Raising the Tax Rates on High-Income Taxpayers: Pros and Cons

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Summary

The set of temporary tax provisions known as the “Bush tax cuts” is scheduled to expire on December 31, 2010. If Congress does not act beforehand, on January 1, 2011, these provisions of the tax code will return to what they had previously been in 2001 and 2003. Their expiration would mean an increase in federal income tax for most taxpayers.

During his presidential campaign, President Obama promised that he would not raise taxes on single taxpayers with income below $200,000, or married couples with income below $250,000. In its budget proposal for FY2011, the Administration proposed to extend the middle-class portion of the Bush tax cuts, but to allow several provisions favoring upper-income taxpayers to expire. Some Members of Congress favor permanently extending the entire package of Bush tax cuts. Other Members favor extending all of the cuts, but only temporarily.

The Treasury Department has estimated that the Obama Administration’s set of proposals to raise taxes on upper-income taxpayers would collect $41 billion in additional revenue in FY2012 and $680 billion over 10 years, measured relative to the current policy baseline. This would reduce the net cost of extending the Bush tax cuts from $258 billion to $217 billion, or by 16%, in FY2012. It would reduce the net 10-year cost from $3.7 trillion to $3.0 trillion, or by 19%. These estimates do not include the interest costs associated with the borrowing required to finance the tax cuts.

This report focuses on the debate over whether the top two marginal tax rates should be permitted to rise back to their 2001 levels—from the current 33% back to 36%, and from the current 35% back to 39.6%. The analysis takes into account the relationship between the top tax rates on ordinary income, the tax rate on capital gains and dividends, and the alternative minimum tax.

In the fall of 2010, decisions about tax policy face two conflicting fiscal policy goals. For the long run, the dominant fiscal policy goal is deficit reduction, which is likely to require some statutory tax increases. In the short run, however, the dominant concern of many observers is encouraging the economy to recover and produce more jobs. To them, raising taxes seems directly counter to the fiscal policy called for when the economy is weak. One compromise would be to extend some or all of the Bush tax cuts only temporarily, rather than permanently. Another compromise would be to extend only those Bush tax cuts thought to stimulate the economy the most, and to permit the other tax cuts to expire—to help reduce the deficit.

Arguments for raising the tax rates on high-income taxpayers start with the need to raise additional revenue and to signal the beginning of an effort by the United States to reduce its deficit. This policy is viewed as collecting revenue from taxpayers with the most income, who received the biggest Bush tax cuts, and who are least likely to reduce their consumption spending or work effort in response to an increase in their marginal tax rate.

Arguments against raising the tax rates on high-income taxpayers start with the bad timing of raising taxes in the midst of a weak economy. The wage and investment income of high-income taxpayers will already be subject to two newly enacted Medicare surtaxes, scheduled to take effect in 2013. Higher tax rates on ordinary income would encourage high earners to convert some of their pay into lower-taxed forms of compensation. Higher tax rates in the top brackets are seen as a negative incentive for small business growth, investment, and employment. In general, higher tax rates increase tax evasion and economic distortions. This report will be updated.

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The set of temporary tax provisions known as the "Bush tax cuts" is scheduled to expire on December 31, 2010. The U.S. Treasury Department has estimated that extending all of the Bush tax cuts would cost $258 billion for one year, FY2012, and $3.7 trillion over 10 years, through FY2020, measured relative to their expiration under current law.

The Bush tax cuts were first enacted by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA, P.L. 107-16) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA, P.L. 108-27).[1] If Congress does not act beforehand, on January 1, 2011, these provisions of the tax code will return to what they had previously been in 2001 or 2003. This would mean an increase in federal income tax for most taxpayers.

Congress faces decisions:

- whether to permit some or all of the Bush tax cuts to expire as scheduled on December 31, 2010;
- whether to extend some or all of the tax cuts and, if they are extended, whether temporarily or permanently; and
- whether to modify some of the tax provisions before extending them—by adopting some or all of the Obama Administration's upper-income tax proposals, for example.

The Bush tax cuts were initially enacted at a time of projected budget surpluses, following one of the longest economic expansions in recent history. Even then, the large dollar size, broad scope, and distribution of the tax cuts in favor of high-income taxpayers raised considerable controversy. The present deliberations are taking place in a much-changed environment, with very large current and projected federal budget deficits and national debt, and a weak economy following a severe and prolonged economic recession in 2008 and 2009. Furthermore, inequality in the distribution of income has continued to rise since 2001:[2] the largest increase in income over the past decade has gone to the top one-tenth of one percent (0.1%) of the population.

Some warn that permitting all of the Bush tax cuts to expire would amount to the biggest tax increase in American history.[3] But others point out that the Bush tax cuts, including interest costs, account for roughly $336 billion, or about one-quarter (24%) of the projected $1.4 trillion deficit for FY2010. Analysts at the Center on Budget and Policy Priorities (CBPP) project further that, as

[1] Some of the tax cuts were accelerated or extended by subsequent laws. For a legislative history of the Bush tax cuts, see CRS Report R41111, *Expiration and Extension of the Individual Income Tax Cuts First Enacted in 2001 and 2003: Background and Analysis*, by James M. Bickley. This report does not address a separate set of temporary tax provisions known as the "tax extenders." These provisions, which expired at the end of 2009, also await action by Congress in 2010. For more information, see CRS Report RL32367, *Certain Temporary Tax Provisions Scheduled to Expire in 2009 ("Extenders")*, by James M. Bickley.

[2] Arloc Sherman and Chad Stone, *Income Gaps between Very Rich and Everyone Else More than Tripled in Last Three Decades, New Data Show*, Center on Budget and Policy Priorities, June 25, 2010. Available at http://www.cbpp.org/cms/index.cfm?fa=view&id=3220.

[3] Tax Relief Coalition's July 23, 2010, letter to Congress, included in TaxCore of the online BNA (Bureau of National Affairs), *Daily Tax Report*, July 26, 2010. Ryan Ellis, "Six Months to Go Until the Largest Tax Hikes in History," Americans for Tax Reform (ATR), July 1, 2010. "The Bush tax cuts are among the three biggest federal tax reductions since the end of World War II, comparable to the Reagan tax cut of 1981 and the Kennedy tax cut of the 1960s, according to the nonprofit Tax Foundation," Lori Montgomery, "Battle looms on tax breaks: Bush-era cuts for rich at issue," *Washington Post*, July 25, 2010, pp. A1, A4.

the budgetary effects of the economic downturn recede, the tax cuts would account for a much larger share of the deficit. Including interest costs, the CBPP estimates that the Bush-era tax cuts, if extended, would account for $702 billion, or nearly 55%, of the $1.3 trillion deficit they project for 2019 under an extension of current policies.[4]

In the fall of 2010, decisions about tax policy face two conflicting fiscal policy goals. For the long run, the dominant fiscal policy goal is deficit reduction. To substantially reduce the large projected federal budget deficits, both statutory increases in taxes and statutory cuts in spending will likely be needed. In the short run, however, the dominant concern of many observers is encouraging the economy to recover and produce more jobs. The traditional fiscal policy tools for stimulating the economy are cutting taxes and increasing government spending. Thus, the standard tax-policy prescriptions for the long run seem to be directly at odds with those for the short run.

During his presidential campaign, President Obama promised that he would not raise taxes on single taxpayers with income below $200,000, or on married couples with income below $250,000—the taxpayers the Administration refers to as middle-class. Consistent with this promise, in its budget proposal for FY2011, the Obama Administration proposed to extend the Bush tax cuts for the middle class, but to permit the lower Bush tax rates for high-income taxpayers to expire and thereby let the top two tax rates rise.

Treasury has estimated that the Obama Administration's set of proposals to raise taxes on the upper-income would collect $41 billion in additional revenue in FY2012 and $680 billion over 10 years, measured relative to the current policy baseline. This would reduce the net cost of extending the Bush tax cuts from $258 billion to $217 billion, or by 16%, in FY2012. Further, it would reduce the net 10-year cost of extending the Bush tax cuts from $3.7 trillion to $3.0 trillion, or by 19%. These estimates do not include the interest costs associated with the borrowing required to finance the tax cuts.

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

A compromise between the Republican proposal to permanently extend all of the Bush tax cuts and the Obama Administration proposal to permanently extend only the middle-class tax cuts would be to extend some or all of the Bush tax cuts only temporarily, rather than permanently. Simon Johnson, former chief economist at the International Monetary Fund (IMF), in testimony to the Senate Budget Committee, suggested that any tax cuts granted for 2011 have an automatic sunset trigger, linked to the unemployment rate: the tax cuts would end when the national unemployment rate fell below a specified percentage.[5]

[4] Kathy A. Ruffing and James R. Horney, Critics Still Wrong on What's Driving Deficits in Coming Years: Economic Downturn, Financial Rescues, and Bush-Era Policies Drive the Numbers, Center on Budget and Policy Priorities, Special Series: Economic Recovery Watch, updated June 28, 2010, pp. 5 and 9 and Table 1 on p. 8. Available at http://www.cbpp.org/cms/index.cfm?fa=view&id=3036.

[5] Simon Johnson, Testimony to Senate Budget Committee hearing on "A Status Report on the U.S. Economy," Aug. 3, 2010.

The report of the President's National Commission on Fiscal Responsibility and Reform is due on December 1, 2010. Many people agree that it would be inappropriate to make permanent changes in the tax code before considering the tax policy recommendations of this commission. Furthermore, many tax analysts believe that the Internal Revenue Code is in serious need of reform and simplification. They consequently oppose permanent extension of the many temporary provisions in the tax code before their effectiveness is evaluated.

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

A major policy question is: if tax rates on the highest-income taxpayers were raised, how would the additional revenue be used? Would it be saved to reduce the deficit? Or would it be spent to finance stimulative government spending programs, other tax cuts, or some of each?

The Obama Administration's FY2011 budget proposal would dedicate the revenue generated by the upper-income tax provisions to deficit reduction.[6] Others recommend, instead, that the revenue now spent on tax cuts for high-income taxpayers could be better spent in other ways expected to have higher economic and job multiplier effects.[7]

Some Members of Congress and the public question the idea that the same marginal tax rate should apply to all income above $200,000 or $250,000, whether under the Republican proposal or the Obama Administration proposal. They favor instead introducing several additional graduated tax rate brackets at the upper end of the income distribution. For example, taxable income above $1 million could be subject to a higher marginal tax rate than income from $250,000 to $1 million. Taxable income above $5 million could be subject to a higher marginal rate than income from $1 million to $5 million. And so forth.

The most-reported area of controversy among Members of Congress and among public commentators regarding the extension of the Bush tax cuts is whether or not to extend the lower marginal tax rates for the highest-income taxpayers. Specifically, the disagreement is about whether or not to extend the 33% rate, rather than letting it rise back to 36%, and whether or not to keep the top rate at 35%, rather than letting it rise back to 39.6%. There is much more agreement on extending the so-called middle-class tax cuts.[8]

The remainder of this report focuses on the debate over whether the top two marginal tax rates should be permitted to rise back to their pre-EGTRRA levels. The analysis takes into account the relationship between the top tax rates on ordinary income, the tax rate on capital gains and

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[6] U.S. Executive Office of the President, Office of Management and Budget, *Analytical Perspectives, Budget of the U.S. Government, Fiscal Year 2011*, Washington, February 2010, p. 182; see footnote 7 regarding the Administration's statutory paygo proposal.

[7] Chuck Marr, Letting High-Income Tax Cuts Expire is Proper Response to Nation's Short- and Long-Term Challenges, Center on Budget and Policy Priorities, July 26, 2010. Also see U.S. Congressional Budget Office, Policies for Increasing Economic Growth and Employment in 2010 and 2011, January 2010.

[8] Brett Ferguson and Heather M. Rothman, "Speaker Pelosi Rejects Calls to Extend Tax Cuts for High-Income Households," *Daily Tax Report*, July 23, 2010, 140 DTR G-9.

dividends, and the alternative minimum tax (AMT).[9] It also acknowledges the two new Medicare surtaxes on the labor (wage) and investment income of high-income taxpayers, scheduled to take effect in 2013 under provisions of the two health care reform acts enacted in March 2010—the Patient Protection and Affordable Care Act (PPACA, P.L. 111-148) and the Health Care and Education Reconciliation Act of 2010 (P.L. 111-152).

The Bush Tax Cuts

Extending the so-called "middle-class tax-cuts" portion of the Bush tax cuts typically includes extending the following tax provisions:

- the new, lowest, 10% rate bracket;
- the 25% rate, rather than allowing it to rise to 28%;
- the 28% rate, rather than allowing it to rise to 31%;
- marriage penalty relief by keeping the wider income range for the 15% bracket and the increased standard deduction for married couples;
- the higher income level for phasing out the EITC (earned income tax credit) for married couples; and
- the reduced tax rates of 15% and 0% on long-term capital gains and qualified dividends.

It also includes extending some special benefits for families with children and education incentives:

- the higher child tax credit of $1,000 (instead of $500);
- the expanded refundability of the child tax credit;
- the increased dependent care credit; and
- the education incentives.

Extending the full set of Bush tax cuts would also include extending provisions affecting upper-income taxpayers:

- the top two marginal tax rates of 33% and 35%, rather than allowing them to rise to 36% and 39.6%, respectively; and
- the eased limits on itemized deductions (Pease limits) and on personal exemptions (PEP limits)

The Bush tax cuts are summarized by items 3 through 12 in the top half of **Table 1**. They are explained in more detail in **Table A-1**, column 1.[10]

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[9] This report does not address the estate tax, another tax likely to affect high-income taxpayers. For more information, see CRS Report R40964, *Estate Tax Legislation in the 111th Congress*, by Nonna A. Noto, and CRS Report R41203, *Estate Tax Options*, by Jane G. Gravelle.

[10] **Table A-1** lists the major components of the Bush tax cuts. For each tax provision, the first column presents the law (continued...)

Table 1. Treasury Department Revenue Estimates for Extension of 2001 and 2003 Tax Cuts and the Administration's Upper-Income Tax Proposals

Impact on tax revenue (in $ billions)

Provision	One Year: FY2012	Next 10 Years: FY2010-FY2020
Continue the 2001 and 2003 Tax Cuts[a]		
1. AMT Patch (alternative minimum tax)	-32.4	-671.7
2. Extend 2009 estate tax law	-18.9	-264.5
3. Tax dividends at 0% and 15%	-4.1	-235.5
4. Tax capital gains at 0% and 15%	-1.5	-112.1
5. Expand expensing for small business	-5.6	-29.2
6. Marginal individual income tax rate reductions	-124.5	-1,574.2
7. Repeal the limitation on itemized deductions (Pease)	-9.7	-131.7
8. Repeal the personal exemption phaseout (PEP)	-3.4	-48.1
9. Expand the child tax credit	-28.1	-261.3
10. Marriage penalty relief	-27.6	-322.7
11. Education incentives	-1.4	-15.7
12. Other incentives for families and children	-0.9	-9.0
Total Cost of Extending all 2001 and 2003 Tax Cuts	-258.0	-3,675.7
Administration's Upper-Income Tax Proposals[b]		
A. Reinstate the 39.6% rate	23.6	327.4
B. Reinstate the 36% rate	2.6	37.1
C. Reinstate Pease limit on itemized deductions for high-income taxpayers	11.2	155.3
D. Reinstate personal exemption phaseout (PEP) for high-income taxpayers	3.7	53.2
E. 20% rate on capital gains and dividends for high-income taxpayers	-0.3	106.7
Total Revenue Gain from Administration's Upper-Income Tax Proposals	40.9	679.6
Net Revenue Cost of Extending All 2001 and 2003 Tax Cuts other than the Upper-Income Provisions	**-217.1**	**-2,996.0**

Source: Compiled by the Urban-Brookings Tax Policy Center (TPC), Table T10-0188, July 29, 2010, from U.S. Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals* (also known as the "Green Book").

Notes: Includes effects on both receipts and outlays (in the cases of refundable credits).

a. Baseline (for the first estimate) is current law.

(...continued)

in effect for 2010 but scheduled to expire on December 31, 2010; the middle column, the law in effect prior to the Bush tax cuts of 2001 and 2003, which will take effect again on January 1, 2011, if no new tax law is enacted beforehand; and the last column, the Obama Administration's proposal, intended to take effect in 2011.

b. Baseline (for the first estimate) is continuation of the 2001 and 2003 tax cuts.

The alternative minimum tax (AMT) is not formally part of the Bush tax cuts, but it interacts with them. This is because taxpayers pay the greater of their regular income tax or their AMT liability. Extending the lower tax rates for the regular income tax would be more costly to the Treasury if the AMT is "patched" for inflation than if the AMT were allowed to revert to its pre-2001 parameters.[11] A patch helps keep the number of taxpayers subject to the AMT from rising.

Cuts in the regular income tax—such as the Bush tax cuts of 2001 and 2003—can make more taxpayers subject to the AMT. It follows that if the AMT exemption amounts are not raised for 2011 and beyond, the tax savings from extending the Bush tax cuts could be offset by an AMT liability for most high-income taxpayers and many middle-income taxpayers. Oppositely, permitting the top two marginal tax rates to rise could mean that some high-income taxpayers would no longer be subject to the AMT because their regular income tax bill would then be higher than their liability under the AMT.[12]

The Treasury Department has estimated that extending all of the 2001 and 2003 Bush tax cuts would cost $258 billion for one year, FY2012, and $3.7 trillion over 10 years, through FY2020. (See the summary row in the middle of **Table 1**.) Note in **Table 1** that all of the Administration's upper-income provisions together just pay for the "AMT Patch," which is projected to cost $32 billion for one year, FY2012, and $672 billion for 10 years (item 1).

The Obama Administration's Upper-Income Tax Proposals

During his presidential campaign, President Obama promised that he would not raise taxes on single taxpayers with income below $200,000, or on married couples with income below $250,000—the taxpayers that the Administration refers to as "middle-class." In its budget proposal for FY2011, the Obama Administration proposed to extend the Bush tax cuts for the middle class, but to permit the lower Bush tax rates for high-income taxpayers to expire. It is estimated that the Administration's proposal would raise taxes for approximately 3% of taxpayers; the remaining 97% of taxpayers would experience no increase in their income taxes.

The Obama Administration proposes to let the top two income tax rates rise. This means letting the 33% rate rise back to 36%, and letting the top 35% rate rise back to 39.6%.

The Administration's upper-income tax proposals also include

- reinstating the limits on itemized deductions (the Pease limits) for high-income taxpayers;

[11] The American Recovery and Reinvestment Act of 2009 (ARRA, P.L. 111-5) provided a one-year patch of the AMT for the 2009 tax year. The AMT has not yet been patched for 2010. Consequently, a "patch" of the AMT, retroactive to January 1, 2010, is one of the tax "extenders" calling for congressional action. Without congressional action, the AMT exemption amounts for 2010 and future years have reverted to their 1993-2000 levels. For a single individual or head-of-household, the exemption fell from $46,700 in 2009, back to $33,750 in 2010. For a married couple filing jointly, the exemption fell from $70,950 in 2009, back to $45,000 in 2010.

[12] For more information about the AMT, see CRS Report RL30149, *The Alternative Minimum Tax for Individuals*, by Steven Maguire.

- reinstating the limits on personal exemptions (the PEP limits) for high-income taxpayers; and
- raising the maximum tax rate on capital gains and dividends from 15% to 20%.

(See line items A through E in the lower half of **Table 1**. Also see **Table A-1** in **Appendix A**.)

As shown in the next-to-last line of **Table 1**, the Treasury Department estimates that the Obama Administration's set of proposals to raise taxes on the upper-income would collect $41 billion in additional revenue in FY2012 and $680 billion over 10 years, measured relative to the current policy baseline. This would reduce the net cost of extending the other Bush tax cuts from $258 billion to $217 billion, or by 16%, in FY2012. It would reduce the net 10-year cost from $3.7 trillion to $3.0 trillion, or by 19%.

Appendix C presents the Joint Committee on Taxation's estimate of the tax rate tables for 2011 if the Obama Administration's proposal were adopted, for the four filing-status categories: single individuals; married filing jointly; head of household; and married individuals filing separate returns.

Tax Cuts by Income Category Under the Administration and Republican Proposals

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

One proposal would enact the middle-class tax cuts and AMT relief that were permitted as policy adjustments under the Statutory Pay-As-You-Go Act of 2010 (PAYGO, Title I of P.L. 111-139, the Public Debt Limit Increase). These provisions would not need to be "paid for" by offsetting increases in taxes or reductions in spending. The first proposal also includes the extension of two provisions enacted by the American Recovery and Reinvestment Act of 2009 (ARRA, P.L. 111-5), which expanded the availability of the child credit and the earned income tax credit (EITC). The tables refer to this package of tax provisions as the Administration proposal. The estimates for the Administration proposal are shown in the first column of both **Table 2** and **Table 3**.[13]

The other proposal estimated by the JCT is the permanent extension of the expiring provisions of both the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Job and Growth Tax Relief Reconciliations Act of 2003 (JGTRRA), plus AMT relief. (It does not include an extension of the provisions enacted by ARRA in 2009.) The tables refer to this as the Republican proposal. The estimates for the Republican proposal are shown in the second column of both **Table 2** and **Table 3**.

The third column in both tables presents the difference in estimated tax cuts between the two proposals. It represents the tax cut under the Administration proposal, minus the tax cut under the

[13] **Table 2** and **Table 3** present estimates from the Joint Committee on Taxation (JCT) of the reduction in taxes relative to current law, by income category under two competing proposals for extending the Bush tax cuts. The estimates shown are for calendar year 2011.

Republican proposal. A negative difference means that the tax cut under the Administration proposal is larger than the tax cut under the Republican proposal. Oppositely, a positive difference means that the tax cut under the Republican proposal is larger than the tax cut under the Administration proposal.

To analyze the projected tax cuts across the income distribution, the JCT constructed its own definition of income. It is not adjusted gross income (AGI), the income measure that is traditionally used by the IRS when it reports income-distributional data from income tax returns. Rather, it is a much broader measure of income, as defined in note "a" to **Table 2**. In addition to the individual income tax, the JCT's estimate of the change in taxes took into account the employer share of employment taxes and the portion of excise taxes attributed to consumers.

Table 2 presents the average reduction in taxes per tax return, by income class. **Table 3** presents the aggregate reduction in taxes for the income class as a whole.

Table 2. Average Reduction in Taxes per Tax Return in 2011 Relative to Present Law, by Income Category, under the Administration and Republican Proposals

(in dollars)

Income Category[a]	(1) Under the 2010 PAYGO Act (Administration Proposal)[b]	(2) Under Permanent Extension of All 2001 and 2003 Bush Tax Cuts (Republican Proposal)[b]	(3) Difference (Administration Proposal Minus Republican Proposal)[c]
Less than $10,000	-53	-4	-48
$10,000 to $20,000	-387	-153	-235
$20,000 to $30,000	-771	-629	-141
$30,000 to $40,000	-896	-821	-75
$40,000 to $50,000	-916	-864	-52
$50,000 to $75,000	-1,132	-1,114	-18
$75,000 to $100,000	-1,900	-1,871	-30
$100,000 to $200,000	-3,766	-3,690	-76
$200,000 to $500,000	-6,743	-7,152	409
$500,000 to $1,000,000	-6,701	-17,467	10,766
$1,000,000 and over	-6,349	-103,835	97,486
Total, All Taxpayers	-1,256	-1,412	155

Source: Average amounts per tax return were calculated by CRS from the aggregate numbers by income category found in: Joint Committee on Taxation, unpublished memorandum on Distributional Analysis, July 30, 2010, Table #D-10-06 for 2010 PAYGO Act; Table #D-10-05 for Permanent extension of all 2001 and 2003 tax cuts; and Table #D-10-08 for number of tax units. The memorandum is included as a TaxCore document attached to the article by Brett Ferguson and Heather M. Rothman, "New JCT Analysis Examines Democratic, Republican Proposals on Bush-Era Tax Cuts," BNA (Bureau of National Affairs), *Daily Tax Report*, no. 154, Aug. 12, 2010, p. G-4. The aggregate numbers for the reported income categories over $200,000 are presented in **Table 3**.

a. For purposes of this analysis the JCT defined income as adjusted gross income (AGI) plus the following: (1) tax-exempt interest; (2) employer contributions for health plans and life insurance; (3) employer share of FICA tax; (4) worker's compensation; (5) nontaxable Social Security benefits; (6) insurance value of

Medicare benefits; (7) alternative minimum tax preference items; and (8) excluded income of U.S. citizens living abroad. Categories are measured at 2009 levels.

b. The federal taxes taken into account by the JCT include the individual income tax (including the outlay portion of refundable credits), employment tax (attributed to employees), and excise taxes (attributed to consumers).

c. The difference in column 3 equals column 1 minus column 2. A negative difference means that the tax cut under the Administration proposal is larger than the tax cut under the Republican proposal. A positive difference means that the tax cut under the Republican proposal is larger than the tax cut under the Administration proposal. Estimates per tax return were rounded to the nearest dollar.

As shown in **Table 2**, under both proposals, the average tax cut per return is larger, the higher the income category. The differences in column 3 indicate that, on average, taxpayers in the eight income categories under $200,000 would receive a lower tax cut under the Republican proposal than the Administration proposal. This ranges from $18 per return less under the Republican proposal for the $50,000 to $75,000 income category, up to $235 per return less in the $10,000 to $20,000 income category.

In contrast, taxpayers in the three income categories above $200,000 would receive a larger tax cut under the Republican proposal than the Administration proposal. The average tax cut per return is estimated to be $409 higher under the Republican proposal for the $200,000 to $500,000 income category, $10,766 higher for the $500,000 to $1 million category, and $97,486 higher for the $1 million and over category.

The income categories below $200,000 receive bigger tax cuts under the Administration proposal compared to the Republican proposal because the Administration proposal would continue the ARRA provisions of expanded eligibility for the child credit and the earned income tax credit (EITC).

In contrast, the income categories above $200,000 receive smaller tax cuts under the Administration proposal than the Republican proposal because of the Administration's upper-income tax provisions. The Administration proposal would not extend the lower EGTTRA tax rates for the top two tax brackets; it would restore the PEP and Pease phaseouts of personal exemptions and certain itemized deductions; and it would raise the maximum capital gains tax rate from 15% to 20%; all of these provisions would apply to high-income taxpayers.

The last line of **Table 3** shows that the JCT's estimate of the total tax cut in 2011, compared with current law, is $202 billion under the Administration proposal (column 1) and $227 billion under the Republican proposal (column 2), or $25 billion more under the Republican proposal (column 3). However, the Republican proposal does not provide a larger tax cut for all of the income categories. The estimated tax cuts for the eight income categories below $200,000 are lower under the Republican proposal than under the Administration proposal. Relative to the Administration proposal, the Republican proposal would provide, in the aggregate, approximately $14 billion less in tax cuts to taxpayers in the income categories below $200,000, and $39 billion more in tax cuts to taxpayers in the income categories above $200,000, for a net difference of $25 billion between the two proposals.

Table 3. JCT Estimates for 2011 of Reduction in Taxes Relative to Present Law Under the Administration and Republican Proposals: Aggregate Dollar Amounts by Income Category

	(dollar amounts in millions)			(in thousands)
	(1)	(2)	(3)	(4)
Income Category[a]	**Under the 2010 PAYGO Act (Administration Proposal)[b]**	**Under Permanent Extension of All 2001 and 2003 Bush Tax Cuts (Republican Proposal)[b]**	**Difference (Administration Proposal Minus Republican Proposal)[c]**	**Number of Tax Units[d]**
Less than $200,000	-170,891	-157,130	-13,761	156,369
$200,000 to $500,000	-25,333	-26,871	1,538	3,757
$500,000 to $1,000,000	-4,074	-10,620	6,546	608
$1,000,000 and over	-2,000	-32,708	30,708	315
Total, All Taxpayers	-202,298	-227,329	25,031	161,049

Source: Joint Committee on Taxation, unpublished memorandum on Distributional Analysis, July 30, 2010, Table #D-10-06 for 2010 PAYGO Act; Table #D-10-05 for Permanent extension of all 2001 and 2003 tax cuts; and Table #D-10-08 for number of tax units. The memorandum is included as a TaxCore document attached to the article by Brett Ferguson and Heather M. Rothman, "New JCT Analysis Examines Democratic, Republican Proposals on Bush-Era Tax Cuts," BNA (Bureau of National Affairs), *Daily Tax Report*, no. 154, Aug. 12, 2010, p. G-4. CRS consolidated the data for the eight income categories under $200,000 into one. Difference in column 3 calculated by CRS by subtracting column 2 from column 1.

a. For purposes of this analysis the JCT defined income as adjusted gross income (AGI) plus the following: (1) tax-exempt interest; (2) employer contributions for health plans and life insurance; (3) employer share of FICA tax; (4) worker's compensation; (5) nontaxable Social Security benefits; (6) insurance value of Medicare benefits; (7) alternative minimum tax preference items; and (8) excluded income of U.S. citizens living abroad. Categories are measured at 2009 levels.

b. The federal taxes taken into account by the JCT include the individual income tax (including the outlay portion of refundable credits), employment tax (attributed to employees), and excise taxes (attributed to consumers).

c. The difference in column 3 equals column 1 minus column 2. A negative difference means that the tax cut under the Administration proposal is larger than the tax cut under the Republican proposal. A positive difference means that the tax cut under the Republican proposal is larger than the tax cut under the Administration proposal. Estimates per tax return were rounded to the nearest dollar.

d. Individuals who are dependents of other taxpayers and taxpayers with negative income are excluded from the analysis.

Raising the Tax Rates on High-Income Taxpayers

This section reviews some of the arguments that have been made for and against allowing the top two marginal tax rates to rise.

Arguments For Allowing the Top Rates to Rise

Revenue

According to the Treasury Department estimates presented earlier in **Table 1**, the Obama Administration's set of proposals to raise taxes on upper-income taxpayers would generate $680 billion in additional revenue over the next decade, FY2010-FY2020, relative to the current policy baseline (next to last line of the table, right-hand column). Adopting these upper-income tax proposals would thus reduce the projected revenue loss from extending the Bush tax cuts by roughly 19%—from $3.7 trillion if all the tax cuts were extended (first subtotal, midway down the table), down to $3.0 trillion for extending only the tax cuts other than for high-income taxpayers (last line), over 10 years.

The top rate bracket is responsible for most of the increased revenue. Letting the top marginal tax rate rise from 36% back up to 39.6% alone accounts for nearly half of the revenue Treasury projects from the upper-income tax proposals—$327.4 billion (line A of **Table 1**) out of $679.6 billion, or 48.2%. Letting the second-highest rate rise from 33% back up to 36% accounts for an additional $37.1 billion in revenue (line B)—just 5.4% of the total for the upper-income tax proposals.

Some warn that if the lower tax rates for the two highest rate brackets are extended even temporarily (say in the interest of buttressing the present weak economy), those lower rates are more likely to be extended in the future. To secure this source of additional revenue for the long run, some support letting the top two tax rates rise in 2011, as scheduled under current law.[14]

Ability to Pay

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

As shown in **Table 2** earlier in this report, under the Republican proposal to extend all of the Bush tax cuts (column 2), the estimated average tax cut per return is $103,835 for the $1 million and over income category; $17,467 for $500,000 to $1 million; and $7,152 for $200,000 to $500,000. By contrast, the average tax savings per return are $1,114 for the $50,000 to $75,000 income category; $1,871 for $75,000 to $100,000; and $3,690 for $100,000 to $200,000.

Note that the three income categories over $200,000 are projected to receive the largest average tax cuts under the Administration proposal as well as the Republican proposal, although at more modest amounts of around $6,600 per return (column 1). This occurs even if the top two tax rates increase, because taxpayers in the those brackets would still benefit from the extension of lower marginal tax rates on income below $200,000 or $250,000 under the Administration proposal.

[14] See, for example, Chuck Marr, *Letting High-Income Tax Cuts Expire is Proper Response to Nation's Short- and Long-Term Challenges*, Center on Budget and Policy Priorities, July 26, 2010. Available at http://www.cbpp.org/cms/index.cfm?fa=view&id=3241.

In another CRS report, Thomas Hungerford found that reducing the top tax rates largely benefited the top 1% of the income distribution. Hungerford found that reducing the tax rates to 33% and 35% in the top two tax brackets increased the after-tax income of the richest 1% of the population by 1.3%. It raised the after-tax income of the next-richest 4% (the 95^{th} to 99% percentiles) by 0.1% (one-tenth of one percent). It made no change in the after-tax income of the remaining 95% of the population. Further, the lower tax rates for the highest-income scored as the most regressive component of the Bush tax cuts (favoring high-income taxpayers relative to low-income taxpayers) according to Hungerford's measurement of the Suits index (-0.7979, where -1.0 is considered completely regressive).[15]

The Rich are Less Likely to Spend Their Tax Savings

To help stimulate the economy, a tax cut needs to be spent, not saved. Empirical evidence suggests that lower-income people spend a higher fraction of any additional dollar they receive than higher-income people do.[16] This evidence suggests that a dollar of tax cut received by a lower-income taxpayer should result in a larger increase in consumer spending than a dollar of tax cut received by a higher-income taxpayer.[17] Applied in reverse, this argument suggests that taxing a high-income taxpayer an additional dollar should dampen consumer spending less than collecting an additional dollar of tax from a low- or middle-income taxpayer.

High-Income Earners Not Expected to Reduce Their Work Effort Much

Raising the marginal tax rates for the top two brackets is not expected to cause much reduction in work effort by high-income taxpayers.[18] In particular, hard-driving professionals, executives, and business owners are not expected to reduce their work effort much in response to a small increase in their marginal tax rate.[19]

Arguments Against Allowing the Top Rates to Rise

Bad Timing in a Weak Economy

Many argue that, during this weak economic recovery, it is a bad time to raise taxes on any income group, including high-income taxpayers, because it is likely to reduce the income

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[15] CRS Report R41393, *The Bush Tax Cuts and the Economy*, by Thomas L. Hungerford, section on "Distributional Effects of the Bush Tax Cut Provisions," including Table 2.

[16] Economists say that lower-income people have a higher "marginal propensity to consume" from additional income. The high propensity of low- and middle-income people to spend their income has fallen somewhat since mid-2008. During the economic boom period through mid-2008, many consumers were spending more than their income—by taking out home equity loans and running up their credit card debt. In contrast, during the recent recession, many consumers have been paying down their credit card and other debt. In the economic statistics, paying down debt counts as saving, not spending. The pay-down of consumer debt has thus contributed to the measured increase in the national savings rate.

[17] CRS Report RS21126, *Tax Cuts and Economic Stimulus: How Effective Are the Alternatives?*, by Jane G. Gravelle, proposition 1 on p. 2.

[18] In economists' jargon, they are expected to have a low "elasticity of labor supply" with respect to taxes.

[19] Joel B. Slemrod, ed., Does Atlas Shrug?: The Economic Consequences of Taxing the Rich, Russell Sage Foundation, 2000.

available for consumer spending. Even if rich people have a lower marginal propensity to consume than lower-income people, they are still likely to spend some of their additional income. This is an argument for extending the lower tax rates for the two highest brackets at least temporarily.

Cut Spending Instead of Raising Taxes

Raising taxes on high-income taxpayers could be bad for long-run economic growth as well. Instead of permitting taxes to rise, total federal revenues should be kept near their historic level of approximately 18.5% of GDP. To reduce the deficit, federal spending should be cut from its current level of roughly 25% of GDP, back to its historic level of roughly 20% of GDP. In this view, the federal government's share of the national economy should return to its historic level, which is among the lowest for the world's industrialized nations.[20]

New Medicare Surtaxes on Wage and Investment Income of High-Income Taxpayers Were Recently Enacted

High-income taxpayers will already be subject to higher tax rates on both their wage and investment income, as the result of two separate surtaxes enacted in March 2010 as part of health care reform legislation, to help finance Medicare. Both taxes are scheduled to take effect in 2013. Under provisions of the Patient Protection and Affordable Care Act (PPACA, P.L. 111-148), enacted on March 23, 2010, an additional payroll tax of 0.9% will be levied on wages over $200,000 for single filers and over $250,000 for joint filers. Consequently, under a simple extension of the Bush tax rates, taxpayers in the top two brackets would face a combined federal tax rate of 33.9% and 36.9% on their wage income starting in 2013. If the Administration proposal to permit the top two marginal tax rates to return to 36% and 39.6% were adopted, taxpayers in these brackets would face a combined federal income tax rate of 36.9% and 40.5%, respectively, on their wage income starting in 2013.

In addition, the Health Care and Education Reconciliation Act of 2010 (P.L. 111-152), enacted a week later on March 30, 2010, provided for a special 3.8% income tax on net investment income for taxpayers with modified adjusted gross income over $200,000 for single filers, $250,000 for joint filers, and $125,000 for married people filing separately, to help finance Medicare, also starting in 2013. This new law defines net investment income to include interest, dividends, non-qualified annuities, royalties, rents, and taxable net capital gains, among others.[21] As a consequence, even under the Republican proposal to extend the 15% top rate on capital gains and dividends, high-income taxpayers would face a combined federal income tax rate of 18.8% on their capital gains and dividend income starting in 2013. If the Administration proposal to raise

[20] J.D. Foster, *Obama Tax Hikes Defended by Myths and Straw Men*, The Heritage Foundation, Backgrounder No. 2454, Aug. 26, 2010. Available at http://report.heritage.org/bg2454.

[21] The 3.8% tax will be imposed on the lesser of (1) net investment income for the taxable year or (2) the excess of modified adjusted gross income (MAGI) over $250,00 for joint filers, $125,000 for married filing separately, and $200,000 for all other returns (including singles and heads of households). Taxpayers who have investment income, but whose MAGI is below these thresholds, will not be subject to this Medicare contribution tax on unearned income.

For more information, see CRS Report R41128, *Health-Related Revenue Provisions in the Patient Protection and Affordable Care Act (PPACA)* , by Janemarie Mulvey, section on "Unearned Income Medicare Contribution," and CRS Report R41413, *The 3.8% Medicare Contribution Tax on Unearned Income, Including Real Estate Transactions*, by Mark P. Keightley.

the tax rate on capital gains and dividends from 15% to 20% for high-income taxpayers were adopted, these taxpayers would face a combined federal tax rate of 23.8% on their capital gains and dividend income starting in 2013.

Higher Tax Rates Would Encourage Shift toward Lower-Taxed Forms of Compensation

Higher tax rates could lead high-paid employees to request that a greater portion of their compensation be paid in the form of nontaxable fringe benefits. Further, stock bonuses taxed at capital gains rates would look even more attractive than pay raises taxed at ordinary income rates.[22]

At 36% and 39.6%, the top two individual tax rates would once again be higher than the top corporate income tax rate of 35%—for the first time in 10 years. The tax rate differential could encourage more small firms to organize themselves as a C corporation rather than a pass-through entity such as a partnership, limited liability company, sole proprietorship, or S corporation. Corporate profits distributed initially as dividends, and perhaps later as capital gains, would be taxed at the lower capital gains and dividend rate of 15% if the Bush tax cut were extended, or 20% if the Obama Administration proposal to raise the top dividend and capital gains rate were adopted.[23]

Negative Incentive for Small Business

A frequent criticism of the Obama Administration's proposal to allow the two highest income tax rates to return to their 2001 levels of 36% and 39.6% is that it would hinder small business formation, investment, and growth. Many successful small business owners are thought to be in the top tax brackets. Higher tax rates in the top brackets would thus be expected to discourage owners of existing businesses from expanding their businesses and hiring more employees, and to discourage potentially high-income taxpayers from forming new businesses.[24]

The Urban-Brookings Tax Policy Center (TPC) used its microsimulation model to project the distribution, by marginal tax bracket, of small business income expected to be reported on individual income tax returns filed for calendar year 2011. The TPC projections assume that the Obama Administration's proposals to raise taxes for upper-income taxpayers starting in 2011 are enacted.

Table 4 presents summary statistics which include two seemingly contradictory numbers that have been cited by Members of Congress and the press. The TPC projected that just 2.2% of tax units reporting positive business income would be in the top marginal rate bracket of 39.6%; but these taxpayers are projected to account for 40.3% of the total positive business income reported from small businesses for tax year 2011. Positive business income is projected to contribute one-

[22] CRS Report RL31458, *Employee Stock Options: Tax Treatment and Tax Issues*, by James M. Bickley.

[23] See the section on "Legal Form of Business Organization" in CRS Report R41085, *Distribution of Small Business Ownership and Income by Individual Tax Rates and Selected Policy Issues* , by Gary Guenther.

[24] For a longer discussion, see CRS Report R41085, *Distribution of Small Business Ownership and Income by Individual Tax Rates and Selected Policy Issues* , by Gary Guenther.

third (33.4%) of the adjusted gross income (AGI) reported for the top tax bracket as a whole, including tax returns without business income as well. (See the row labeled 39.6.)

The TPC projected that the second-highest rate bracket of 36% would include just 1.0% of all tax units with business income and 4.0% of the total positive business income reported. Business income was projected to contribute one-quarter (26.3%) of the AGI for the 36% rate bracket as a whole. (See the row labeled 36.)

The link between small business and employment or job-creation is open to debate. Many small businesses are sole proprietorships with no employees, or only one or two employees.[25] Even if they do not employ many workers, however, small businesses can still generate income for the economy and tax revenue for the government.

Table 4. Distribution of Small Business Income by Marginal Tax Rate: Projections for 2011 by the Tax Policy Center

Baseline: Current policy plus the Administration's upper-income tax proposals

Statutory Marginal Income Tax Rate (%)	Percent of Total Tax Units Reporting Positive Business Income	Percent of Total Positive Business Income Reported	Positive Business Income as a Percentage of Total AGI for All Tax Units in the Rate Bracket
Non-filers	2.9	0.3	6.2
0	26.0	6.2	25.5
10	14.4	4.8	7.6
15	27.8	11.8	4.4
25	16.4	11.9	4.8
26 (AMT)	2.6	3.9	7.9
28 (regular)	3.4	5.0	9.7
28 (AMT)	3.4	11.8	16.3
36	1.0	4.0	26.3
39.6	2.2	40.3	33.4
All	100.0	100.0	10.9
Total amount	24.1 million units	$962.5 billion	—

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0509-5), preliminary results, Table T10-0186, July 27, 2010.

Notes: The Tax Policy Center defined a small business owner as any tax-filer reporting income or loss on Schedule C (self-employment income), Schedule E (income from rents, royalties, partnerships, limited liability companies, and S corporations), or Schedule F (income from farming). The numbers reported in this table are based on the subset of tax units reporting positive business income: specifically, taxpayers for whom the sum of income and losses on Schedules C, E, and F is positive.

The Administration's upper-income tax proposals taken into account by the TPC include reinstating the 39.6% rate; reinstating the 36% rate for married taxpayers with income over

[25] For a detailed discussion of this topic, see CRS Report R41392, *Small Business and the Expiration of the 2001 Tax Rate Reductions: Economic Issues*, by Jane G. Gravelle.

$250,000 ($200,000 for singles); reinstating the limitation on itemized deductions and the personal exemption phase-out for married taxpayers with income over $250,000 ($200,000 for singles); and imposing a 20% tax rate on capital gains and qualified dividends for taxpayers in the top two tax brackets.

The alternative minimum tax (AMT) warrants attention in the debate over the top regular income tax rates and their possible effect on small business. As shown in **Table 4**, the Tax Policy Center projected for 2011 that slightly more tax units with small business income would face the top AMT rate of 28% (3.4% of those tax units) than either of the top two regular tax rates of 36% or 39.6% (3.2% of those tax units). Furthermore, tax returns in the 28% AMT rate bracket are estimated to account for 11.8% of the total positive business income reported. (See the row labeled 28 (AMT).) This is nearly three times the 4.0% share of business income projected for the regular 36% rate bracket.

Higher Tax Rates Increase Economic Distortions and Tax Evasion

Tax economists generally prefer a tax with a low rate. That preference is because the distortions and inefficiencies in economic behavior caused by a tax—including tax evasion—are expected to increase, the higher the tax rate.[26]

Tax Rates on Capital Gains and Dividends

There is a long history of lower tax rates for capital gains. But the lower rate for dividends was introduced with JGTRRA of 2003, as explained under the next heading, “Recent Law.”

The Republican proposal for extending the full package of Bush tax cuts includes extending the 15% rate on capital gains and qualified dividends for taxpayers in the regular marginal tax rate brackets of 25% and above (the 25%, 28%, 33%, and 35% rate brackets), and extending the 0% capital gains and qualified dividends rate for taxpayers in the 10% and 15% rate brackets for regular income. An argument could be made for extending JGTRRA’s initial 5% rate for the two lowest brackets, instead of the 0% rate, as part of extending the Bush tax cuts.

The Obama Administration’s proposal would permanently extend the current capital gains and dividends tax rates of 15% and 0% for middle-class taxpayers—defined as taxpayers with adjusted gross income (AGI) below $200,000 for single individuals and below $250,000 for married couples filing jointly. But the Administration proposal would permanently raise the tax rate on capital gains and dividends from 15% to 20% for single taxpayers with AGI over $200,000 and married joint filers with AGI over $250,000. (These taxpayers would be in the 36% or 39.6% marginal tax rate bracket for ordinary income under the Administration proposal.)[27]

[26] Standard economic analysis shows that the economic distortions have been found to increase in proportion to the square of the tax rate (t^2). For example, if the tax rate is 10%, the square of the tax rate is .10 x .10 = .01. If the tax rate is 25%, the square of the tax rate is .25 x .25 = .0625. If the tax rate is 50%, the square of the tax rate is .50 x .50 = .25. Thus, while a 50% tax rate is 5 times the size of a 10% tax rate, the distortion associated with a 50% rate is 25 times as large—.25 compared to .01.

[27] The Administration has also proposed repealing the 18% and 8% rates on capital gains from the sale of assets held over five years, which were in effect prior to JGTRRA.

Recent Law

The Tax Reform Act of 1986 (P.L. 99-514), which lowered tax rates overall, provided for only two rate brackets under the individual income tax—15% and 28%. Capital gains and dividends were taxed at the same rates as ordinary income.

Immediately prior to JGTRRA of 2003, individuals in the 15% regular income tax bracket paid a 10% tax rate on long-term capital gains (on assets held over one year and up to five years). Individuals in all of the higher regular income tax rate brackets paid a 20% rate on long-term capital gains. Gains on property held for more than five years were taxed at 8% and 18%, respectively. There was no reduced rate on dividends: dividends were taxed at ordinary income tax rates.

Under provisions of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA, P.L. 108-27), the tax rate on capital gains was lowered from 20% to 15% for taxpayers with a marginal tax rate on regular income of 25% or higher. JGTRRA also extended the capital gains tax rates to income from qualified dividends.

For taxpayers in the 10% or 15% rate brackets for regular income, JGTRRA initially lowered the capital gains tax rate from 10% to 5% and applied that rate to qualified dividend income as well. The 5% rate was in effect from May 3, 2003, through tax year 2007. For tax year 2008, JGTRRA further lowered the tax rate on capital gains and dividends from 5% to 0%—that is, no tax at all on long-term capital gains and dividend income—for taxpayers in the 10% or 15% marginal rate bracket on their regular income. The capital gains and dividends provisions of JGTRRA were extended for two years (from year-end 2008 through year-end 2010) by the Tax Increase Prevention and Reconciliation Act of 2005 (P.L. 109-222).

Historical Justifications

For a long time, the tax code has contained either a percentage exclusion or lower tax rate for income from long-term capital gains. Over time, this treatment has been justified in several ways. One common justification for a lower effective tax rate on capital gains is to compensate for inflation in the price of assets held over a long period of time. Another justification is to compensate for the inability of taxpayers to income-average over several years to avoid being thrown into a higher tax bracket because of a large one-time capital-gain realization. More recently, the Taxpayer Relief Act of 1997 (P.L. 105-34) provided a lower tax rate for capital gains, with the expressed objectives to increase saving and risk-taking, and to reduce lock-in—the phenomenon of people holding on to assets to avoid having to pay tax if they sold them.

Similarly, it has long been argued that the taxation of dividends represents double taxation of corporate income. That is, corporate income is first subject to the corporate income tax. Then, when corporate income is distributed to shareholders as dividends, it is subject to the individual income tax. The lower tax rate on dividends is an attempt to redress this double taxation.

The stated rationale for lower tax rates on both capital gains and dividends under JGTRRA was to encourage business investment and growth. High taxes on dividends were seen as encouraging businesses to use debt finance instead of equity, and to retain earnings rather than distribute them as dividends to shareholders.[28]

Analysis

Extending the current lower tax rates for qualified dividends is projected to cost over twice as much as extending the same lower tax rates for capital gains. According to Treasury Department estimates shown in **Table 1**, earlier in this report, extending the 0% and 15% rates on capital gains would cost $1.5 billion for the 2012 fiscal year (first column, item 4). In comparison, extending the lower rates on dividends would cost $4.1 billion (item 3) for FY2012, well over twice as much. Cumulatively over the next 10 fiscal years through FY2020, Treasury estimated that extending the lower rates on capital gains would cost $112.1 billion (second column of **Table 1**, item 4). In comparison, extending the lower rates on dividends would cost just over twice as much over 10 years—$235.5 billion (item 3). This approaches the estimated 10-year cost of extending 2009 estate tax law—$264.5 billion (item 2).

The lower tax rates on capital gains and dividends favor high-income taxpayers: they are the ones most likely to receive income from capital gains and dividends. Internal Revenue Service (IRS) data collected from individual income tax returns filed in 2008 show that the vast majority of capital gains[29] and a very high fraction of dividend income are reported by taxpayers in the highest AGI classes. As shown in **Table 5**, taxpayers with adjusted gross income (AGI) of $250,000 or more accounted for 81.4% of the net capital gains and 54.6% of the qualified dividends reported on tax returns filed in 2008. In contrast, this top income category accounted for 35.8% of all capital gain distributions (which typically come from mutual fund investments) and 33.6% of taxable interest reported.[30]

In contrast, taxable interest is the main source of investment income for taxpayers with AGI (adjustable gross income) less than $100,000. (See the first two rows of **Table 5**.) These taxpayers are at a disadvantage in a system that taxes interest at ordinary income rates, but dividends and capital gains at a 15% or zero rate. Furthermore, people who purchase stocks in traditional tax-deferred retirement accounts funded with before-tax contributions (contributions which have been deducted from taxable income), such as traditional IRAs and 401(k)s, do not receive the advantage of lower tax rates on capital gains and dividends. Money withdrawn from these retirement accounts is subject to ordinary income tax rates.[31]

Another way to collect more tax from high-income people would be to tax these two important sources of their income at—or closer to—ordinary income tax rates, and not at special reduced tax rates. The Treasury Department estimated that the Administration proposal to raise the tax rate

[28] The lower tax rates on capital gains and dividends are both classified as tax expenditures. U.S. Congress, Senate, Committee on the Budget, *Tax Expenditures*, prepared by the Congressional Research Service, 110th Cong., 2nd sess., S.Prt. 110-667, Dec. 2008, pp. 392.

[29] Most capital gains come from sales of corporate stock and sales of business and rental real estate. U.S. Congress, Senate, Committee on the Budget, *Tax Expenditures*, prepared by the Congressional Research Service, 110th Cong., 2nd sess., S.Prt. 110-667, Dec. 2008, pp. 390-391.

[30] For a more detailed analysis, see CRS Report R41394, *Tax Treatment of Long-Term Capital Gains and Dividends and Related Provisions in the President's FY2011 Budget Proposal*, by Mark P. Keightley.

[31] There is no income tax on monies withdrawn during retirement from a Roth IRA account—the type of retirement account funded by after-tax contributions from the individual (contributions from income on which tax has been paid).

on capital gains and dividends from 15% to 20% for high-income taxpayers would raise $107 billion in additional revenue over 10 years.[32] (See **Table 1**, item E.) Raising the rate on high-income taxpayers to 20% could thus reduce the net cost of extending lower rates on capital gains and dividends by 30%—from $348 billion down to $241 billion, cumulatively for fiscal years 2010 to 2020.[33]

Table 5. Percentage Distribution by AGI Class of Income from Taxable Interest, Qualified Dividends, Net Capital Gains, and Capital Gain Distributions

For individual income tax returns filed in 2008

AGI Class	Taxable Interest	Qualified Dividends	Net Capital Gains	Capital Gain Distributions[a]
Under $50,000	23.8%	10.1%	5.0%	17.0%
$50,000 - $100,000	20.8	13.3	4.2	20.2
$100,000-$200,000	17.7	17.4	6.9	21.7
$200,000-$250,000	4.1	4.6	2.5	5.4
$250,000 and over	33.6	54.6	81.4	35.8
Total	100.0	100.0	100.0	100.0
Total Income Reported (in $ billions)	**$197.2**	**$144.8**	**$446.6**	**$22.0**

Source: Michael Parisi, "Individual Income Tax Returns, Preliminary Data, 2008," Internal Revenue Service, *Statistics of Income Bulletin*, Winter 2010, Washington, D.C., Table 1, p. 12. Percentages calculated by CRS.

a. Capital gain distributions from mutual funds.

Tax economists are wary of taxing different types of income at different tax rates. Unequal rates encourage taxpayers to re-characterize or convert income from a high-taxed category into a lower-taxed one, when possible. This behavior is referred to formally as "tax arbitraging" or, in more common parlance, as "gaming the tax system." How the "carried interest" earnings of partners in hedge funds should be taxed is an example that has received considerable attention in

[32] A CRS analysis concluded that both the Joint Committee on Taxation (JCT) and the Treasury Department estimates of the additional revenue that would be generated by permitting the tax rates on capital gains to rise are likely to be on the low side, because of the large behavioral responses from taxpayers that these organizations assumed. That is, both JCT and Treasury assumed that there would be a big decline in the amount of assets sold by taxpayers, and consequently in the dollar amount of capital gains realized, if the top capital gains tax rate increased from 15% to 20%. Lower capital gains realizations mean a lower amount of tax revenue at any given capital gains tax rate. JCT and Treasury assumed a larger decline in capital gains realizations than other studies have found.

The CRS report surveys a large number of studies that have used different methods to estimate the additional revenue expected from permitting the tax rate on capital gains to rise. The methods differ principally in their assumption about the size of the "realizations response" or "elasticity," also described as the "behavioral response." In this case, the elasticity is a measurement that summarizes the dollar amount by which capital gains realizations (on the sales of capital assets held long-term) change in response to a change in the tax rate on capital gains. CRS Report R41364, *Capital Gains Tax Options: Behavioral Responses and Revenues*, by Jane G. Gravelle.

[33] Calculated from numbers in the last column of **Table 1**, presented earlier in this report. Line E ($106.7 billion) is the additional revenue expected from the Administration's proposed 20% rate on capital gains and dividends for high-income taxpayers. This is divided by $347.6 billion, which is the sum of line 3 (a loss of $235.5 billion in revenue from extending the current lower rates on dividends) plus line 4 (a loss of $112.1 billion from extending the current lower rates on capital gains). The minus signs indicating revenue loss are disregarded; the "absolute value" of the number is used.

the past few years. The essence of that debate is whether carried interest is considered compensation for services—which would be taxed as ordinary income under several proposals—or an interest in the partnership's capital—which would be taxed as capital gains, as under current law.[34] Another example, being discussed in anticipation of the possible expiration of the Bush tax cut for dividend income, is the possibility of converting dividends into capital gains.[35]

Capital gains and qualified dividends would be taxed at lower rates than ordinary income, both under an extension of current policy and under the Obama Administration's proposal for 2011 and beyond. Under the Obama Administration's proposal to raise the maximum ordinary income rate to 39.6% and the maximum capital gains and dividend rate to 20%, the top tax rate on labor income and interest would be double the top rate on capital gains and dividends. Under current policy, it is more than double—with a 35% top rate on ordinary income and a 15% top rate on capital gains and dividends.

[34] CRS Report RS22717, *Taxation of Private Equity and Hedge Fund Partnerships: Characterization of Carried Interest*, by Donald J. Marples.

[35] See, for example, Robert Willens, "New Attention Likely for Companies Paying 'Capital Gain' Dividends," *Daily Tax Report*, no. 158, Aug. 18, 2010, p. J-1.

Appendix A. Comparison of the Bush Tax Cuts, Prior Law, and the Obama Administration Proposal, by Tax Provision

Table A-1 lists the major components of the Bush tax cuts. For each tax provision, the first column presents the law that is in effect for 2010, but which is scheduled to expire on December 31, 2010. The middle column presents the law that was in effect prior to the Bush tax cuts of 2001 and 2003 and which will take effect again on January 1, 2011, if no new tax law is enacted beforehand. The last column presents the proposal included in the Obama Administration's FY2011 budget, submitted in February 2010. The Administration's proposals are intended to take effect January 1, 2011.

Table A-1. Bush Tax Cuts, Prior Law, and Obama Administration Proposal

Bush Tax Cut Provision	Bush Tax Cuts: Law in 2010, Scheduled to Expire 12/31/10	Prior Law: Scheduled to Resume in 2011	Obama Administration Proposal: To Take Effect in 2011
Income Tax Rates and Brackets			
Create 10% bracket	First $8,375 of taxable income for singles, $16,750 for couples (indexed)	10% bracket expires	Retain 10% bracket
Reduce tax rates in top four tax brackets	35%	39.6%	39.6%
	33%	36%	36%[a]
	28%	31%	28%[b]
	25%	28%	25%
Reduce tax rates on capital gains and dividends	15% or 0%, depending on other income; from 2003 through 2007 the lower rate was 5%	Maximum of 20% on capital gains; regular tax rate on dividends	20% top rate on capital gains; taxpayers in top two brackets would pay 20% on dividends; 0% and 15% rates would continue for lower tax brackets
Limits on Itemized Deductions and Personal Exemptions			
Eased limits on itemized deductions and personal exemptions	No limits in 2010 only	Pease and PEP limits reinstated	Pease and PEP limits reinstated; itemized deductions capped at a 28% rate for taxpayers in the top two brackets
Provisions for Children and Married Couples			
Increase child tax credit	$1,000 credit per child	$500 credit per child	$1,000 credit per child
Expand refundability of child tax credit	Refundable up to 15% over income threshold of $3,000	Provisions of both EGTRRA and ARRA expire	Refundable up to 15% over income threshold of $3,000

Bush Tax Cut Provision	Bush Tax Cuts: Law in 2010, Scheduled to Expire 12/31/10	Prior Law: Scheduled to Resume in 2011	Obama Administration Proposal: To Take Effect in 2011
Increase dependent care credit	Maximum eligible expenses of $3,000 for one child and $6,000 for two or more children. Maximum credit rate of 35% phases down as AGI rises above $15,000; minimum credit rate of 20% applies to taxpayers with AGI over $43,000.	Maximum eligible expenses of $2,400 for one child and $4,800 for two or more children. Maximum credit rate of 30% phases down as AGI rises above $10,000; minimum credit rate of 20% applies to taxpayers with AGI over $28,000.	Maximum eligible expenses of $3,000 for one child and $6,000 for two or more children. Maximum credit rate of 35% phases down as AGI rises above $85,000; minimum credit rate of 20% applies to taxpayers with AGI over $113,000.
Increase standard deduction for married couples	Deduction for couples is 200% (double) the deduction for singles	Deduction for couples is 167% (one and two-thirds) the deduction for singles	Deduction for couples is 200% (double) the deduction for singles
Expand 15% bracket for married couples	Maximum income for couples is 200% (double) the maximum for singles	Maximum income for couples is 167% (one and two-thirds) the income for singles	Maximum income for couples is 200% (double) the maximum for singles
Increase in EITC phase-out income for married couples	Increase by $5,000 in 2009, indexed for inflation for 2010	No increase	Increase the beginning and ending points of the EITC phaseout by $5,000, indexed for inflation
Small Business Provisions			
Increase the maximum amount (from $125,000 to $250,000) and phaseout threshold (from $500,000-indexed, to $800,000-not indexed) under section 179 expensing for small business (instead of depreciation deductions)	Maximum amount $250,000, phaseout threshold $800,000, not indexed	Maximum amount $25,000, phaseout threshold $200,000, not indexed	Maximum amount $125,000, phaseout threshold $500,000, both indexed for inflation
Alternative Minimum Tax (AMT)			
Increase AMT exemption for singles/ couples	For 2009: $46,700/$70,950. For 2010,reverts to $33,750/$45,000 unless an "AMT patch" is enacted.	Reverts to $33,750/$45,000 unless an "AMT patch" is enacted.	Adjust the 2009 AMT exemption for inflation
Estate Tax			
Raise exemption, reduce top tax rate	For 2009, $3.5 million exemption per decedent, 45% top tax rate. For 2010 only, no estate tax.	$1.0 million exemption per decedents, 55% top tax rate.	Restore 2009 levels of a $3.5 million exemption per decedent and a top tax rate of 45%

Source: Bush tax cuts in 2010 and current law for 2011, CRS Report R41111, *Expiration and Extension of the Individual Income Tax Cuts First Enacted in 2001 and 2003: Background and Analysis*, by James M. Bickley, updated by James M. Bickley, appendix table, pp. 13-14. Obama Administration proposal, U.S. Executive Office of the President, Office of Management and Budget, *Analytical Perspectives, Budget of the U.S. Government, Fiscal Year 2011*, Washington, February 2010, Chapter 14 "Governmental Receipts," pp. 159-192. U.S. Congress, Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2011 Budget Proposal*, JCS-2-10, 111th Cong., 2nd sess., Aug. 16, 2010.

a. The Administration proposal would raise the bottom of the 36% bracket to exclude adjustable gross income up to $250,000 for married couples. For head-of-household filers the starting point of the 36%

bracket would be midway between the starting points for single filers and married joint filers, rounded down to the nearest $50.

b. The Administration proposal would raise the top of the 28% bracket to include adjustable gross income up to $200,000 for single individuals.

Appendix B. Income Tax Rate Schedules for 2010

Table B-1. 2010 Tax Rate Schedule for Single Individuals

Unmarried individuals other than qualifying widow(er)s and heads of household

If taxable income is		The tax is		
Over	But not over	Base amount	Plus: Marginal tax rate	Of the amount over
$0	$8,375	$0	10%	$0
$8,375	$34,000	$837.50	15%	$8,375
$34,000	$82,400	$4,681.25	25%	$34,000
$82,400	$171,850	$16,781.25	28%	$82,400
$171,850	$373,650	$41,827.25	33%	$171,850
$373,650		$108,421.25	35%	$373,650

Table B-2. 2010 Tax Rate Schedule for Married Filing Jointly

and qualifying widow(er)s

If taxable income is		The tax is		
Over	But not over	Base amount	Plus: Marginal tax rate	Of the amount over
$0	$16,750	$0	10%	$0
$16,750	$68,000	$1,675.00	15%	$16,750
$68,000	$137,300	$9,362.50	25%	$68,000
$137,300	$209,250	$26,687.50	28%	$137,300
$209,250	$373,650	$46,833.50	33%	$209,250
$373,650		$101,085.50	35%	$373,650

Table B-3. 2010 Tax Rate Schedule for Head of Household

If taxable income is		The tax is		
Over	**But not over**	**Base amount**	**Plus: Marginal tax rate**	**Of the amount over**
$0	$11,950	$0	10%	$0
$11,950	$45,550	$1,195	15%	$11,950
$45,550	$117,650	$6,235	25%	$45,550
$117,650	$190,550	$24,260	28%	$117,650
$190,550	$373,650	$44,672	33%	$190,550
$373,650		$105,095	35%	$373,650

Table B-4. 2010 Tax Rate Schedule for Married Individuals Filing Separate Returns

If taxable income is		The tax is		
Over	**But not over**	**Base amount**	**Plus: Marginal tax rate**	**Of the amount over**
$0	$8,375	$0	10%	$0
$8,375	$34,000	$837.50	15%	$8,375
$34,000	$68,650	$4,681.25	25%	$34,000
$68,650	$104,625	$13,343.75	28%	$68,650
$104,625	$186,825	$23,416.75	33%	$104,625
$186,825		$50,542.75	35%	$186,825

Sources for all four tables in this appendix: U.S. Congress, Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2011 Budget Proposal*, JCS-2-10, 111th Cong., 2nd sess., Aug. 16, 2010, p. 22.

Internal Revenue Service, "2010 Inflation-adjusted values," Rev. Proc. 2009-50, Oct. 15, 2009; also published in *Internal Revenue Bulletin* 2009-45, Nov. 9, 2009; Section 3.01.

Appendix C. Proposed Income Tax Rate Schedules for 2011 under the Obama Administration Proposal

Table C-1. Proposed 2011 Tax Rate Schedule for Single Individuals

Unmarried individuals other than qualifying widow(er)s and heads of household

If taxable income is		The tax is		
Over	**But not over**	**Base amount**	**Plus: Marginal tax rate**	**Of the amount over**
$0	$8,575	$0	10%	$0
$8,575	$34,850	$858	15%	$8,575
$34,850	$84,350	$4,799	25%	$34,850
$84,350	$195,550	$17,174	28%	$84,350
$195,550	$382,650	$48,310	36%	$195,550
$382,650		$115,666	39.6%	$382,650

Table C-2. Proposed 2011 Tax Rate Schedule for Married Filing Jointly

and qualifying widow(er)s

If taxable income is		The tax is		
Over	**But not over**	**Base amount**	**Plus: Marginal tax rate**	**Of the amount over**
$0	$17,150	$0	10%	$0
$17,150	$69,700	$1,715	15%	$17,150
$69,700	$140,600	$9,598	25%	$69,700
$140,600	$237,300	$27,323	28%	$140,600
$237,300	$382,650	$54,399	36%	$237,300
$382,650		$106,725	39.6%	$382,650

Table C-3. Proposed 2011 Tax Rate Schedule for Head of Household

If taxable income is		The tax is		
Over	But not over	Base amount	Plus: Marginal tax rate	Of the amount over
$0	$12,250	$0	10%	$0
$12,250	$46,650	$1,225	15%	$12,250
$46,650	$120,500	$6,385	25%	$46,650
$120,500	$216,400	$24,848	28%	$120,500
$216,400	$382,650	$51,700	36%	$216,400
$382,650		$111,550	39.6%	$382,650

Table C-4. Proposed 2011 Tax Rate Schedule for Married Individuals Filing Separate Returns

If taxable income is		The tax is		
Over	But not over	Base amount	Plus: Marginal tax rate	Of the amount over
$0	$8,575	$0	10%	$0
$8,575	$34,850	$857.50	15%	$8,575
$34,850	$70,300	$4,799.00	25%	$34,850
$70,300	$118,650	$13,661.50	28%	$70,300
$118,650	$191,325	$27,199.50	36%	$118,650
$191,325		$53,362.50	39.6%	$191,325

Sources for all four tables in this appendix: U.S. Congress, Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2011 Budget Proposal*, JCS-2-10, 111th Cong., 2nd sess., Aug. 16, 2010, p. 24.

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