Tax Watch

Fall 2010

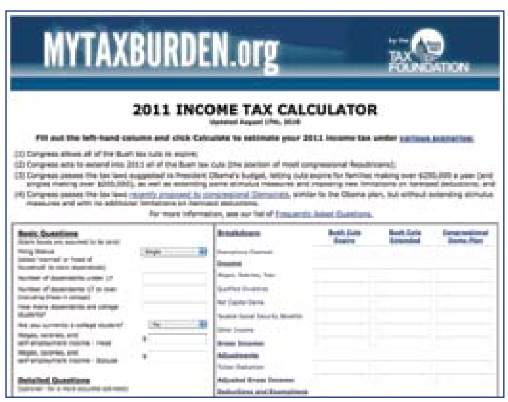
TAX FOUNDATION Since 1937

Costly Countdown: Will the Bush Tax Cuts Expire?

The Bush-era tax cuts provided Americans with billions in tax relief. But as their expiration looms, families are bracing for what may be the biggest peacetime tax hike of all time—if Congress fails to preserve the cuts.

"Many taxpayers are unaware of the huge number of tax increases that may be on the way next year," said Scott A. Hodge, President of the Tax Foundation. "If Congress fails to act, most federal income tax rates will rise, the estate tax and marriage penalty will return, capital gains taxes will rise, and more."

To help educate Americans about the expiring cuts, the Tax Foundation has produced a flurry of analysis this summer, highlighting which taxes may be on the rise, who will pay, and how those extra tax burdens would affect the struggling U.S. economy.



Learn how the expiring Bush-era tax cuts would affect your taxes at www.MyTaxBurden.org.

MyTaxBurden.Org

"The most important question facing most families is, how much will our taxes rise if the Bush-era tax cuts expire?" said Hodge.

To help answer that question, the Tax Foundation launched a free online calculator this summer at www.MyTaxBurden.org, which shows families how much the expiring cuts would cost them.

Using the calculator, taxpayers can type in basic information such as filing status, income and number of dependents, and see how their 2011 income taxes would change under three scenarios: if all the Bush tax cuts expire, if they're all made permanent, or if President Obama's proposed budget is adopted, which would include a mix of both tax hikes and tax-cut extensions.

For example, if Congress fails to extend the Bush-era tax cuts, a married couple filing jointly making $80,000 with two children would pay $2,137 more in federal income taxes next year than if all the cuts were extended.

"Since the calculator was launched in July, it has been greeted with rave reviews," said Hodge. The website www.MyTaxBurden.org was prominently featured in a Fox News story on the Bush-era tax cuts, and has been visited by over 138,000 taxpayers so far.

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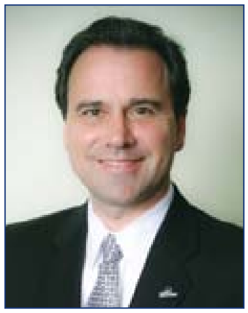
Message from the President:

Gearing Up for D-Day on Taxes



By the time you read this we will have about 90 days before the expiration of the Bush tax cuts. Never in history have we seen anything quite like this, where such a major portion of the tax code is set to expire on a single date and affect so many Americans all at once.

It means a return to Clinton-era tax policies: a top federal tax rate on wages, interest and dividends of 40 percent, and a "death tax" rate of 55 percent. And that's before the health reform taxes take effect in 2013, bringing the top tax rate on wages, interest, dividends, rents and royalties to 43.4 percent.

The typical middle-income family will see a tax hike of $1,540. On a state-by-state basis, that same family would see a tax increase of $1,959 in Alaska, which has the highest median incomes in the nation, and a $1,316 tax increase in West Virginia, which has one of the lowest.

But since all politics is local, we also calculated how the median family would be impacted in all 535 congressional districts. I've been told by the staff director of a member of the Ways and Means Committee that our list has been circulating all over Capitol Hill since every member wants to know how their constituents will be affected.

And to really personalize the issue, we built an online calculator at www.MyTaxBurden.org where people can see for themselves how much their taxes will go up automatically next year.

But I worry that the secret goal of many in Congress is to allow the Bush tax cuts to expire without lifting a finger. Why? Because now that spending is where they want it at European-levels, they need to trick Americans into higher taxes to pay for it.

You remember Ronald Reagan's strategy of "starve the beast." Well, the folks in Washington have created a new strategy called "feed the beast."

The problem with "feed the beast" is that it takes ruinously high taxes to pay for that new spending. In order to raise enough money to close this year's $1.5 trillion deficit, Washington would have to either: enact a 25 percent VAT; take 130 percent of the profits earned by U.S. companies this year; raise the top income tax rates to 100 percent; or take 100 percent of business income earned by individual taxpayers.

These examples make it clear that the deficit is being caused by reckless spending, not a shortfall of taxes. Cutting spending is the only way to get the nation's finances under control.

When the ball drops in Times Square at midnight on December 31, Americans may face a massive tax increase. We are explaining the issue to the public, but need your help to reach more people with our message. Please consider making a major gift today to support our efforts.

Sincerely,

Scott A. Hodge
President

TaxWatch

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TAX FOUNDATION Since 1937

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Estate Tax May Rise from the Grave

For the first time in a century, the federal estate tax is repealed this year. But with the unpopular tax scheduled to return next year, a new Tax Foundation study offers a variety of reasons Congress should put the "death tax" to permanent rest.

"Many experts view this year's repeal of the estate tax as a great improvement in tax policy that should be made permanent," said William Ahern, Director of Policy and Communications at the Tax Foundation. "In their view, the tax is unfair, preposterously complex and far more economically damaging per dollar of tax collected than any other individual tax."

Gerald Prante discusses the expiration of the Bush-era tax cuts on C-SPAN's 'Washington Journal.'

> *"The estate tax discourages wealth creation among America's most productive entrepreneurs."*

Over the years, many Tax Foundation studies have analyzed the federal estate tax. The new report condenses decades worth of research into an 8-page brief on what the recent estate tax repeal means for taxpayers.

A common argument in favor of estate taxation is that it helps redistribute wealth from rich to poor. But recent economic data show this argument is outdated.

"The traditional rationale for estate taxation—preventing excessive concentration of wealth—is obsolete," said Ahern. "The U.S. economy has become so dynamic that a constant turnover occurs among the nation's wealthiest people."

According to the report, studies show the same few families do not stay at the top of the nation's income distribution for generations, as is commonly assumed. Instead, new entrepreneurs routinely emerge and overtake older fortunes.

IRS data show that only seven of the top 400 taxpayers stayed in the nation's top income tier between 1992 and 2007. Meanwhile, more than 2,500 taxpayers made just one appearance in that top group, demonstrating the tremendous turnover that exists among the nation's wealthiest families.

Penalizing Wealth Creation

By penalizing entrepreneurship, the estate tax may actually reduce turnover among wealthy families. Previous Tax Foundation studies have found the estate tax acts as a sharp disincentive toward entrepreneurship. A 1994 study found that the estate tax's 55 percent rate at the time had roughly the same disincentive effect as doubling an entrepreneur's top effective marginal income tax rate.

"Because the estate tax penalizes saving and capital formation, it can discourage the creation of new wealth among America's most innovative, productive entrepreneurs," said Ahern.

While estate tax repeal has been controversial in Congress, the study shows it has never been an important federal revenue source. The tax has typically accounted for just 1 to 2 percent of federal collections in recent years.

While it raises little revenue, economists argue the tax leads to very large compliance costs, both for taxpayers and the IRS.

By allowing the estate tax to be permanently repealed, the report notes that Congress could save Americans billions in estate planning costs, as well as lighten the administrative cost to taxpayers of IRS operations.

"Over the years, myriad studies have found the estate tax penalizes hard work and investment while raising little revenue in the process," said Scott A. Hodge, President of the Tax Foundation. "It's time for Congress to retire the 'death tax' once and for all."

Read the full report, "The Federal Estate Tax: Will It Rise From the Grave in 2011 or Sooner?" at taxfoundation.org/publications/show/26360.html.

Tax Fact:

Tax increase for a typical middle-income family if the Bush-era tax cuts expire: $1,540.

Congress Targets Oil Companies for Tax Hikes

Lawmakers looking to raise revenue have aimed their crosshairs at the oil and gas industry. But according to a new Tax Foundation study, repealing corporate tax deductions for a single industry is a costly and unfair way to raise federal revenue.

"Instead of unfairly punishing one industry by repealing a manufacturing deduction just for oil companies, the Obama administration should instead lower the U.S. federal corporate tax rate, which would benefit all American companies," said Scott A. Hodge, President of the Tax Foundation.

Scott A. Hodge discusses capital gains taxes on CNBC's 'Street Signs.'

The Obama administration has proposed repealing a corporate tax provision called the Domestic Manufacturing Activities Deduction or the "Section 199 deduction." It allows companies to deduct up to 9 percent of their income from domestic manufacturing activities. Studies show the deduction cuts corporate tax burdens on these activities from 35 percent—which is today's top corporate income tax rate—to 32 percent.

"While the tax deduction is by no means perfect, it's available to a broad swath of industries, not just oil and gas," said Hodge. "Tax laws shouldn't be used to punish one industry over another. Using the tax code in this way is arbitrary and has led to the byzantine tax system we suffer from today."

> *"Tax laws shouldn't be used to punish one industry over another."*

Picking Winners and Losers

Under current law, a wide range of industries qualify for the deduction, including clothing, food and software manufacturers; music recordings and film; producers of electricity, natural gas and water; residential and commercial building construction; construction of roads and power lines; and even some engineering and architectural services.

"Why has the administration decided that companies that produce t-shirts, hamburgers, toys, software, or rap music are qualified to receive a tax credit, but oil companies are not?" said Hodge. "It appears that it comes down to environmental politics, not sound tax policy or good economics."

The Obama administration argues the Section 199 deduction distorts markets by lowering taxes for oil companies, thus encouraging "too much" investment and overproduction of oil and gas. But according to the study, by that reasoning the deduction should be repealed for all industries, not just oil and gas.

The deduction was originally enacted as part of the American Jobs Creation Act of 2004 in response to an earlier World Trade Organization ruling that the U.S.'s "extraterritorial income exclusion" violated trade laws. To mitigate the harm from repealing these provisions, Congress enacted a new tax deduction available to domestic manufacturers. However, a better policy may have been an across-the-board rate cut in the federal corporate income tax rather than a special new deduction.

According to the study, the main reason American companies were disadvantaged before the Section 199 deduction is the same reason they are struggling today: a U.S. corporate tax rate of 35 percent that is sharply higher than most other wealthy nations.

"Rather than creating a new tax deduction, lawmakers should have responded by slashing the U.S. corporate tax rate to a competitive level," said Hodge. "It would be wrong and punitive to carve up the existing deduction simply to score political points against the oil and gas industry."

Read the full study, "The Administration's Assault on the Manufacturing Deduction for Oil Companies," at www.taxfoundation.org/publications/show/26579.html.

Dividend Tax Rate May Soar to 68 Percent

Hold onto your wallets, investors. According to a new Tax Foundation study, America's top tax rate on dividends could soar to 68 percent next year—the highest rate in the industrialized world.

"A U.S. integrated dividend tax rate of 68 percent is substantially higher than in other nations," said economist Robert Carroll, author of the new report. "The average rate among OECD member nations is about 44 percent and the average among the larger G-7 economies is about 47 percent."

Economists have long criticized America's double tax on corporate profits, which are taxed once by corporate income taxes and again by dividend taxes when distributed to shareholders.

Mark Robyn discusses sales tax holidays on Fox Business Network's 'The Willis Report.'

> "Double taxation lowers productivity and reduces living standards for all U.S. citizens."

In 2003, Congress partially addressed the double-tax problem. The Bush-era tax cuts lowered the top tax rate on dividends from 39.6 percent to 15 percent, and cut the tax rate on capital gains from 20 percent to 15 percent. However, those tax cuts expire at the end of this year. Along with other new taxes on investment passed as part of the recent health care reform, double taxation of dividends may soar next year.

More Double Taxation

"The double tax on corporate profits discourages productive capital formation, which ultimately hurts U.S. wages and living standards," said Carroll.

One way high dividend taxes hurt growth is by biasing investment away from its best use in the economy. By pushing investment dollars into less-valuable uses for tax reasons, the economy's capital is being used poorly, leading to lower GDP than would otherwise be possible.

"The greater tax burden on corporations encourages business owners to choose partnerships and other pass-through entities that enjoy a single level of taxation but don't have the benefit of limited liability found in the corporate structure," said Carroll.

Double taxation also encourages companies to carry higher debt loads. According to the study, higher taxes on dividends lead to an over-reliance on debt finance for corporate investment. In turn, these higher debt burdens increase a company's risk of bankruptcy during economy-wide downturns.

The study notes another problem with high dividend taxes: they encourage companies not to issue dividends to shareholders, potentially leading to poorer investor oversight of corporations.

"The payment of dividends may improve corporate governance by providing an important signal to investors of a company's underlying financial health and profitability," said Carroll. "To the extent that dividend payments are more heavily taxed than capital gains, U.S. companies are discouraged from distributing earnings to investors through dividend payments."

These tax-related changes in companies' dividend policies can have a big impact on families. According to the study, even if the higher dividend tax rate resulting from the expiring Bush-era tax cuts is limited to families earning over $250,000, all households that hold dividend-paying stocks—regardless of their income—would be affected. In 2007, one-fifth of all income tax returns reported earning dividend income.

"High dividend and corporate tax rates raise serious concerns about the international competitiveness of the U.S.," said Carroll. "By injecting tax considerations into investment decisions, double taxation lowers productivity and ultimately reduces living standards for U.S. citizens."

Read the full study, "The Economic Effects of the Lower Tax Rate on Dividends," at www.taxfoundation.org/publications/show/26384.html.

Tax Fact:

Federal estate tax rate in 2010: 0 percent.

Federal estate tax rate in 2011: 55 percent.

(continued from page 1)

> *"If Congress fails to act, income tax rates will rise, the estate tax will return, and capital gains taxes will jump sharply."*

Which Areas Pay Most?

While nearly all Americans would pay higher taxes if the Bush-era tax cuts expire, the burden would not be shared equally. Differences in incomes and lifestyles throughout the nation mean the tax increases would take a bigger bite out of some areas than others.

According to Tax Foundation research, the nationwide typical middle-income family with a median income of $63,366 would see its federal income tax burden increase by $1,540 if the tax cuts expire. However, middle-income families in Alaska would face a much higher tax increase of $1,959—the highest in the nation—followed by families in Connecticut ($1,903), New Jersey ($1,860), Massachusetts ($1,831), and Utah ($1,779).

Among congressional districts, the biggest tax increases would hit middle-income families in California's 14th district near San Francisco, who would pay $3,194 more in taxes. They are followed by families in Virginia's 11th district near Fairfax ($3,180), families in New York's 14th district near Manhattan ($3,066), New Jersey's 11th district near Dover ($2,987), and Virginia's 8th district near Arlington ($2,895).

These facts could affect the politics of tax debates. According to the study, eight of the ten congressional districts facing the biggest tax hikes are represented by Democrats, while just two are represented by Republicans.

The Tax Foundation has also posted a "frequently asked questions" list on their website at www.taxfoundation.org to answer common questions about the Bush-era cuts. According to the list, families are facing a long list of tax increases if Congress fails to act:

- The estate tax returns with an exemption level of $1 million and a top tax rate of 55 percent;
- The "marriage penalty" for joint filers returns;
- The child tax credit will be cut from $1,000 to $500 per child;
- Long-term capital gains taxes rise from 15 percent to 20 percent, and dividend taxes rise from 15 percent to ordinary income tax rates;
- The 10 percent tax bracket expires, reverting to 15 percent, and the top tax rate rises from 35 percent to the Clinton-era rate of 39.6 percent.

"Experts have been warning for years that if the Bush-era tax cuts expire, Americans will face tremendous tax increases," said Hodge. "This year the Tax Foundation has greatly expanded our research on this issue, highlighting the serious risks to taxpayers if Congress fails to act."

To learn more about how the expiring Bush-era tax cuts could affect your family, visit www.MyTaxBurden.org.

Thanks to Our Sponsors: 2010 National Taxpayers Conference

Each year since the 1940s, presidents of state taxpayers' associations have gathered to discuss current trends in fiscal policy. The Tax Foundation was honored to host the annual gathering this year, September 26th to 29th in Washington D.C.

Over a dozen expert speakers and panelists shared their insights about tax developments in the states. Noteworthy events included a roundtable on state budget trends, panelists discussing new research on state pension problems, presentations on how states are improving budget transparency, and, of course, the latest research from the Tax Foundation.

The 2010 National Taxpayers Conference meeting was graciously supported by **DCI Group**, **Expedia**, **Altria, Verizon**, the **Council on State Taxation**, and **Corporate Press**.

Media Impact Report

Joseph Henchman testifies before the U.S. House Committee on the Judiciary on how state taxes affect the nation's economy.

With the looming expiration of the Bush-era tax cuts, Tax Foundation experts were cited throughout the media this summer.

Television and Radio

President Scott Hodge appeared on several Fox News Channel programs to discuss the expiration of the Bush-era tax cuts and the Tax Foundation's web calculator at www.MyTaxBurden.org. Hodge was also interviewed on Fox Business Network, CNBC's "Street Signs," CNN's "CNN Sunday Morning," CNN's "American Morning," and Radio America's "Dateline DC."

Senior Economist Gerald Prante, Ph.D., was a guest on C-SPAN's "Washington Journal" to discuss the expiring Bush-era tax cuts. Economist Mark Robyn appeared on Fox Business Network's "The Willis Report" and "Fox Business" to discuss sales tax holidays. Robyn was also interviewed by CBS News Radio, Illinois Public Radio and stations in Richmond, VA, Austin, TX and Charlotte, NC.

Newspapers

Manager of Media Relations Natasha Altamirano published an op-ed on CNN.com about the new excise tax on indoor tanning. Intern Aaron Merchak authored an op-ed on "jock taxes" and LeBron James for CNBC's Sports Biz blog, the *Sacramento Bee* and the *Arizona Republic*. Intern Ryan Forster published an op-ed on cell phone taxes in the *San Diego Union-Tribune*.

Tax Foundation research on the expiring Bush-era tax cuts was featured by the *Wall Street Journal*, the *Hill* and the *Los Angeles Times*, and other studies appeared in *Reuters*, *Bloomberg*, *Associated Press*, *USA Today*, Stateline.org and others.

Learn more about the Tax Foundation's media impact at www.taxfoundation.org/press/.

Bringing Sound Tax Policy to the States

Tax Foundation experts have been busy throughout the states this summer:

California: The *San Diego Union-Tribune* in July ran an op-ed by summer intern Ryan Forster on a wave of new local cell phone taxes being adopted in the state.

Kentucky: Tax Foundation experts met with state legislators from across the country attending the National Conference of State Legislatures (NCSL) annual conference in July.

Nevada: As a state commission considers ideas for new business taxes, we released a report debunking claims that gross receipts taxes are not distortive and that corporate income taxes are less volatile than other taxes.

Ohio/Florida: Tax Foundation intern Aaron Merchak received wide media attention for his op-ed on the tax implications of basketball star LeBron James' decision to play for Miami instead of Cleveland.

Rhode Island: We hosted Gov. Don Carcieri on our podcast program to discuss the Ocean State's dramatic income tax reduction, and how Tax Foundation research played a major part in it.

Nationally: Our updated report on sales tax holidays, which explains how they fail to promote economic growth or reduce taxes, received wide coverage as 16 states held "back-to-school" tax holidays.

Learn more about the Tax Foundation's state policy work at www.taxfoundation.org/research/topic/9.html.

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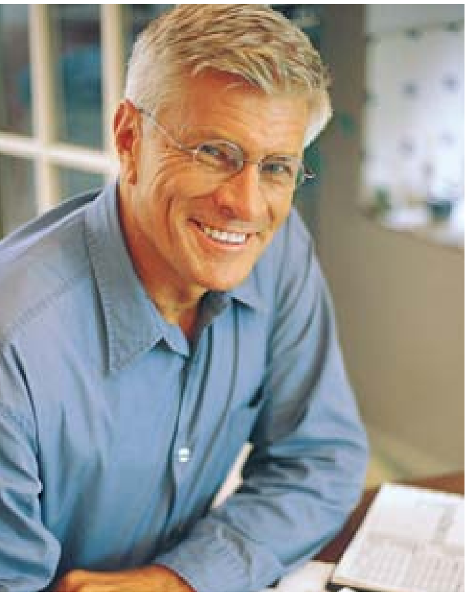

In 1937, at the height of the New Deal when federal spending had grown 170 percent in the previous decade, the Tax Foundation was founded to monitor the growth of government.

From our founding day, we have been grounded in the belief that dissemination of basic information about government finance is the foundation of good policy in a free society. Today, with federal spending on the rise and the Bush-era tax cuts set to expire, our mission is more important than ever.

By making a gift to the Tax Foundation, you can help ensure the future of sound tax policy for coming generations of American taxpayers, as well as our own.

When you are planning your estate, we understand the importance of providing support for those you love and who uphold the values you have dedicated your life to. As you provide for your estate please consider making a charitable gift to support the Tax Foundation.

Our staff is available to discuss planned giving options such as bequests, stock gifts or endowed gifts. Please join us in leaving a legacy of improved tax policy in America. For more information about planned giving, please contact Carter DeWitt at (202) 464-5110.

Tax Foundation—The gold standard for nonpartisan research and analysis on sound tax policy...since 1937.