



# Tax Simplification That Works for Everyone

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# Introduction and summary

The idea of simplifying the U.S. tax code is perennially appealing. Yet proposals to simplify the tax code often promise more than they can deliver, by dramatically changing the balance of who pays taxes or significantly reducing tax receipts needed to fund government services.

Some congressional proposals would achieve simplification by repealing whole sections of the tax code—such as the top tax rates,<sup>1</sup> capital gains taxes,<sup>2</sup> the corporate income tax,<sup>3</sup> or the estate tax<sup>4</sup>—taxes that are mainly paid by wealthy individuals and big companies. Those plans, while they seem simpler, would also lose unprecedented amounts of revenue<sup>5</sup> and ultimately would place a heavier burden on middle-class individuals and families by increasing their taxes or cutting programs that benefit them, such as Social Security, education, and infrastructure. Furthermore, there is scant evidence that such huge tax cuts in the name of tax simplification would increase economic growth, despite claims to the contrary.<sup>6</sup>

Other tax simplification proposals focus on the number of hours taxpayers spend preparing their tax returns<sup>7</sup> or promise tax returns that can be filed on a postcard. Yet no one would argue that time spent on securing important education or retirement tax incentives is worthless or that such tax benefits should be tossed out in favor of a postcard tax return.

How policymakers simplify the tax code matters. A tax code that is fair as applied to the diverse range of individuals and entities in the country and raises sufficient revenue necessarily requires a significant degree of complexity. But there are steps policymakers can take to simplify the tax code without jeopardizing the important goals of fairness and fiscal responsibility. For example, it makes sense to clear out complex and unnecessary tax loopholes that enable corporations and those who are wealthy to avoid paying their fair share. Those types of provisions reduce tax revenues needed for important public programs and erode public confidence in the system. It is also prudent to fix tax provisions that are fair but have become too complicated for the average individual or small business to use.

This report outlines three steps policymakers can take to simplify the tax system so that it works better for everyone, raises adequate revenue, and meets Americans' fundamental understanding of fairness:

1. Eliminate special rules and loopholes in the current tax system that complicate the tax code and primarily benefit high-income individuals and large corporations
2. Use some of the revenue saved from closing those tax loopholes to simplify two of the most important areas of middle-class tax incentives—education and retirement savings—so that those incentives better accomplish what they were intended to do
3. Eliminate some of the accounting and other administrative tax burdens faced by truly small businesses, which lack the resources of large corporate taxpayers to deal with tax compliance

The nation does not need to abandon fairness and fiscal responsibility in order to simplify the tax code. Tax simplification that improves tax fairness for everyone and supports fiscal responsibility is possible.

# Eliminate special rules and loopholes from the tax code

The U.S. tax code is loaded with special rules and loopholes that provide a financial benefit to specific activities, entities, or groups of people and make the tax system more complex. Conservatives and progressives alike have rightly called for removing special rules and loopholes. President Barack Obama’s 2016 update to his “Framework for Business Tax Reform” stated that “reducing the number of tax expenditures and loopholes would reduce the complexity of the tax system and lessen the tax compliance burden for large corporations and small businesses alike.”<sup>8</sup> The fiscal year 2017 House Republican budget called for reducing complexity in the tax code by “closing special interest loopholes that distort the marketplace, limit innovation, and waste time and resources.”<sup>9</sup>

Even though the federal income tax is progressive overall, dozens of these special rules in the income tax code primarily enable wealthy individuals and corporations to avoid paying taxes that they would otherwise have to pay on some or all of their income. Therefore, the tax system is less progressive at the top. These exceptions in the tax code are no different from any other form of government spending—except for the fact that most people are not aware of them and they are not subject to regular review, as is the case with other forms of government spending.<sup>10</sup>

Those who benefit from these loopholes may not be concerned about the complexity these provisions add to tax filing—after all, most high-income taxpayers and large companies have the financial resources to hire professional tax advisers who know the rules and can ensure that their clients pay the least tax legally possible.<sup>11</sup>

It would be more efficient and better for the U.S. economy if wealthy and corporate taxpayers focused their efforts on productive activities, such as investments in training their employees, researching better products, or growing their companies, instead of spending enormous resources looking for ways to avoid paying taxes. A portion of the revenue gained from removing these complex tax provisions could be used to fund simplification elsewhere in the tax code.

While there are many special rules and loopholes from which to choose, the following are particularly important to eliminate from a tax fairness perspective and represent a substantial amount of lost tax revenue.

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Require multinational corporations to pay tax on all of their income at the end of the year, just like small and midsized companies do

U.S. multinational companies make billions of dollars from selling products abroad that were developed here in the United States. Yet currently these companies are allowed to defer paying U.S. tax on much of the income earned abroad by their subsidiary companies until that income is repatriated. U.S. multinational corporations take advantage of this tax benefit—known as deferral—and use complicated tactics to shift profits offshore and thus delay paying taxes on those profits for years, even indefinitely. Individual taxpayers cannot defer taxes on income they earn abroad, and huge multinational companies should not be able to either.<sup>12</sup> It is estimated that profit shifting by U.S. multinationals reduces U.S. tax receipts by more than \$100 billion each year, and 82 percent of the profits are shifted to just seven tax haven countries.<sup>13</sup>

Congress should end deferral for U.S. multinational companies. The tax code should treat these companies similar to individuals and domestic companies and require them to pay tax on their income at the end of the year—no matter where that income was earned. This would eliminate the complicated transactions and accounting schemes in which businesses currently engage to shift profits offshore and recharacterize income as having a foreign source. At the same time, U.S. multinationals should pay the taxes they owe on the more than \$2 trillion of untaxed profits these companies have already amassed offshore.<sup>14</sup>

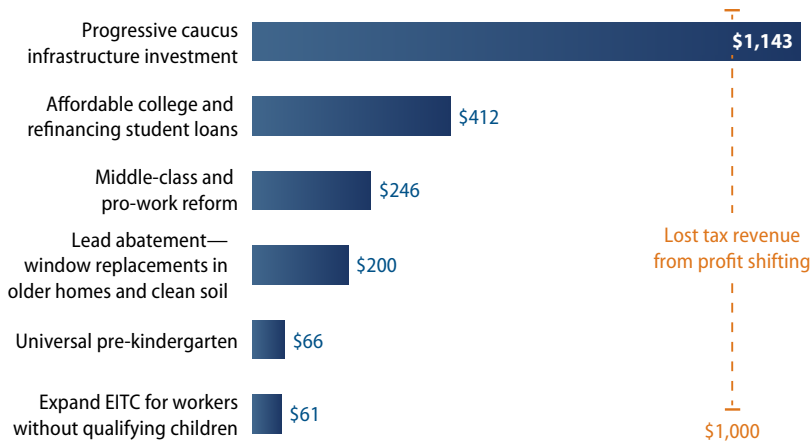
As noted in a September 2014 Center for American Progress report, “The Growing Consensus to Improve Our Tax Code,” policymakers across the political spectrum agree that deferral leads to significant income shifting through such tactics as earnings stripping and transfer pricing and that these practices result in substantial loss of tax revenues to the U.S. Treasury.<sup>15</sup> While some conservatives would address the problem by eliminating any U.S. tax at all on foreign-source income of U.S. multinationals, such an approach would result in the loss of an enormous amount of revenue and could lead to even more profit shifting to take advantage of the lack of tax on offshore profits. Both President Obama and former



House Committee on Ways and Means Chair Dave Camp (R-MI) proposed alternatives for partially or completely eliminating the ability of U.S. multinationals to defer U.S. tax on foreign-source income.<sup>16</sup> President Obama's proposal would impose a per-country minimum tax on foreign earnings of U.S. corporations and their subsidiaries, though some groups have legitimately questioned why the rate should be any lower than that imposed on U.S.-source income.<sup>17</sup>

**FIGURE 1**  
**Lost tax receipts from multinational profit shifting as compared with the cost of progressive proposals**

Costs are 10-year estimates in billions of dollars



Sources: Kimberly A. Clausing, "Profit Shifting and U.S. Corporate Tax Policy Reform" (Washington: Washington Center for Equitable Growth, 2016), available at <http://equitablegrowth.org/report/profit-shifting-and-u-s-corporate-tax-policy-reform/>; Infrastructure investment and affordable college proposals from Congressional Progressive Caucus, "The People's Budget" (2016), available at <https://cpc-grijalva.house.gov/uploads/CPC%20People's%20Budget%20FY%202017%20Full%20Budget2.pdf>; Universal pre-kindergarten proposal from Office of Management and Budget, "Budget of the U.S. Government, Fiscal Year 2017" (2016), available at <https://www.whitehouse.gov/sites/default/files/omb/budget/fy2017/assets/budget.pdf>; Kevin Drum, "Lead: America's Real Criminal Element," Mother Jones, February 11, 2016, available at <http://www.motherjones.com/environment/2016/02/lead-exposure-gasoline-crime-increase-children-health/>; Middle-class and pro-work reform and EITC expansion proposals from U.S. Department of the Treasury, "Administration's Fiscal Year 2017 Revenue Proposals," available at [https://www.treasury.gov/resource-center/tax-policy/Pages/general\\_explanation.aspx](https://www.treasury.gov/resource-center/tax-policy/Pages/general_explanation.aspx) (last accessed July 2016).

At a minimum, if these large companies decide to change their legal residence and thus escape U.S. taxation, they should pay their taxes before they leave, just like U.S. citizens who renounce their citizenship.<sup>18</sup> Over the past 15 to 20 years, a growing number of U.S. companies have merged with foreign companies and changed their tax residence. These so-called corporate inversions and other types of mergers enable the now-foreign parented firm to access—tax-free—the offshore profits of



the former U.S. firm that had not yet been taxed by the United States. The more than \$2 trillion of untaxed profits currently held offshore by U.S. multinational companies represents at least \$500 billion in tax receipts, taxes that these companies should have to pay if they decide to expatriate from the United States.<sup>19</sup>

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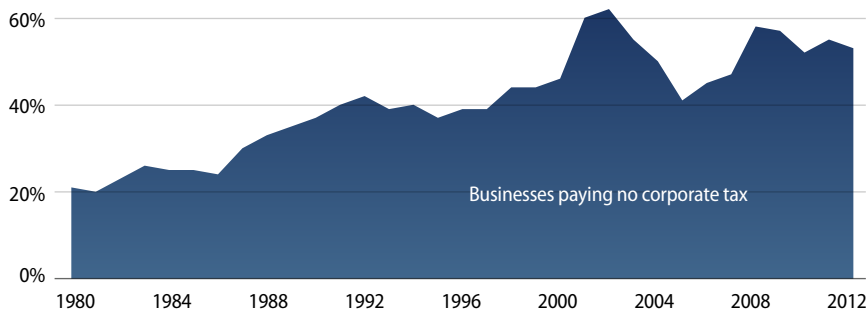
## Require all large businesses to pay the corporate income tax, regardless of their organizational form

Businesses organized under Subchapter C of the U.S. Internal Revenue Code pay the corporate income tax. But businesses structured as partnerships, Subchapter S corporations, or sole proprietorships get to skip the entity-level tax and pass their income through to the individual owners, who include their business-related income on their personal tax returns. These so-called pass-through businesses thus pay no corporate tax at all.

In the past, most pass-through businesses were genuinely small or simply structured businesses, such as law firms or physician partnerships. However, as a result of several developments in federal tax and state business laws in recent decades, companies with hundreds of millions, if not billions, of dollars in profits today are organizing as S corporations, partnerships, and LLCs—a business form that is taxed similar to a partnership—in order to avoid paying the corporate income tax. In fact, excluding sole proprietorships, pass-through business forms grew from representing less than 50 percent of all businesses in 1985 to comprising 80 percent in 2012.<sup>20</sup> And, even more surprising, more than 70 percent of partnership and S corporation revenue goes to big businesses.<sup>21</sup> Some of the partnerships have thousands of partners. Moreover, partners in partnerships can be other partnerships, corporations, or tax-exempt organizations or individuals, and the partners do not have to be U.S. residents. Thus, some partners are actually corporations located in tax haven countries. These intentionally complex partnerships prevent the IRS from identifying and tracking down each partner that owes taxes.<sup>22</sup> It is a brazen legal distortion that should be curtailed. All businesses above a specified size should pay the corporate income tax.

**FIGURE 2****Most business income is no longer subject to the corporate tax**

Share of net business income going to pass-through businesses



Source: Michael Cooper and others, *Business in the United States: Who Owns It and How Much Tax Do They Pay?* (Cambridge: National Bureau of Economic Research, forthcoming), data available at [http://faculty.chicagobooth.edu/owen.zidar/research/data/tpe/-Business\\_in\\_the\\_US\\_-\\_Data.xlsx](http://faculty.chicagobooth.edu/owen.zidar/research/data/tpe/-Business_in_the_US_-_Data.xlsx).

## Clean up the estate, gift, and trust tax rules

Today, high-income families—who nearly always hold substantial wealth in the form of stock, real estate, and valuables such as antiques, jewelry, and art—can use complex tax strategies to pass those assets down to their children without ever paying income or estate tax on the assets. It has been estimated that over the next few decades, more than \$30 trillion will be transferred from the Baby Boom generation to their heirs.<sup>23</sup> With so much at stake, Congress should eliminate the special tax rules and loopholes that allow very wealthy individuals to bypass income and estate taxes when passing assets to their heirs.

Normally, when taxpayers sell assets, they must pay income tax on the gain in value of those assets over the basis, or the amount they originally paid for them. But, if taxpayers can afford to hold onto those assets their whole life, the law allows their heirs to “step up” the basis in the assets to the value on the day they inherited them. In other words, the heirs could sell the assets the very next day and pay no income tax at all on the gain in value during the life of the original taxpayer. Heirs who benefit from stepped-up basis claim that it is too difficult to determine what the original taxpayer paid for the assets. They say stepped-up basis is simpler. But an equally simple rule would be to provide standard valuations in cases where no proof of original cost is available. In addition, the tax should apply at the time of transfer to the heirs, instead of waiting until the heirs sell the asset, if ever.

The estate tax imposes a one-time tax on wealth exceeding \$5.4 million per person or \$10.8 million per couple that is passed on to heirs. Hardly any estates are big enough to be subject to the tax—in 2013, for example, more than 99.8 percent of estates were not subject to the estate tax.<sup>24</sup>

Yet there are many ways that the richest Americans can circumvent the estate tax, as well as the gift tax, which is a companion tax that taxes transfers of wealth above a substantial annual allowance during a taxpayer's lifetime. A primary tactic involves the use of trusts, into which wealthy individuals can transfer assets that they are fairly certain will keep growing in value. These are commonly referred to as grantor retained annuity trusts, or GRATs. The tax law requires the taxpayer to pay income tax on the growth in value of the trust assets based on an annuity interest valuation rate set by statute.<sup>25</sup> Any growth in value of the assets in excess of that amount is transferred tax-free to the beneficiaries.<sup>26</sup> Because the statutory valuation rates are fairly low and many trust assets appreciate much faster, the amount transferred to the beneficiaries is often quite substantial. In another variation, the charitable lead annuity trust, taxpayers can avoid their portion of the income tax by donating the principle to a charity with the remaining growth over the statutory interest passing tax-free to the beneficiaries.<sup>27</sup>

These complicated tax avoidance techniques substantially undermine the estate tax. In many instances, it is clear that they are set up solely as a tax avoidance technique, such as when hedge fund managers set up trusts and fund them with shares of companies they know are about to go through an initial public offering that will increase the value of the shares. Often these trusts are set up with short terms to avoid the risk that the grantor will die during the term, which would cause the entire amount in the trust to be included in the grantor's estate and thus potentially subject to the estate tax.

The estate tax is an important backstop to the income tax. In addition to raising needed revenue and enhancing progressivity, it was originally designed to help ensure that wealth does not become too concentrated in the hands of a few.<sup>28</sup> Because a significant portion of wealth in the United States is inherited, the estate tax plays an important role in reducing wealth inequality.<sup>29</sup> The estate tax is more important now than ever given historically high levels of inequality in the United States. A recent study found that the share of U.S. wealth held by the top 1 percent of the population grew steadily beginning in the late 1970s and reached nearly 42 percent of total household wealth in 2012.<sup>30</sup> The estate tax is the country's most progressive tax.<sup>31</sup>

There are a number of ways to address the complex strategies used to avoid the estate and gift tax. Congress could pass legislation to prevent abuse of GRATs, for example. In an example specifically aimed at GRATs abuses, estate tax experts Paul Caron and James Repetti proposed that the gift tax be imposed on the value of the property that ultimately passes to the remainder beneficiaries of the trust.<sup>32</sup> A simpler approach they propose would impose a lifetime cap on the amount that can be transferred to a GRAT.<sup>33</sup> Another alternative, proposed by Lily Batchelder, would tax inheritances instead of estates, which, if designed appropriately, could eliminate many of the tax avoidance strategies and problems with valuation.<sup>34</sup>

# Simplify middle-class tax incentives

Over time, Congress has enacted a variety of tax incentive programs to strengthen the middle class and help those who aspire to the middle class. But some of these tax incentives are not delivering on their promises because they are too complex. Complex provisions are less likely to be taken up by lower-income individuals, who lack access to the assistance needed to maximize the options.<sup>35</sup> Thus, these provisions can actually amplify inequality.<sup>36</sup> This outcome is particularly likely with respect to tax incentives for higher education and retirement savings, two of the most important goals for those who seek the opportunity to achieve a middle-class life and remain there.

Simplification could go a long way toward improving the utilization of these incentives by those at the lower end of the income scale. That, in turn, would improve opportunities for everyone to pursue these critical life objectives.

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## Simplify tax incentives for higher education

It has never been more important than it is today for Congress to simplify education tax incentives and improve the ability of low- and moderate-income students to use them. Today, the average annual estimated cost of a college degree ranges from \$24,000 to \$47,000 for a four-year program.<sup>37</sup> These costs are only climbing, as the published prices of attending college—whether two-year or four-year, public or private—have consistently grown at a faster rate than inflation in recent decades.<sup>38</sup>

The tax code provides at least nine tax incentives for higher education.

**TABLE 1**  
**Major individual tax provisions for higher education, 2016**

What is it?	Who is eligible?	Amount of annual foregone tax revenue
Pre-college tax expenditures		
State-run, Section 529 college savings plans in which investments grow tax-free if ultimately used for higher education expenses—with virtually no limit on contributions.	No income limit	\$1.9 billion
Coverdell Education Savings Accounts in which up to \$2,000 in annual contributions—before age 18—grow tax-free if used for K-12 or higher education expenses before age 30.	Single filers earning less than \$110,000 annually; joint filers earning less than \$220,000 annually	\$30 million
Tax expenditures while enrolled in school		
American Opportunity Tax Credit of up to \$2,500 for the first four years of postsecondary education expenses for students who are enrolled at least half time in an eligible higher education institution; up to 40 percent of the credit is refundable.	Incomes less than \$90,000 for single filers, \$180,000 for joint filers	\$13.4 billion
Lifetime Learning Credit up to \$2,000 nonrefundable for qualified education expenses for any student; no need to be tied to a degree.	Incomes less than \$65,000 for single filers, \$131,000 for joint filers	\$2.5 billion
Counting college students from ages 19 to 23 as dependents on their parents' tax returns if they are enrolled full time during five months of the year.	No income limit	\$4.4 billion
Not counting scholarship and fellowship sources as taxable income.	No income limit	\$3.3 billion
Tuition and fees deduction of up to the first \$4,000 in qualified higher education expenses if other education credits are not claimed.	Incomes less than \$80,000 for single filers, \$160,000 for joint filers	\$390 million*
Post-enrollment tax expenditures		
Student-loan interest deduction for up to the first \$2,500 in interest paid during the year.	Incomes less than \$80,000 for single filers, \$160,000 for joint filers; phaseout begins at \$65,000 for single filers, \$130,000 for joint filers	\$1.8 billion
Discharge of student-loan indebtedness for borrowers in particular employment situations or repayment plans such as public service loan forgiveness and permanently disabled borrowers.	No income limit	\$90 million
<b>Total:</b>		<b>\$27.7 billion**</b>

\*Indicates a 2015 estimate. The 2016 estimate was not available.

\*\*Numbers may not add up due to rounding.

Source: Office of Management and Budget, *Analytical Perspectives, Budget of the U.S. Government, Tax Expenditures* (Executive Office of the President, 2016), available at [https://www.whitehouse.gov/omb/budget/Analytical\\_Perspectives](https://www.whitehouse.gov/omb/budget/Analytical_Perspectives).

While these incentives nearly double government funding to families for higher education,<sup>39</sup> they fail to live up to their potential. The rules are confusing; different incentives have different eligibility criteria and many provisions interact with other tax provisions in ways that limit their support.<sup>40</sup> As a result, many of the low- and moderate-income students for whom these incentives were intended do not make optimal choices among these incentives, let alone receive the support they need to enable them to invest in an education that will improve their long-term financial security.

A closer look at the education tax incentives reveals why students, or their families if they are dependents, often do not make optimal choices. For example, as Table 1 shows, there are two different tax credits—as well as a deduction for expenses—available to students while they are in school. Each of these tax provisions has its own eligibility criteria. A 2012 study by the U.S. Government Accountability Office noted that nearly \$800 million in tax benefits are lost because approximately 237,000 parents and students take a financially disadvantageous deduction or credit rather than the tax provision that would save them the most money, while 1.5 million tax filers miss these deductions and credits entirely.<sup>41</sup>

As a first-order priority, Congress should consider the value of expanding grant programs for higher education, such as Pell Grants and work-study programs. Unlike tax benefits, which come at the end of the year when tax returns are filed, these programs are dispensed during the year when students need them. Unfortunately, however, the congressional budget process does not encourage members to think about spending and tax programs in a holistic manner. Nevertheless, legislators can still do much to improve the education tax incentives so that they better support higher education for low- and middle-income individuals. Congress should simplify the tax incentives for higher education and rationalize how these policies can work together so that use of one incentive does not prevent the use of other incentives or education programs on the non-tax side of the federal budget. These efforts would go a long way toward making this area of the tax code simpler and fairer for middle-class families and those who aspire to the middle class.

Below are four approaches Congress could use to simplify tax incentives for higher education.



## Combine the American Opportunity Tax Credit and Lifetime Learning Credit into one stronger, simpler credit

The American Opportunity Tax Credit, or AOTC, and the Lifetime Learning Credit are both available for higher learning, but they are different in many ways, including eligibility criteria, amounts, income limits, and types of expenses that may be counted toward the credit.<sup>42</sup> While the Lifetime Learning Credit is available for both undergraduate- and graduate-level education, it would be more efficient and simpler to combine the credits into a stronger AOTC that is more likely to achieve the goal of ensuring that everyone has the opportunity to get a college degree.

The new AOTC credit should be 100 percent refundable up to the maximum amount of the credit. Currently, only 40 percent or a maximum of \$1,000 is refundable and a complicated calculation is necessary to determine the refundable amount to which a taxpayer is entitled. Full refundability would create a more certain refund amount and allow students to understand in advance how much assistance they can expect from the credit. This increased certainty would be a significant help to families struggling to meet higher education costs. In addition, the maximum credit should be expanded to include up to \$500 of room and board expenses. This expansion would help many low-income students who receive scholarship funds but are still prevented from attending school by the high cost of room and board. One study found that tuition and fees on average accounted for only 19 percent of the cost of attending a public two-year institution in 2008.<sup>43</sup>

Additionally, President Obama has already proposed a simplifying change that would make the AOTC available to students during their first five years of attending a postsecondary institution at least half time or for five tax years for students attending such an institution less than half time.<sup>44</sup> This would make the AOTC more flexible for students, the majority of whom fluctuate between attending school full or part time.<sup>45</sup> Other improvements would include annually adjusting all income limits and credit amounts to inflation and eliminating the ban that prevents students with a prior drug-related felony conviction from using the AOTC.

Finally, students using the AOTC should not have to include their Pell Grants in their calculations for the credit. The current requirement of including Pell Grants is both unnecessarily complicated and counterproductive because Pell Grant recipients are already screened for eligibility and are the most in need of assistance.

## Strengthen 1098-T reporting

Every year, institutions of higher learning are supposed to file Form 1098-T for each student. The form officially states the amount of any scholarships or grants the student received and provides verification of these amounts to third parties. Institutions should be required to file these forms early enough so that students can use them in completing their tax returns to determine eligibility for the AOTC. In some cases, institutions of higher learning are not aware of scholarships or grants that students have received from third parties. Thus, another helpful step would be to require any institution that provides a student with a scholarship of \$500 or more to complete a Form 1098-T. These changes would make it simpler for students, or their families if they are dependents, to apply for the AOTC at tax time.

## Make Pell Grants fully exempt from income tax

As noted above, the application process for a Pell Grant is fairly rigorous, and grant recipients have the highest financial need. It makes no sense to tax Pell Grant amounts. Doing so merely adds complexity at tax time for these mostly low-income taxpayers.

## Rationalize student debt tax provisions

Tax code provisions related to student loan debt need an update to reflect changing times. The student loan interest deduction, which costs the federal government more than \$2 billion per year,<sup>46</sup> provides a larger tax benefit to those in higher tax brackets and does little to help students while they are in school. As the nation faces a huge student debt problem, it is clear that students must receive better assistance at the time of college attendance rather than incur huge sums of debt while attending college. Under the current system, far too many graduates are unable to pay back their loans because they are unemployed or working low-paying jobs. Policymakers should consider gradually phasing out the student loan interest deduction and applying the savings to an expansion of Pell Grants.

Additionally, the U.S. Department of Education should coordinate with the U.S. Department of the Treasury to address student loan debt that is discharged due to the death or permanent disability of the student. This coordination would seamlessly discharge the debt so that grieving families are not saddled with any resulting tax liability.

Finally, income-based repayment plans have become increasingly popular but low-income students who fail to repay the full loan over a long period of time may face tax liability when the loans ultimately are discharged with a remaining balance. There should be no discharge-of-indebtedness income in these cases for tax purposes.

Simplify tax incentives for retirement savings

Tax incentives to promote saving for retirement are among the most expensive federal tax programs in terms of foregone federal tax revenue. The U.S. Congress’ Joint Committee on Taxation estimates that these tax expenditures will cost the federal government about \$170 billion in 2016 alone.<sup>47</sup> Yet retirement savings tax incentives are among the least accessible incentives to low- and moderate-income taxpayers.

TABLE 2  
Major individual tax provisions for retirement, 2016

What is it?	Amount of annual foregone tax revenue
Defined benefit employer plans	\$66.6 billion
Defined contribution employer plans	\$64.7 billion
Individual retirement accounts, or IRAs	\$16.9 billion
Low- and moderate-income Saver’s Credit	\$1.3 billion
Self-employed plans	\$28 billion
<b>Total:</b>	<b>\$177.5 billion</b>

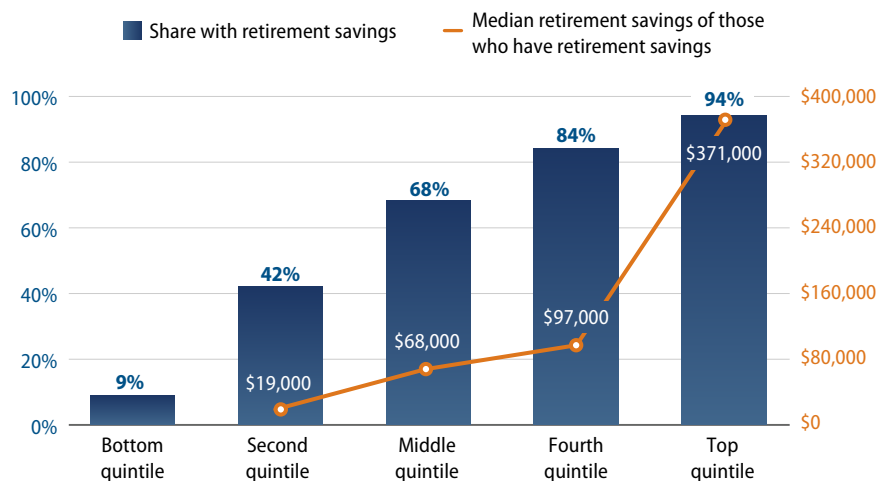
Source: Office of Management and Budget, *Analytical Perspectives, Budget of the U.S. Government, Tax Expenditures* (Executive Office of the President, 2016), available at [https://www.whitehouse.gov/omb/budget/Analytical\\_Perspectives](https://www.whitehouse.gov/omb/budget/Analytical_Perspectives).

Taxpayers do indeed have many options for tax-preferred saving for retirement, but the options are too confusing for the average person with a limited ability to save. In addition, most retirement savings tax incentives are structured in ways that effectively provide the greatest benefit to high-income taxpayers who do not need it. Meanwhile, the majority of working individuals and families have little or no retirement savings at all.<sup>48</sup>

FIGURE 3

## There is a huge discrepancy in savings between low- and high-income households

Retirement savings for households ages 55–64, by income quintile



Note: The sample size for the bottom quintile was insufficient to produce a reliable estimate.

Source: Based on analysis of 2013 Survey of Consumer Finances data in U.S. Government Accountability Office, "Retirement Security: Most Households Approaching Retirement Have Low Savings," GAO-15-419, Report to the Ranking Member, Subcommittee on Primary and Retirement Security, Senate Committee on Health, Education, Labor, and Pensions, May 2015, available at <http://www.gao.gov/assets/680/670153.pdf>.

According to the Joint Committee on Taxation, only 66 percent of private-sector workers had access to a qualified retirement plan through their employers in 2015 and only 49 percent of those actually participated.<sup>49</sup> Traditional forms of retirement plans, such as defined benefit plans and money purchase pension plans, are required to provide a life annuity to participants and their surviving spouses.<sup>50</sup> In other words, the participant and the participant's spouse are guaranteed a fixed amount for as long as they live. The employer bears the risk of ensuring that the plan is managed properly so that there will be sufficient funds to make promised distributions.<sup>51</sup> But increasingly employers are establishing defined contribution plans, such as profit-sharing and stock bonus plans, that do not have these requirements.<sup>52</sup> Instead, the retiring employee's benefit is essentially an account balance, meaning it is all too possible for participants and their surviving spouses to outlive their funds—a concern that is heightened by longer life expectancies.

Individuals with or without retirement plans through their employers can establish a tax-preferred individual retirement account, or IRA. Although individuals with low or moderate incomes may deduct contributions to regular IRAs, the

overall tax benefits of IRAs are largely skewed to higher-income taxpayers. They have the resources to make annual contributions, can access investments not available to the average person, and reap the largest tax benefit due to their higher tax brackets. An October 2014 report by the U.S. Government Accountability Office, or GAO, found that an estimated 314 taxpayers had IRA account balances exceeding \$25 million in 2011.<sup>53</sup> While taxpayers are not permitted to contribute more than about \$5,500 per year to an IRA, the GAO surmised that this small group of taxpayers had accumulated larger IRA balances by investing their IRAs in assets initially valued very low but offering unusually high investment return potential—investments not available to average taxpayers.<sup>54</sup> Also, there are no limits on how many funds a taxpayer can roll over into an IRA from other qualified plans, nor are there limits on total accumulations in an IRA.

Lower-income taxpayers may avail themselves of the Retirement Savings Contribution Credit, more commonly known as the Saver's Credit, an additional tax credit of up to \$2,000 for contributions to an IRA, but the credit is not refundable—that is, while it reduces taxes owed, it is wasted if the taxpayer has no income tax liability, which is frequently the case for low-income taxpayers.<sup>55</sup> The newly created myRA—short for My Retirement Account—holds greater promise. Designed as a portable fee-free retirement savings vehicle managed by the U.S. Department of the Treasury, myRAs can be deducted automatically from a taxpayer's paycheck or bank account. Unfortunately, contributions are not matched and the entire account must be rolled over to a private-sector account once the balance reaches \$15,000. Contributions to a myRA are eligible for the Saver's Credit, but few low-income taxpayers are aware of this.

The goals of increasing access to and participation in retirement savings plans, as well as preserving savings and making them last through retirement, were all recognized by the Senate Committee on Finance bipartisan Tax Reform Working Group on Savings and Investment.<sup>56</sup> Congress can address many of these problems by putting limits on the tax benefits for those at the top, while making the rules simpler and easier for low- and moderate-income people to save automatically and receive matching contributions through a refundable credit.

Below are three approaches Congress could use to improve middle-class retirement savings tax programs.

## Make the Saver's Credit pay

Low- and moderate-income taxpayers do not have the cash flow to deal with the uncertainty of the current Saver's Credit. They lack the financial flexibility to make a contribution without knowing whether or not they will have sufficient tax liability against which to take the credit. Thus, the Saver's Credit should be fully refundable, plain and simple. The credit already has income limits—it is phased out for those with incomes roughly below \$60,000 for married couples filing jointly and \$30,000 for single people—thus, full refundability would significantly improve the progressivity of retirement savings tax incentives overall. In addition, for most low-income people, full refundability would take the guesswork out of deciding whether to contribute to retirement savings. It would also ensure that they benefit from saving tax incentives just like higher-income people do.

For many low-income taxpayers, tax refund season is the only time during the year when they have sufficient funds to set aside a portion for retirement. The Center for American Progress previously advocated for allowing taxpayers to contribute their tax refund to a myRA or other qualified retirement account and claim the Saver's Credit on the same return.<sup>57</sup> The extra line on the tax return necessary to accomplish this would also serve as a reminder to low-income taxpayers that this is an option they should consider, and it would make contributing to retirement simpler and faster for many low-income taxpayers.

## Make the myRA easier to use

It is currently not clear when a contribution to a myRA will count against asset limits for programs in other federal agencies. This creates confusion for taxpayers, and CAP recommended that this be resolved by excluding myRA contributions from the asset limits for other federal agency programs.<sup>58</sup> Another simplifying change to the myRA recommended by CAP would allow older workers—those who reach age 62 before accumulating the transfer threshold amount of \$15,000—to keep their myRA account, even if it later exceeds the threshold.<sup>59</sup> These individuals are no longer seeking the highest returns possible and will benefit less from the effects of compound interest. Moreover, they are more likely to face high fees and riskier terms on the private market, if they are able to roll over the funds at all.

## Create a National Savings Plan

For many taxpayers, it is not just the tax incentives themselves that are complex, it is all of the other decisions surrounding a retirement plan: where to invest, how to evaluate plan fees, and what distribution options make the most sense upon retirement. In January 2016, the Center for American Progress Action Fund proposed a National Savings Plan to solve many of these problems.<sup>60</sup> Workers without access to a retirement plan at their workplaces would be automatically enrolled, and the plan would have features similar to the existing Thrift Savings Plan for federal government workers and retirees.<sup>61</sup> The plan would represent a substantial simplification for taxpayers who lack a workplace plan or the resources to make use of other high-cost retirement plan options and confusing retirement savings tax incentives. The plan would offer a low-fee life cycle fund, and upon retirement, it would convert to a stream of income that could not be outlived.<sup>62</sup> Importantly, it could be a default rollover plan for myRAs that have reached the transfer threshold, and it could be a plan of last resort for part-time workers who often are not included in their employer's retirement plan. Small employers—those with fewer than 10 employees—would be able to join the plan and improve retirement savings options for their workers.

Beyond these tax simplification measures, there are other steps that Congress could take to improve retirement savings tax incentives. For example, CAP has previously called for a more aggressive use of federal savings matches to incentivize more saving at low and moderate income levels for both education and retirement.<sup>63</sup> Tax benefits for saving are government programs and, as such, should be targeted at those most in need. Yet tax incentives for saving for retirement, as well as for other important goals such as education, health care, and buying a home, are structured in ways that offer larger incentives for higher-income households and smaller or no benefits for low-income households.<sup>64</sup> Simplification should incorporate restructuring that both eliminates unnecessary tax breaks that only benefit high-income taxpayers, as mentioned in the first section above, and rebalances tax incentives that are retained for important public policy goals—for example, by converting deductions to refundable tax credits with income caps.



# Free small businesses from complicated accounting rules

Complicated tax rules represent a significant cost for small businesses, which lack the resources to hire expensive tax and accounting assistance. Making tax rules simpler for small businesses would enable them to comply with tax rules more affordably and could even remove one barrier to entrepreneurship. A few changes can substantially simplify tax rules for many small businesses.

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## Increase expensing

The Protecting Americans from Tax Hikes Act of 2015 permanently expanded Section 179 of the U.S. Internal Revenue Code, which allows small businesses to immediately deduct the cost of new business equipment, rather than using complicated depreciation rules to deduct the cost ratably over time. Doubling the maximum deduction to \$1 million and continuing to index that limit to inflation, as proposed in President Obama's FY 2017 budget, would free many more small businesses from depreciation burdens.<sup>65</sup>

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## Establish uniform accounting rules

Business taxpayers currently must use different accounting rules for different purposes across the tax code, including for capitalizing costs and for keeping track of inventory. Exceptions for certain businesses apply in some cases but are not uniform. This tangled web could be reduced or eliminated by creating a uniform small business threshold for allowing exceptions from certain accounting rules. For example, the president has proposed a threshold of \$25 million in average annual gross receipts.<sup>66</sup>

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## Include small businesses in a newly created National Savings Plan

Many small-business owners want very much to provide retirement benefits for their employees but find the cost per employee too high for a small plan. The National Savings Plan discussed above could offer a much simpler and less expensive vehicle for small businesses to provide retirement benefits for their employees. It would also be a simpler option for those who are self-employed. Because the National Savings Plan would have a large pool of beneficiaries, low fees, and simplified investment options, it would be a much easier and affordable option for small businesses and self-employed individuals.

# Conclusion

Tax simplification proposals that are nothing more than disguised attempts to reduce taxes for high-income individuals or large corporations would undermine the fairness of the tax code and reduce tax revenues that fund critical public investments—investments that promote a strong economy and ensure opportunity for all. At a time of severe income inequality and fiscal challenges, the smartest tax simplification will also improve tax fairness and support fiscal responsibility. It is a time for tax simplification that works for everyone.

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## About the author

Alexandra Thornton is the Senior Director of Tax Policy on the Economic Policy team at the Center for American Progress. She focuses on corporate and international taxation issues, tax reform to achieve fairness and progressivity, and tax approaches to address environmental externalities. She draws from nearly 10 years as tax counsel to a member of the U.S. Senate Committee on Finance, as well as extensive experience in nonprofits and private law practice. She holds a law degree from the University of Virginia School of Law and a business degree from the College of William and Mary.

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