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Focus on Tax Policy: An Introduction

By: Professor Annette Nellen, *SJSU MST Program Director*

This section of The Contemporary Tax Journal includes tax policy work of SJSU MST students. We offer it here and on the journal website to showcase the range of tax knowledge the students gain from the program and to provide a public service. We think the analysis of existing tax rules and proposals using objective tax policy criteria will be of interest to lawmakers and their staff, and individuals interested in better understanding taxation.

One of the learning objectives of the SJSU MST Program is: *To develop an appreciation for tax policy issues that underpin our tax laws.*

Students learn about principles of good tax policy starting in their first MST class - Tax Research and Decision-making. The AICPA's tax policy tool, issued in 2001,¹ which lays out ten principles of good tax policy, is used to analyze existing tax rules as well as proposals for change.

Beyond their initial tax course, SJSU MST students examine the principles and policies that underlie and shape tax systems and rules in the Tax Policy Capstone course. In other courses, such as taxation of business entities and accounting methods, students learn the policy underlying the rules and concepts of the technical subject matter in order to better understand the rules and to learn more about the structure and design theory of tax systems.

The seven tax policy analyses included in this section join the growing archive of such analyses on the journal website (under "[Focus on Tax Policy](#)").

- 1) Transferability of the Research Tax Credit.
- 2) Return of the 20% Capital Gains Rate for Certain High Income Individuals.
- 3) Surtax on Millionaires.
- 4) Excessive Compensation – How Much is Too Much?
- 5) Increase and Make Permanent the Research Tax Credit.
- 6) Preferential Treatment of Capital Gains.
- 7) Repeal of the Inclusion of Social Security Benefits in Gross Income.

¹ AICPA. (2001) Tax Policy Concept Statement 1 – Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals. Available [here](#). Professor Nellen was the lead author of this AICPA document.

Surtax on Millionaires

By: John Lowrie, *MST Student*

Despite similar proposals, which have been buzzed about in the past, the surtax on millionaires proposed late in 2011 was received with much controversy.¹ If one particular proposal were to be enacted, a 5.6% tax on modified adjusted gross income in excess of \$1,000,000 would be imposed on non-corporate taxpayers for tax years starting after December 31, 2012.² While intended to help fund President Obama's jobs plan, opponents of the legislation declared it just the contrary: This proposal would be a job killer. Some supporters of the proposed surtax were unable to locate a small business millionaire who felt the resulting increase in their marginal tax rate would influence hiring decisions.³

The numerous political views about the surtax on millionaires are subjective in nature and ultimately fail to address this important question: Does the proposed legislation qualify as good tax policy? In an effort to evaluate the proposal in an objective manner, the following analysis will avoid examining the proposed legislation under a tinted political light by reviewing the surtax on millionaires based on the ten principles of good tax policy as provided by the AICPA.

1 Hook, J. (2011, Oct. 6). Democrats Float Tax on Top Earners. *The Wall Street Journal*. Retrieved from <http://online.wsj.com/article/SB10001424052970203476804576612930412626412.html>

2 American Jobs Act of 2011, S.1660, 112th Cong., 2nd Sess. (2012).

3 Keith, T. (2011, Dec. 9). GOP Objects To Millionaires Surtax; Millionaires We Found? Not So Much. NPR. Retrieved from <http://www.npr.org/blogs/itsallpolitics/2011/12/09/143398685/gop-objects-to-millionaires-surtax-millionaires-we-found-not-so-much>

Equity and Fairness

Similarly situated taxpayers should be taxed similarly.

The surtax on millionaires has the intention of promoting vertical equity in that those who are subject to the tax are assumed to have a greater ability to pay taxes. Presumably those who have modified adjusted gross income greater than \$1 million should have a greater ability to pay taxes than those with income less than that threshold. The income threshold for the top tax bracket for married filing jointly in 2012 was \$388,350⁴. As such, while taxpayers with \$388,350⁴ of income have a lesser ability to pay tax than taxpayers with \$1,000,000 or more, each level of income is subject to the same rate. The surtax on millionaires would address this disparity and, as a result increase vertical equity. Do note, however, that this same vertical equity could be achieved by merely adding an additional tax bracket to the current income tax brackets. This point will be discussed further under the principle of simplicity.

At first glance, horizontal equity is to be expected for the millionaires subject to this tax. After all, it is assumed that all millionaires have one thing in common: they have plenty of income to meet basic human needs. Digging deeper however, there could be two very differently situated millionaires. Consider a millionaire who earns all their income from long term capital gains. Under the proposal their initial million

dollars of income is only subject to a 15% capital gains tax rate. Contrast that to a sole proprietor who earns his income from his business. Under the proposal, the sole proprietor's initial million dollars of income is subject to a 35% income tax rate. While a claim can be made that all millionaires have income available to pay additional taxes, clearly not all have an equal ability to pay additional taxes.

The surtax on millionaires has further horizontal inequality as a result of a lack of differential treatment for single, head of household and married filing jointly taxpayers. Under the current income tax brackets, equity is granted to these different filing statuses by increasing the income thresholds for each of these filing statuses respectively. Clearly the intention of the current income tax system is to tax taxpayers in each filing status differently. The proposed legislation, however, only differentiates the income threshold for married filing separately taxpayers thus creating a marriage penalty.

As with most income tax considerations time related equity also becomes a consideration, because income tax is calculated at one point in time, the end of the year, rather than over a lifetime. Setting a threshold of increased tax at \$1 million will inevitably encourage taxpayers to try and schedule their income over time in a manner where they do not exceed the million dollar threshold. Consider the sale of an asset

valued at \$4,000,000, such as a business. A taxpayer able to sell the asset in an installment sale with five annual payments of \$800,000 avoids this proposed tax, while a taxpayer who receives the full payment in the year of the sale has \$3,000,000 subject to the proposed tax.

The level of equity and fairness of the surtax on millionaires depends on how much weight vertical equity receives. While a case can be made for inequities amongst the millionaires, ultimately those with income of such levels have a greater ability to pay. If these inequities are a concern, they could easily be addressed by an initial surtax on income over \$1,000,000 coupled with another higher surtax imposed on a higher income amount. Keep in mind the current income tax system is already generally considered fair with its current progressivity. This tax proposal merely adds a new layer of progressivity to the tax system.

Certainty

The tax rules should specify when the tax is to be paid, how it is to be paid and how the amount to be paid is to be determined.

The functionality of the proposed legislation seems obvious under a preliminary review. A taxpayer's income greater than one million dollars is subject to an additional 5.6% tax. Since the tax is due and paid at the same time as regular income tax calculations, taxpayers will surely understand when and how to pay the tax. Unfortunately, what is likely not certain is how to calculate Modified Adjusted Gross Income (MAGI). The average taxpayer has a minimal idea of how to do such a calculation. They probably know nothing more than what can be obtained from the name of the term: adjusted gross income, modified in some manner. Potential confusion is compounded by the several definitions of MAGI that exist in the Internal Revenue Code. The proposed legislation does provide its own definition of MAGI, which certainly helps, however it would aid the taxpayer in understanding the definition of MAGI tied to one that high income taxpayers are likely to be familiar with. Such an example would be MAGI as defined under IRC §68, Overall Limitation on Itemized Deduction phase out.

⁴ U.S. Treasury. (2011, Oct. 20). Rev. Proc. 2011-52, 2011-45 IRB. Sec. 3 2012 Adjusted Items

Convenience of Payment

A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.

A taxpayer who will be subject to the surtax on millionaires will surely be calculating and paying income tax liability every year. As such the proposed legislation does not result in an increased difficulty in the timing or the manner that the tax is paid.

Economy of Collection

The costs to collect a tax should be kept to a minimum for both the government and taxpayers.

The proposed legislation will cause the government to incur costs in the form of additional training for IRS enforcement as well as issuance of guidance to the taxpayers; however the government already has system in place to enforce the collection of income tax. As such the cost of collection should not hinder the effectiveness of the tax. As stated in the convenience of payment section, taxpayers already calculate their income tax. The tax proposal in question would merely add an additional step to that income tax calculation, and software programs can perform the calculations. While any additional step to calculating a tax liability will result in increased compliance cost, this cost to taxpayers should not hinder the effectiveness of the tax.

Simplicity

The tax law should be simple so that taxpayers understand the rules and can comply with them correctly and in a cost-efficient manner.

As previously discussed, the proposed tax law initially appears simple. Income in excess of \$1,000,000 is subject to an additional 5.6% tax. The income which is subject to the tax is not merely taxable income, but rather the more intricate MAGI. The determination of modified adjusted gross income, which is necessary to calculate the additional tax on income in excess of \$1,000,000, adds a layer of complexity to the proposal. While the calculation is likely not unduly complex, the various definitions of MAGI throughout the IRC may lead to confusion.

As suggested by the AICPA principles of good tax policy, the simplest approach to collecting the tax should be pursued. An approach which would better fit this principle would be to merely add an additional income tax bracket to the current brackets. By doing so the top tax bracket would move from a 35% tax rate to a 40.6% tax rate on income greater than \$1,000,000. This modification to the proposal would accomplish AICPA goals of achieving the simplest approach. The modification would also minimize compliance burdens by collecting the tax through a concept which taxpayers already are familiar with as well as improve transparency by allowing taxpayers to visualize tax burdens all displayed on one rate schedule.

Neutrality

The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.

Neutrality may be hindered through the proposed legislation's effect on entity form decisions. Since the tax is imposed on non-corporate taxpayers, it may influence some pass-through entities which intend to reinvest profits within the company to incorporate. The decision for sole proprietors and members of pass-through entities to incorporate their business as a result of the proposed surtax will only be further incentivized if the corporate income tax rate is lowered as President Obama⁵ and many legislators⁶ suggest. While the decision to incorporate is influenced by much more than just the proposed legislation, the surtax on millionaires unquestionably adds an additional consideration. Neutrality will also be negatively impacted as proposed legislation will affect a taxpayer's decision in the timing of income. As mentioned in the prior discussion on time related equity, the additional tax on income in excess of \$1,000,000 may influence taxpayers to alter transactions in an attempt to delay the timing of income in order to ensure income is less than \$1,000,000 in any given year.

While the surtax on millionaires has its neutrality faults, those faults are kept to a minimum. Ultimately the tax accomplishes the goal of raising additional revenues to support President Obama's job stimulus plan. It does not favor particular industries nor is it attempting to influence taxpayer behavior. At its core the proposed legislation maintains the concept of neutrality.

⁵ Goldman, J. & Rubin, R. (2012, Feb. 22). Obama Readies Plan to Cut Corporate Tax Rate. Bloomberg. Retrieved from <http://www.bloomberg.com/news/2012-02-22/obama-to-ask-congress-to-lower-corporate-tax-rate-to-28-remove-loopholes.html>

⁶ Bendavid, N. (2012, Mar. 19). House GOP Budget to Target Tax Rates. The Wall Street Journal. Retrieved from <http://budget.house.gov/News/DocumentSingle.aspx?DocumentID=285510>

Economic Growth and Efficiency

A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.

Although the increased tax revenue from the surtax on millionaires is intended to support a job stimulus package, there is a concern that it would in fact impede the economy through reduced job growth from small businesses. The rationale is that small businesses are most vulnerable to a reduction in income, and as such, the reduced after tax income would affect a small business's decision to hire new employees. However, note that the surtax on millionaires would not affect corporations, and therefore, corporate jobs should not be hindered. The businesses that could potentially be affected by the proposed legislation are sole proprietorships, partnerships, S-corporations and LLCs. In order to analyze the effect of the tax on these small businesses, first the pool of small businesses which would be affected must be identified.

A study conducted by the Treasury in August 2011 attempted to quantify the number of non-corporate small businesses.⁷ The study points out that merely receiving income from a sole proprietorship, partnership, S-corporation or LLC does not make the taxpayer a small business owner. Considerations included whether the taxpayer is actually earning income

⁷ United States Department of Treasury, Office of Technical Analysis, (2011, Aug.). *Methodology to Identify Small Businesses and Their Owners*, Retrieved from <http://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/OTA-T2011-04-Small-Business-Methodology-Aug-8-2011.pdf>

from a business (as opposed to income from a hobby, a side rental activity or as contract employee) and the significance of the business income in relation to total income. The report further considers that a small business may not actually be an employer. Of those who were determined to be a small business employer who report business income on their personal return, merely one percent have income greater than \$1,000,000. Under analysis derived from this report, the impediment on job growth, or the economy as the whole, assumed to result from the surtax on millionaires appears to be overstated. Perhaps this is why supporters of the proposal were unable to locate any millionaire small business employers who felt the tax increase would affect hiring decisions; there is only a small minority of businesses affected by the proposal to be found.

Transparency and Visibility

Taxpayers should know that the tax exists and how and when it is imposed upon them and others.

Transparency and visibility is hindered by the same factors which hurt the tax proposal's certainty and simplicity. Taxpayers are likely to understand that income in excess of \$1,000,000 is subject to the additional 5.6% tax. What is less transparent is how that income threshold is determined since it is calculated on MAGI.

Since this income definition is different from "taxable income," it will not be completely clear to the taxpayer whether transactions will increase or decrease their MAGI. Just like certainty and simplicity, transparency and visibility would benefit if the tax was calculated on Taxable Income. Alternatively, as stated prior, transparency could be aided by tying the definition of MAGI for the surtax on millionaires to another provision's definition already familiar to high income taxpayers.

Minimum Tax Gap

A tax should be structured to minimize noncompliance.

As a result of the surtax on millionaires, unintentional non-compliance may result from confusion over the calculation of MAGI. Again, this could be mitigated by using an existing definition of MAGI that is already familiar to high income taxpayers.

Despite potential unintentional non-compliance due to the additional layer of complexity, an argument could be made that this proposal would actually reduce the minimum tax gap. As a result of the proposal, tax collected from millionaires will increase. This will result in a larger portion of total tax revenue derived from these individuals. While there is no indication that millionaire taxpayers are innately inclined to be more law abiding taxpayers than those with lower income, millionaires are much more likely to be audited.⁸ Increased audit risk should lead to increased timely compliance, thus lowering the tax gap. Hindering this argument is that increased tax by the proposal will further incentivize millionaires to take action to avoid or evade taxes, such as moving income to offshore "tax havens."

⁸ Ellis, B. (2012, Mar. 23). *Audit Rates of Millionaires Nearly Doubles*. *CNN Money*. Retrieved from http://money.cnn.com/2012/03/23/pf/taxes/tax_audits_millionaires/index.htm

Appropriate Government Revenues

The tax system should enable the government to determine how much tax revenue will likely be collected and when.

If the Treasury report is any indication, clearly there is substantial data available for the government to estimate the taxpayers who would be subject to the tax and their income levels. As such, the amount of potential revenue to be generated from the surtax on millionaires can easily be determined. The time of the collection is certain since it will be when the rest of income tax from individuals is collected.

Rating Summary

Equity and Fairness	+/-
Certainty	+/-
Convenience of Payment	N/A
Economy in Collection	+
Simplicity	-
Neutrality	+
Economic Growth and Efficiency	+
Transparency and Visibility	+/-
Minimum Tax Gap	+
Appropriate Government	+

Conclusion

The proposed legislation meets six of the ten principles of good tax policy, has a mixed review on three and fails to meet one. While the proposed surtax on millionaires overall meets the principles of good tax policy overall, it certainly could be improved.

Possible Improvements

Equity could be improved by creating different income thresholds for each filing statuses. Confusion related to the calculation of MAGI, which hurts certainty and simplicity, could be alleviated by tying the definition to one used in a provision already familiar to high income taxpayers. An improvement that would address all of the mentioned principles would be to add an additional, or perhaps several, new tax brackets for high income individuals. Collecting the additional tax revenue through the new tax brackets would also benefit transparency.

Ultimately, the goal of the proposed legislation is to raise revenues to support President Obama's job stimulus plan. This would be better accomplished with the new tax bracket approach. By doing so, a larger tax base could be encompassed by targeting individuals with high income yet under \$1 million. This would offer the chance for a tax increase less than the suggested 5.6% on taxpayers with income less than \$1 million. Furthermore the additional brackets would provide the opportunity for a tax increase greater than 5.6% on taxpayers with extremely high income. Such a potential group is the top 400 taxpayers who have an average annual income of \$270 million⁹. Lastly President Obama's job stimulus plan is a temporary plan and as such only needs temporary funding. For that reason, it seems appropriate that the proposed legislation be a temporary provision.

The suggested improvements would also address this question: "Why start the tax rate increase at \$1 million?" The tax increase as initially proposed arbitrarily targets millionaires. This seems more like good politics rather than good tax policy. While it is easy to gain support for a tax increase against a demographic group that few will express sympathy for, a broader and simpler approach through the before mentioned improvements will result in a proposal that is just better tax policy.

⁹ United States Department of Treasury, Internal Revenue Service. (2012, Apr. 8). The 400 Individual Income Tax Returns Reporting the Highest Adjusted Gross Incomes Each Year, 1992-2008. Retrieved from <http://www.irs.gov/pub/irs-soi/08intop400.pdf>