his position and over the years rose to Senior Director of Corporate Relations, providing outreach and significant value to our corporate supporters. In his new position, Michael will be overseeing all fund raising activities for our organization including the grants program, events, individual donors, and corporate memberships.



Daisy Weill has joined the Tax Foundation as our new Development Associate. She will manage our direct mail operations and assists with event planning. She previously worked at a political fundraising firm in northern Virginia, where she assisted with local, state, and federal level campaigns.

She has also spent time working with several non-profit organizations, including Historic Jamestown and

Colonial Williamsburg. Daisy majored in History at the College of William and Mary, with a focus on public history.



Alan Cole has joined our Center for Federal Tax Policy as an Economist. Alan's primary area of research is in dynamically modeling the effects of federal taxes on the economy. He works on our Taxes and Growth Model, which predicts how taxes affect our labor force, capital stock, and economic output.

Alan earned his degree in Economics from Yale University, where he specialized in game theory,

computational finance, and international economics. Alan came to the Tax Foundation from Capitol Hill, where he researched public policy for the Republican Study Committee. Alan has also worked in financial consulting for pension funds.



Chris Mullaney has joined the Tax Foundation as our Director of Donor Relations. He is responsible for ensuring that donors experience highly personalized, quality interactions with the Foundation and that all gifts are consistent with donor intent. Chris will be overseeing the Major Gift Planning Program that allows donors to support the Foundation through principal annual donations and multiple-year pledges, as well as bequests, charitable trusts, and estate gifts.

After serving in the U.S. Navy, Chris earned his B.A. from American University with a double major in International Studies and Economics.



Tax Foundation Summer 2013 Intern Class
From left:

Philip Hammersley *Candidate for B.A. in Politics, Hillsdale College*

Zachary Bartsch *B.S. in Economics; candidate for Ph.D. in Economics, George Mason University*

Russ Hayes *Candidate for B.A. in History and Political Science, University of Michigan*

Dan Carvajal *B.S. in Economics, George Mason University*

Noah Glyn *B.A. in Economics and History, Rutgers University; candidate for M.P.P., Rutgers University*

Lyman Stone *B.A. in Economics, Transylvania University; candidate for M.A. in International Trade & Investment Policy*

Andy Chou *B.S. in Economics, Michigan State University; candidate for Ph.D. in Economics, Michigan State University*

Austin John Broyhill Family Foundation Intern
Candidate for B.A. in Economics and Political Science, Lynchburg College

Increasing U.S. Competitiveness with Tax Reform Focused on Small Businesses and Domestic Manufacturers

by Congressman Ron Kind (D-WI)

Competitiveness, in the context of tax reform, is a word heard in Washington all the time. As a member of the Ways and Means Committee, I hear it often from stakeholders with respect to their effective tax rate. Higher tax rates, they claim, are ruining their competitive advantage globally. While I agree with them—that it's necessary for our multinational companies to remain competitive—it's also just as important that tax reform boosts economic growth and fosters the creation of sustainable jobs here at home. That's why we should particularly focus on those entities that grow, build, and create goods in the United States: small businesses and domestic manufacturers.

America's small businesses drive our economy. They create two out of every three jobs, employing millions of Americans. Small businesses innovate, create, and expand to meet the challenges of the twenty-first century in an increasingly competitive global economy. But these small businesses spend far too much valuable time understanding and complying with the complexities in the tax code. We must make commonsense simplifications to the tax code, thus allowing small businesses to successfully navigate it without excess cost, tedium, or fear of audits.

Simplifications in tax reform should not focus only on the corporate side of the tax code, relying on the majority of small businesses organized as pass-through entities to pay for corporate rate reduction. Though the terms "small business" and "pass-through entity" are not synonymous, the majority of small businesses are pass-through entities: LLCs, S Corps, and partnerships. It is important, therefore, to reform the individual and corporate tax codes in tandem, relieving pass-through entities of the potential burden of paying for corporate rate reduction and simplifications.

Specifically, domestic manufacturers—often organized as pass-through entities and usually considered small or mid-sized businesses—stand to benefit from a simplified tax code. Clearly, American manufacturing is vital to our economy and provides stable jobs with sustainable wages to Americans in every state. On average, manufacturing jobs provide wages that are above the national average and provide a gateway to the middle class. Those who produce American goods and hire American workers should be a priority. Yet, small and mid-sized manufacturers currently pay an effective tax rate somewhere between 27 and 31 per cent, though it varies by region and the size of equipment used in production.

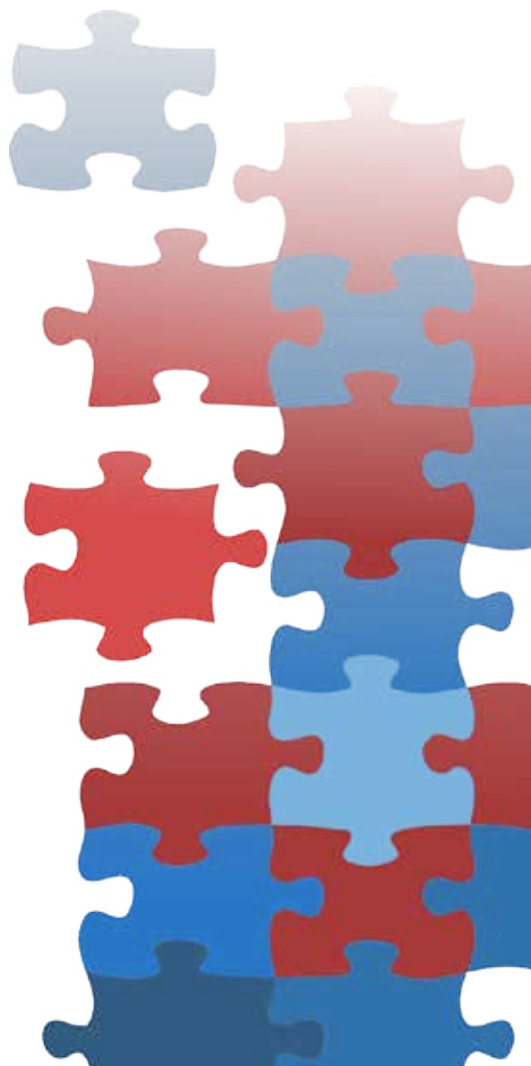
In order to spur growth by making American manufacturing a priority in tax reform efforts, I intend to reintroduce a bill with many of my Ways and Means Democratic colleagues that would reduce the effective tax rate for domestic manufacturers by 43 per cent, thus providing a 20 per cent effective tax rate. A country as great as ours should have the ability to invent, create, and grow things, otherwise we will lose our greatness. Companies that do so should be given incentives to do so in America. The Rebuilding American Manufacturing Act is not the sole answer to fixing our economy and reforming our tax code, but promoting domestic jobs and production must be a central part of reform.

Promoting American manufacturing, protecting small businesses by not burdening them with the majority of the cost of tax reform, and simplification must be the crux of comprehensive reform in order to improve US competitiveness in the global economy. **TW**

The Tax Foundation invites national leaders from all perspectives to contribute columns to Tax Watch. The opinions expressed are those of the authors and not necessarily those of the Tax Foundation.



Simplification must be the crux of comprehensive reform.



Tax Foundation

2013 Media Roundup

(January-June)

Total Citations

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5,905

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Cited in



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Growth: '12-'13



11.8%

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830

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Interviews



65

Online Media
Citations



4,955

Website Visits



1.9 million

Blog Posts



289

Podcasts



27

Social Media



11,079 Twitter followers
2,950 Facebook friends

Soundbites from the Podcasts

David Brunori on the Virtues of the Gas Tax:

TF: Gas taxes are general good because they connects the cost of providing a government service with the people who are actually using it, so what are the problems we are seeing with gas taxes now, though, with new car technology?

DB: This is what has been driving a lot of the debate. In the last ten years or so, Americans have been using less gasoline per capita because of generally more fuel efficient cars [...]. They are buying less gasoline which means they are paying less gas taxes, but the problem is that they aren't driving any less. They are still using the roads—they are still tearing up the roads, and the roads still need to be maintained—except, the revenue dedicated for those services has been falling. So, something has to give in terms of how you pay for the roads, and that's what's really spurring the debate. **TW**

Lester Jones on Beer Taxes:

TF: Beer is subjected to greater tax and regulation than other consumer products. Can you explain the simple outline about how federal and state taxes end up getting added on to the price of beer?

DB: Every two years we do a big study called and we call it the *Beer Serves America* study. It's actually on a website called beerservesamerica.com, which includes our methodology and an overview of the study. What we do with that study is, we take an industrywide look at all the brewers, importers, distributors, partners, and retailer partners, and we figure out the true impact of what's going on in the beer industry; and part of that impact is going through the tax structure in each state. So, what we find in *Beer Serves America* is that the industry pays about \$49 billion in taxes and that our industry has about a 40% tax burden, so about 40% of the retail price of the beer that our consumer drink actually includes taxes. And that's call kinds of taxes to keep in mind: business taxes, such as income taxes—person and corporate—FICA, city, state and local taxes, but it also includes all the consumption taxes including things like federal and state excise taxes, as well special hotel and bar taxes, and other local community taxes that can apply to beer. Keep in mind, beer is taxed in a lot of different ways. The answer to your question about taxation is that we feel beer is over taxed because brewers and importers pay tax before beer even gets into the distribution network, or onto the retailers' shelves. **TW**

Michael Schuyler on the Benefits of Cutting the U.S. Corporate Tax Rate:

TF: Now, when we talk about getting increased economic growth from a cut in the corporate tax rate and therefore getting more revenue overall, does that include both [a] more revenue from the corporate tax itself because there will be more profits coming in to be taxed even though it's a lower rate, as well as [b] other tax receipts going out, say income taxes from people taking more profits, and things?

MS: I am glad you asked that question, Richard. Let me start back and say that a number of studies on corporate tax rate reductions in other countries concluded that a lower corporate tax rate would boost corporate tax revenues. We think that effect is largely because of changes in tax planning strategies. Our model looks at the effects of economic growth, but not tax planning, unless the tax planning affects the growth of the economy. Because of that limitation of our model, we show a lower corporate rate reducing corporate tax revenues. The reason we show an increase of total federal revenue is that the growth would increase taxes throughout the economy. Basically the idea is that you have a larger economic pie: [the revenue from] income taxes, payroll taxes, excise taxes, and many other government fees and charges would grow along with a larger economy.

TF: Can you talk a little bit about the two different ways of making economic estimates: between what people call a “static” prediction and what you’ve done here, a “dynamic” prediction?

MS: That's right. In static revenue scoring it's assumed that macro-economic aggregates such as total investment, total income, total employment, total production, remain absolutely constant in reference to the tax system. In other words, in a static estimate, it's assumed that whether the tax rate is 0 or 100 percent, the number of jobs, the amount of output, the amount of investment, are the same. In a dynamic estimate, we recognize that taxes have incentive effects, and that if you change marginal tax rates, people will respond sensibly to the new incentives. The level of investment is especially sensitive, according empirical evidence, to the incentives faced, and that's really a big driver in the Tax Foundation's dynamic simulation model. You reduce the corporate tax rate, and you will see a surge of investment by companies in equipment and structures leading to a more productive economy, leading to higher employment, higher wages, higher output, and higher revenues. **TW**

In the News

The nation's most influential news publications regularly depend on the Tax Foundation for fair and reliable analysis.



THE WALL STREET JOURNAL

February 17, 2013

"Organizations such as the Tax Foundation have made the case that lower taxes will encourage companies to add workers, expand and make more purchases of plants and other equipment."



June 27, 2013

"It's part of a broader trend in that direction," the Tax Foundation's Joe Henchman said of taxing Internet transactions. "States are tired of waiting for Congress to act and are looking to defy or creatively interpret the law in the meantime."

The New York Times

May 24, 2013

"On three of the [Tax Foundation's] other major rankings—property taxes, sales taxes and corporate taxes—Texas ranks in the bottom 20 states."

Los Angeles Times

March 13, 2013

"There's no way this will be able to create a sustainable industry for the long term, and in the meantime, it is a poor use of taxpayers' dollars," said Joe Henchman, vice president of state projects for the Tax Foundation, a Washington research group opposed to film tax breaks."

DAILY NEWS

May 26, 2013

"This is exactly the kind of thinking that makes New York score so poorly in our tax index," said Scott Drenkard, an economist with the Washington, D.C.-based Tax Foundation, a nonpartisan, national tax research association. "The bread and butter of a good tax policy is its broad-based taxes. That means you don't have giveaways to certain businesses. Instead, you operate on a level playing field."

NEW YORK POST

June 11, 2013

"New York businesses already know everywhere else is cheaper. The state ranks dead last in sales-tax climate, according to the non-profit Tax Foundation, while Texas breaks the Top 10."

The Washington Post

May 29, 2013

"As of January, Maryland's [gas] tax was the 29th highest among states, according to an analysis by the Tax Foundation, a nonpartisan research group based in Washington. Once fully phased in, the bill passed by the legislature would catapult the state into the top 10, if projections by state legislative analysts prove true."

CHICAGO SUN-TIMES

March 8, 2013

"In Indiana, the sales tax is already high at 7 percent so getting rid of the income tax right now is not realistic. But Pence's plan is a move in the right direction. According to the Tax Foundation, it would make Indiana's income tax rate 'the lowest in the country among those states that levy an individual income tax.'"

The Dallas Morning News

May 10, 2013

"Texas ranks No. 30 nationally for its state excise tax rate on beer, according to a new map on alcohol taxes from the Tax Foundation."



President Scott Hodge speaks with Mr. Toshinori Doi, Finance Minister, Embassy of Japan



President Scott Hodge testifying before the House Ways and Means committee

About the Tax Foundation

What Do We Stand For?

As a nonpartisan educational organization, the Tax Foundation has earned a reputation for independence and credibility. However, it is not devoid of perspective. All Tax Foundation research is guided by the following principles of sound tax policy, which should serve as touchstones for good tax policy everywhere:

Simplicity: Administrative costs are a loss to society, and complicated taxation undermines voluntary compliance by creating incentives to shelter and disguise income.

Transparency: Tax legislation should be based on sound legislative procedures and careful analysis. A good tax system requires informed taxpayers who understand how tax assessment, collection, and compliance works. There should be open hearings and revenue estimates should be fully explained and replicable.

Neutrality: The fewer economic decisions that are made for tax reasons, the better. The primary purpose of taxes is to raise needed revenue, not to micromanage the economy. The tax system should not favor certain industries, activities, or products.

Stability: When tax laws are in constant flux, long-range financial planning is difficult. Lawmakers should avoid enacting temporary tax laws, including tax holidays and amnesties.

No Retroactivity: As a corollary to the principle of stability, taxpayers should rely with confidence on the law as it exists when contracts are signed and transactions made.

Broad Bases and Low Rates: As a corollary to the principle of neutrality, lawmakers should avoid enacting targeted deductions, credits and exclusions. If such tax preferences are few, substantial revenue can be raised with low tax rates. Broad-based taxes can also produce relatively stable tax revenues from year to year.

Our Mission

The mission of the Tax Foundation is to educate taxpayers about sensible tax policy and the size of the tax burden borne by Americans at all levels of government. From its founding in 1937, the Tax Foundation has been grounded in the belief that the dissemination of basic information about government finance is the foundation of sensible policy in a free society.



National Press Building
529 14th Street, NW, Suite 420
Washington, DC 20045



The Tax Foundation's

76th Annual Dinner

Thursday, November 21, 2013

Cocktail Reception 6:00 pm
Dinner 7:00 pm
After Dinner Reception 9:00pm

Mayflower Renaissance Hotel
1127 Connecticut Ave NW.
Washington, DC 20036

Black Tie Suggested

RSVP by November 10th, 2013 to
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or 202-464-5108

