



Federal Tax Policy and the States

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Federal Tax Policy Creates Challenges for States

- AMT
- Repeal of estate tax
- Exploding federal deficits
- Is flat tax or sales tax on second-term agenda?

AMT

- Original target: high-income tax shirkers
- Will become de facto tax for millions of upper-middle income families
- Especially in high-tax states
- Impetus for "tax reform"

For a discussion of the AMT, see Len Burman, William Gale, and Jeff Rohaly, "The AMT: Projections and Problems," *Tax Notes*. July 7, 2003. (Numbers updated for this presentation.)

Determination of AMT Liability Steps 1 and 2 of 5

- Calculate AMT tax base
 - Regular taxable income for AMT purposes
 - + AMT preferences
 - + AMT adjustments
 - = Alternative minimum taxable income
 - Allowable AMT exemption
 - = Line 23 of form 6251 (AMT tax base)
- Calculate pre-credit tentative AMT liability
 - Apply the AMT tax rate schedule and AMT exemption phase-out to the AMT tax base

Burman, Gale, and Rohaly, "The AMT: Projections and Problems," *Tax Notes*. July 7, 2003.

Determination of AMT Liability Steps 3 - 5

- Calculate tentative AMT liability
 - Pre-credit tentative AMT liability
 - Allowable AMT foreign tax credit
 - = Tentative AMT liability

- Calculate regular tax liability for AMT purposes
 - Regular tax before credits (line 40 of the 1040)
 - Taxes due to lump sum distributions
 - Allowable regular foreign tax credits
 - = Regular tax liability for AMT purposes

- Calculate AMT liability
 - AMT is the excess (if any) of tentative AMT liability over regular tax liability for AMT purposes

Burman, Gale, and Rohaly, "The AMT: Projections and Problems," *Tax Notes*. July 7, 2003.

AMT Exemptions and Schedule

Exemption

	<u>2003-4</u>	<u>Beyond 2005</u>	<u>Threshold for Phase-out</u>
Married couples, joint	\$58,000	\$45,000	\$150,000
Singles	\$40,250	\$33,750	\$112,500

Schedule

	<u>\$0 - \$175,000</u>	<u>Above \$175,000</u>
Married couples and singles	26%	28%

Burman, Gale, and Rohaly, "The AMT: Projections and Problems," *Tax Notes*. July 7, 2003. (Numbers updated for this presentation.)

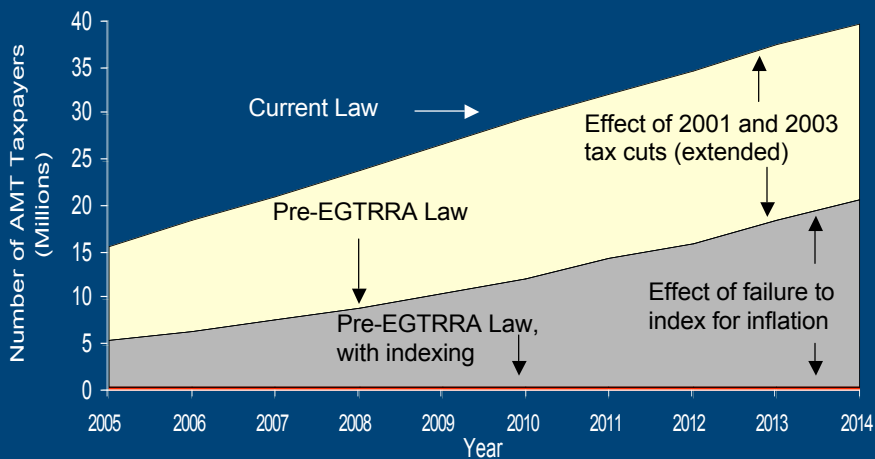


Tax Policy Center Model

- Model similar to CBO, JCT, OTA
- Includes income tax rates, AMT, exemptions, deductions, and credits
- Includes effects of 2001-2003 tax cuts
- Based on 1999 IRS public use file
- 2000-2014 data are obtained by aging the 1999 data based on 2000-2001 actuals and CBO projections



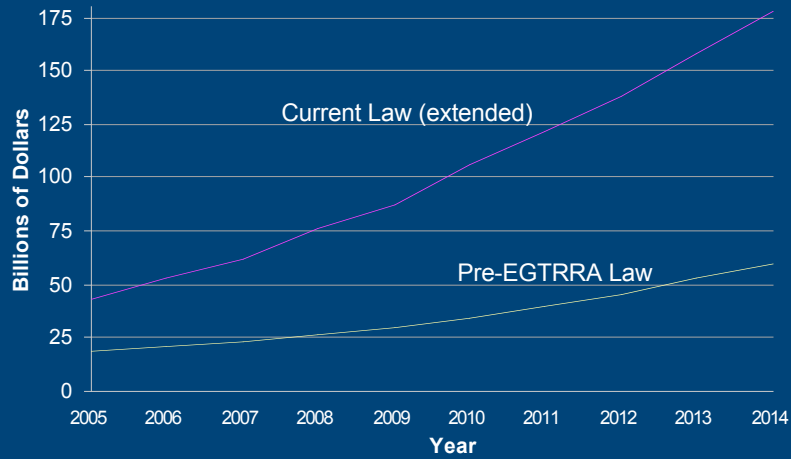
Explosive Growth of AMT



Urban-Brookings Tax Policy Center Microsimulation Model, 2004



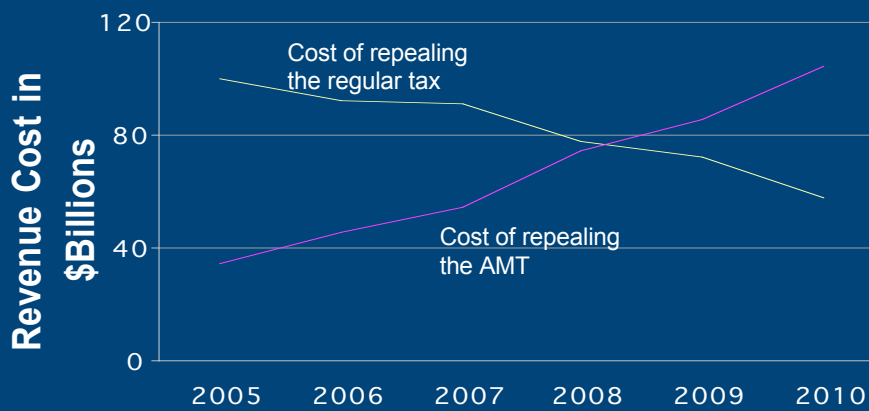
Total AMT Revenue, 2005-14



Urban-Brookings Tax Policy Center Microsimulation Model, 2004



By 2008, it will cost more to repeal the AMT than the regular income tax



Urban-Brookings Tax Policy Center Microsimulation Model, 2004



Aggregate AMT Projections, 2005-2014

	2005	2010	2014	Total 2005-14
Current Law (with EGTRRA and JGTRRA extended)				
Number of Returns (millions)	15.6	29.5	39.8	
As Percent of Taxpayers	17.7	30.5	38.8	
As Percent of Tax Filers	12.5	22.5	29.2	
AMT Revenue				
Total (\$ billions)	43.5	106.3	178.6	1,025.6
Pre-EGTRRA Law				
Number of Returns (millions)	5.6	12.2	20.7	
As Percent of Taxpayers	5.9	12.0	19.4	
As Percent of Tax Filers	4.5	9.3	15.2	
AMT Revenue				
Total (billions)	18.1	34.2	59.9	348.6

Urban-Brookings Tax Policy Center Microsimulation Model, 2004



AMT Projections by Individual Characteristics

Characteristic	Percent on AMT		
	Current Law		Pre-EGTRRA
	2005	2010	2010
Percent of Taxpayers	12.9	29.9	12.0
Percent of Tax Filers	9.3	22.2	9.3
by Filing Status			
Single	1.3	2.8	1.1
Married Filing Joint	18.7	47.1	18.4
Head of Household	3.5	7.7	6.2
Married Filing Separate	18.2	45.0	17.3

Urban-Brookings Tax Policy Center Microsimulation Model, 2004



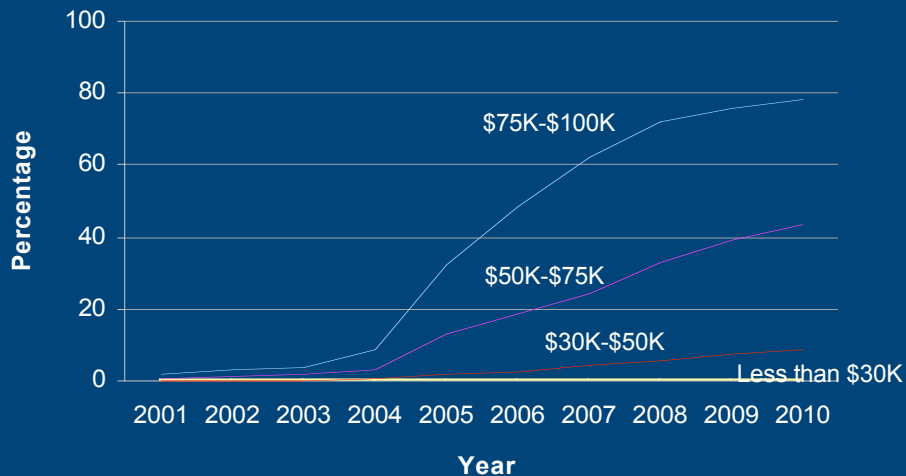
AMT Projections by Individual Characteristics

Characteristic	AMT Participation Rate (percent)		
	Current Law		Pre-EGTRRA Law
	2005	2010	2010
Filers by Number of Children			
0	4.1	15.2	2.7
1	9.9	27.4	9.2
2	23.6	40.3	27.8
3 or more	32.0	47.2	46.7
Filers By State Tax Level			
High	11.0	23.4	11.6
Middle	7.8	22.2	8.5
Low	5.5	18.0	6.7
Filers by Filing Status			
Single	1.3	2.8	1.1
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Urban-Brookings Tax Policy Center Microsimulation Model, 2004



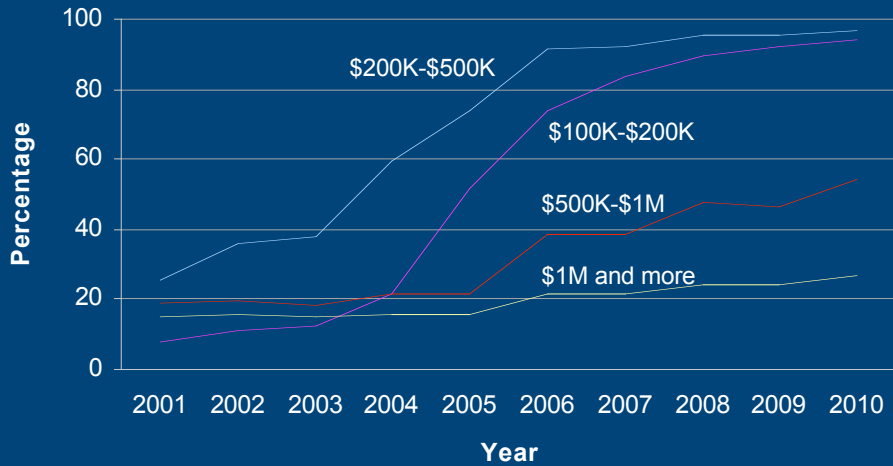
Filers Affected by the AMT Under Current Law, AGI Less than \$100,000, 2001-10



Len Burman, Bill Gale, Jeff Rohaly, and Benjamin Harris. "AMT: Problems and Potential Solutions," Figure 5. Urban-Brookings Tax Policy Center Microsimulation Model, 2002



Filers Affected by the AMT Under Current Law, AGI Greater than \$100,000, 2001-10



Len Burman, Bill Gale, Jeff Rohaly, and Benjamin Harris. "AMT: Problems and Potential Solutions," Figure 5. Urban-Brookings Tax Policy Center Microsimulation Model, 2002



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Effect of the AMT on EGTRRA Income Tax Cuts 2010

Cash Income Class (thousands of 2003\$)	Percent of Tax Filers With No Cut Due to AMT	Percent of Cut Taken Back By AMT
All	2.6	29.4
Less than 30	*	*
30-50	0.3	0.2
50-75	1.8	3.1
75-100	3.3	22.7
100-200	10.9	47.2
200-500	27.2	70.2
500-1,000	10.0	22.8
More than 1,000	8.1	9.2

* Less than 0.05 percent.

Urban-Brookings Tax Policy Center Microsimulation Model, 2004

Reform Options

- Revenue- and distributionally-neutral AMT and income tax changes
- Changes to the AMT on a stand-alone basis
- Changes to the AMT coupled with freeze of EGTRRA income and estate tax cuts
- Revenue-neutral AMT reform



AMT Options: Overview

AMT Status	Number of AMT Taxpayers, 2010 (millions)	Number of Zero-Tax Returns, 2010 (thousands)		Effect on Budget 2005-14 (\$ billions)	
		AGI > \$200K	AGI > \$1,000K	Current Law	01, 03 Cuts Extended
Maintain Current Law	29.2	32.6	2.7		
Plan 1: Index after 2004	3.7	33.8	2.8	-467	-776
Plan 2: Plan 1, plus Allow dependent exemptions	3.0	33.9	2.8	-488	-810
Plan 3: Plan 2, plus Allow deductions for expenses and taxes	0.5	42.5	4.4	-619	-1,002
Repeal after 2004	0.0	77.3	7.6	-710	-1,108
Revenue Neutral Option	5.2	42.5	4.4	109	65

Urban-Brookings Tax Policy Center Microsimulation Model 2004 and authors' calculations.

Repeal of Estate Tax

- Estate tax dies out by 2010, resurrected in 2011
- State death tax credit phased out by 2006
 - Credit made state taxes essentially free source of revenue
 - Many states tie their estate taxes to federal credit, so major loss of revenue for states

State Estate Taxes Pre- and Post-EGTRRA

Update of Pickup Tax	Pickup Tax	Stand-alone + pickup tax		Total
		Inheritance	Estate	
Automatic	28	10	1	39
Legislated	<u>10</u>	<u>0</u>	<u>1</u>	<u>11</u>
Total	38	10	2	50
No estate tax in 2005				28
No estate tax by 2010				32

Sources: Harley T. Duncan, "State Responses to Estate Tax Changes Enacted as Part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)," Federation of Tax Administrators, October 24, 2002; Joel Michael, "State Responses to EGTRRA Estate Tax Changes," *Tax Notes*, April 1, 2004.

States with no Estate Tax in 2005 (black; later in Grey)



Sources: Michael (2004) update of Duncan (2002).

Effects of Repeal

- Will cost states almost \$5 billion in lost revenues in 2007 (Duncan)
- Makes tax system less progressive
- Helps few farmers/small businesses

Distribution of Estate Tax by Economic Income, 2001

Economic Income Class	Percent of Taxable Returns	Percent of Tax	Estate Tax/Income (Percent)
Lowest Quintile	0.0	0.0	0.0
Second Quintile	0.0	0.0	0.0
Middle Quintile	0.3	0.0	0.0
Fourth Quintile	8.0	1.2	0.0
Top Quintile	91.5	98.5	0.4
All	100.0	100.0	0.3
Addendum			
Top 10 Percent	72.2	96.0	0.6
Top 5 Percent	52.7	91.1	0.7
Top 1 Percent	14.7	64.2	0.9
Top 0.5 Percent	8.5	51.8	0.9
Top 0.1 Percent	1.9	26.7	0.8

Urban-Brookings Tax Policy Center Microsimulation Model, 2004

Distribution of Estate Tax by Amount Paid, 2001

Net Estate Tax (\$ thousands)	All Estate Tax Returns			
	Number (thousands)	Percent of Total	Amount (\$millions)	Percent of Total
0	50.8	50.0	0.0	0.0
Less than 10	3.3	3.2	17.1	0.1
10-25	4.4	4.3	75.5	0.3
25-50	6.1	6.0	212.5	1.0
50-100	9.9	9.8	702.5	3.2
100-200	8.6	8.5	1,216.6	5.6
200-500	9.9	9.7	3,320.3	15.3
500-1,000	4.1	4.1	2,849.2	13.1
1,000-2,000	2.9	2.8	4,046.0	18.7
2,000-5,000	1.3	1.3	3,866.2	17.8
More than 5,000	0.4	0.4	5,375.0	24.8
All	101.6	100.0	21,680.8	100.0

Urban-Brookings Tax Policy Center Microsimulation Model, 2004

All Farms and Businesses, 2001

Estate Tax (\$1,000)	All Farms and Businesses ³		
	Number	Percent of Returns	Percent of Tax
0	2,870	71.6	0.0
Less than 100	700	17.5	1.9
100-500	210	5.2	5.6
500-1,000	50	1.2	4.0
1,000-2,000	80	2.0	10.6
2,000-5,000	60	1.5	17.4
More than 5,000	30	0.7	60.5
All	4,010	100.0	100.0

Urban-Brookings Tax Policy Center Microsimulation Model, 2004

Reform Could Save Revenue, Spare All But Largest Estates

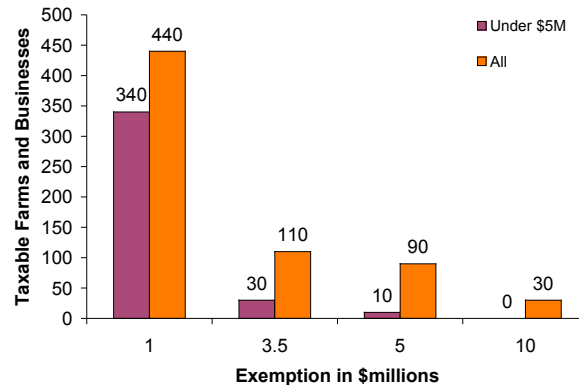
- Estate tax *is* complex
 - In part because of all the loopholes put in place to benefit super-rich
- Vast majority of tax paid by a few very large estates
- Most farms & small businesses easy to exempt

Permanent Options v. Permanent Baseline 10-Year Estate Tax Gain

	Revenue Gain	w/ SDTC
1. \$3.5M Ex, 45% Top Rate	68.1	15.8
2. Option 1 Plus Index	53.7	4.3
3. \$5M Ex, 35% Top Rate	1.0	-44.5
4. \$5M Ex, 45% Top Rate	29.4	-14.6
7. Kerry (\$2m ex, \$5M QFOBI)	164.2	99.8

Note: EGTRRA permanent baseline revenue equals \$89.9 billion (calendar years)

Taxable Farms and Businesses by Size of Exemption, 2004

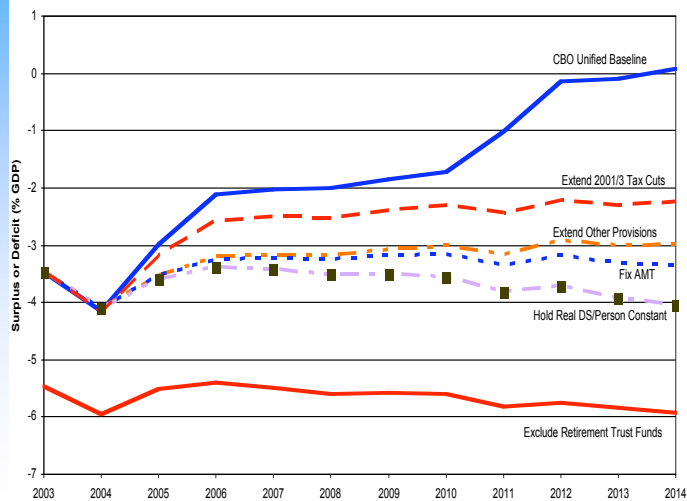


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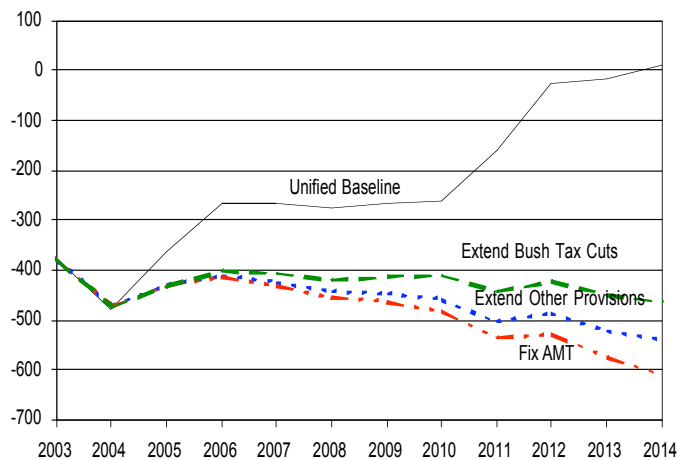
Other Fed Tax Changes Affecting States

- Many states used federal definition of tax depreciation before 2002
 - JGTRRA allows 50% "bonus depreciation" through 2004
 - 34 states have "decoupled"
 - Rest stand to lose \$4 billion (Lav and Brecher, CBPP, May 12, 2004)
- Several states used to base their tax on federal income tax or taxable income
 - They have all had to decouple to maintain their tax base, but that contributes to complexity

Federal Revenues Far Less than Spending



Federal Revenues Far Less than Spending



Required Spending Cuts to Balance Budget in 2009 by Baseline Concept (%)

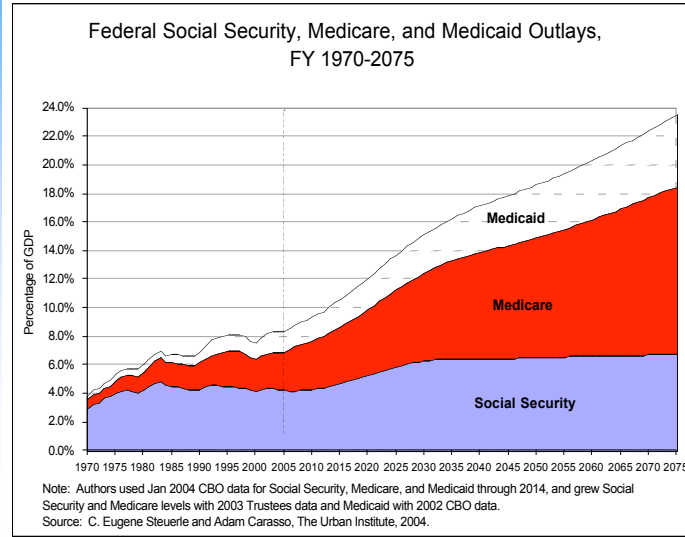
	Baseline Concept		
	CBO	Adjusted CBO	Adjusted Non-Retirement
Projected Deficit	268	430	740
as % of GDP	1.8	3.0	5.1
Percent Cut in :			
All Non-interest Outlays	-10.3	-19.2	-31.7
All Mandatory Spending	-16.8	-32.1	-50.3
All Discretionary	-26.2	-48.0	-86.0
All Non-Defense DS	-55.6	-101.7	-183.8

William Gale and Peter Orszag, "The Budget Outlook: Updates and Implications," *Tax Notes*, February 16, 2004.



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The long-term situation is even worse

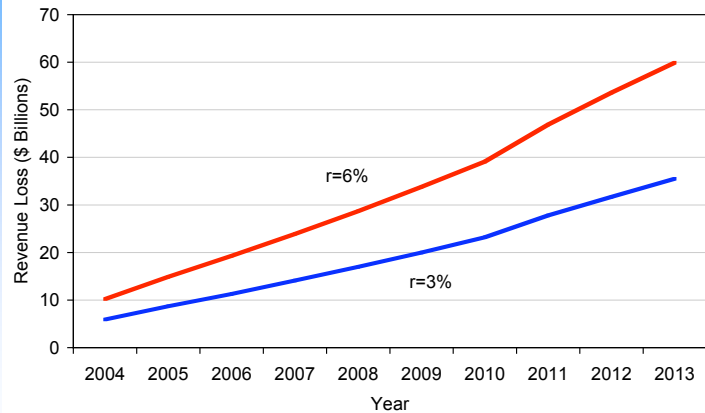


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Second Term Agenda and the States

- Administration officials have made no secret of desire for flat tax
- RSA/LSA proposal would exempt most people's saving from tax
- ERP/budget argue for consumption tax
- Many conservatives argue that flat tax is only solution to AMT problem

LSA as Capital Income Exclusion (2003 version)



Note that 2004 version would allow smaller accounts, so revenue loss would be approximately 1/3 smaller. However, revenue loss does not include cost of expanding access to tax-free retirement accounts or loss from rollovers out of existing accounts. See Len Burman, William Gale, and Peter Orszag, "The Administration's Savings Proposals: Preliminary Analysis," *Tax Notes*, March 2003.

Is State Income Tax Viable Under Flat Tax?

- Admin/compliance costs of state income tax magnified without fed tax
 - Large relative to revenue
 - Difficult, if not impossible, to collect 1099s for out-of-state entities
 - Voters would want states to conform to feds
- State taxes very regressive overall (see McIntyre et al., *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States, Second Edition*.)
 - Undermining state income and estate taxes would further increase burdens on low/middle income people
- And federal government is also limiting states' ability to raise revenue from other sources
 - Internet (explicitly) and sales tax (through neglect)