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SENATE TAX BILL RAISES MARGINAL TAX RATES, FAILS TO SPUR GROWTH

The Revenue Act of 1992, reported out by the Senate Finance Committee on July 31, would permanently extend two de facto increases in marginal tax rates on upper income taxpayers enacted in the 1990 budget agreement in exchange for growth provisions that are largely ineffective and temporary. The few modest pluses — repeal of some luxury taxes, amortization of intangibles, and easing of the alternative minimum tax — are half measures at best.

Damaging tax increases. The de facto increases in marginal tax rates in the 1990 budget agreement stem from the phase-out of itemized deductions for taxpayers with adjusted gross income (AGI) over $105,250 and the phase-out of personal exemptions for taxpayers with AGI of $157,900 (joint filers) or $105,250 (single filers). The itemized deduction phase-out implicitly increases the 31% tax rate to nearly 32% (more precisely, 31.93%). The personal exemption phase-out implicitly raises the marginal tax rate by roughly 0.57% per exemption, adding over 1.1% to the tax rate for a married couple, over 2.3% for a family of four, and over 3.4% for a family of six. The combined effect of the two provisions is to generate marginal tax rates of about 32.5% for a single taxpayer, 33.1% for a couple filing jointly, 34.2% for a family of four, and 35.4% for a family of six. (Further details below.)

These anti-growth provisions are currently scheduled to expire after 1995. The Senate tax bill would make them permanent. This would be a great mistake, particularly if one expects pressure in the future for explicit increases in the top tax rate, either alone or in connection with a restoration of a capital gains differential.

Another anti-growth tax increase in the bill would require securities firms to pay tax on unrealized gains in their securities inventories.

The bill would damage real estate by extending the write-off period for commercial real estate to 40 years from 31.5 years.

The bill in its current form would likely depress rather than expand the economy compared to current law, especially after 1995.

Ineffective growth incentives. The bill would offer a temporary additional 15% first year write-off for equipment installed before next July. The basis of the equipment would be reduced accordingly, lowering future write-offs by an equal amount and offsetting most of the benefit to the investor. Much of the limited benefit would go to investment already planned, and would do little within the short time frame to spark additional investment not yet under way. More importantly, the current weakness in investment is not merely a temporary recession-related phenomenon. It has been caused by features of the 1986 Tax Reform Act that raised the cost of capital on a permanent basis. A temporary credit will not restore investment to permanently higher levels.

The bill offers only partial relief from the passive loss limitations on real estate deductions of the 1986 Tax Reform Act. The one-time home buyer credit is an ineffective give-away.

The bill slightly eases the alternative minimum tax (AMT) by eliminating the ACE adjustment to capital recovery allowances. The entire AMT should be repealed.

The bill provides no capital gains relief.

Enterprise zones. The enterprise zone proposals have been sharply curtailed, and would not, in any event, constitute a general growth initiative. An amendment may be offered by Senators Kasten and Lieberman to enhance investment incentives, including provision of a "neutral cost recovery system" (NCRS) enhancing capital cost recovery provisions within the zones to be equal in present value to first-year write-off, and capital gains relief. Such an amendment would be desirable, and could serve as a model for the treatment of capital outside the zones as well.

Saving incentive. The bill would restore IRA deductibility to all taxpayers and offer an alternative that would permit savers to make non-deductible IRA contributions with proceeds tax exempt upon withdrawal. However, the sum of a taxpayer's contributions to an IRA and other deferred compensation plans (SEPs, 401(k)s, 403(b)s, etc.) could not exceed the limits on the other deferred plans. Thus, taxpayers already fully utilizing other deferred compensation plans would not be allowed to contribute to an IRA. The non-deductible IRA contributions allowed under current law would no longer be permitted. These limitations offset much of the liberalization contained in this provision. A much greater expansion of IRAs should be considered.

Intangibles. The bill permits businesses to amortize intangibles, a legitimate practice the IRS has refused to accept in the past. However, the amortization period is far too long. These outlays should be expensed.

Impact. The bill in its current form would likely depress rather than expand the economy compared to current law, especially after 1995.

Further details on the phase-outs. The 1990 budget agreement provided for the phase-out of up to 80% of selected itemized deductions for taxpayers with AGI of $100,000 or more, with the threshold to rise with inflation. For 1992, the threshold is $105,250. This phase-out provision expires after 1995. The deductions are phased out at a rate of 3% of AGI in excess of the threshold. For each dollar of income over the threshold, taxable income rises by $1.03. For affected taxpayers in the 31% tax bracket, this is equivalent to an increase in the tax rate on the extra dollar of income to 31.93% (= 1.03 x 31%). (For taxpayers in the 28% bracket, the implicit increase is to 28.84%.)

The 1990 budget agreement also provided for the phase-out of personal exemptions for taxpayers with AGI of $150,000 or more for joint filers and $100,000 for single filers. These thresholds are indexed for inflation, and are $157,900 and $105,250, respectively, for 1992. The phase-out provision expires after 1995. The exemptions are phased out at a rate of 2% of the exemption for every $2,500 of AGI in excess of the threshold. For 1992, the personal exemption is $2,300. Consequently, the phase-out rate is equal to a loss of $46 for each $2,500 in excess AGI, or a phase-out rate of 1.84% of income over the thresholds (46/2500 = 0.0184). For taxpayers in the 31% tax bracket, this is equivalent to an increase in the marginal tax rate of 0.5704% (= 1.0184 x 31%) for every personal exemption claimed. This rate bubble rises with each annual increase in the personal exemption, because the $2,500 figure in the phase-out definition is not adjusted for inflation.

In addition to being bad economics, the phase-outs are bad tax policy. If an expense is of a type that constitutes a legitimate and appropriate deduction from income, it should remain deductible regardless of the income of the taxpayer. Similarly, if a personal exemption is an appropriate component of the income tax, its appropriateness does not diminish with income.

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Note: Nothing written here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before Congress.