less-than-perfect transfer pricing system. And when
tax breaks like the DRD are offered to corporations,
the whole worldwide tax system seems to be all
bark and no bite.
If that is the reality, and if that reality is expected
to continue as corporations continue lobbying for
their earnings to come home from tax havens tax
free, why not reform the system to allow this? At
what point would it make more sense to get rid of
the worldwide system and adopt a territorial sys-
tem that exempts foreign earnings altogether? Is it
more intellectually honest to exempt foreign-source
income rather than continue with antidefferral rules
that don’t really work?
Again, that answer is also not clear, but as
recently stated by Michael Mundaca, Treasury’s
deputy assistant secretary for international tax af-
fairs, during the Practising Law Institute’s tax plan-
ing forum in New York, that debate promises to be
“front and center” in light of upcoming presidential
elections. (For an article quoting Mundaca, see Tax
Notes, June 9, 2008, p. 1061, Doc 2008-12060, or 2008
TNT 106-2.)
The bottom line is that the entire system needs an
overhaul, and the DRD is just an example of a quick
fix disguised as something else because the task at
hand is monumental. Absent broader international
tax reform, we can expect to see tax breaks akin to
the DRD every time the cash cows in the Nether-
lands get bloated.

NEWS ANALYSIS
Linking Tax Changes, Income, and
Revenue

By Joann M. Weiner — jweiner@tax.org

There is a popular saying attributed to an apo-
cryphal conversation between F. Scott Fitzgerald and
Ernest Hemingway that “the rich are different be-
cause they make more money than the rest of us.”
The tax economist’s popular saying, however, is
slightly different. Tax economists believe the rich
are different because they are more sensitive to tax
rate changes than the rest of us.
At least that’s the conclusion reached by several
recent studies on the elasticity of taxable income.
Because higher-income taxpayers earn income in a
variety of ways — salaries, capital gains, partner-
ships, dividends, tax-exempt interest, etc. — their
reported taxable income is likely to be more sensi-
tive to tax rate changes than lower-income tax-
payers’. This greater sensitivity to tax rates also
helps explain why tax revenue might increase when
tax rates decrease: High-income taxpayers report
more taxable income when their tax rates fall.
As Harvard Prof. Martin S. Feldstein noted in his
remarks to the 100th anniversary conference of the
National Tax Association last November, changes in
tax rates affect more than the number of hours
worked; they also affect the form of compensation
and the types of consumption (see “Effects of Taxes
on Economic Behavior,” in the National Tax Journal,
Mar. 2008). Tax rate increases, especially for higher-
income taxpayers, might not lead those taxpayers to
reduce the number of hours they work, but they
might lead them to receive their compensation in
tax-favored forms, such as untaxed fringe benefits,
or to increase their tax-deductible expenditures,
such as charitable contributions. University of
Michigan Prof. Joel Slemrod has noted that changes
in the timing of transactions are the most common
behavioral response to tax changes, especially for
corporate stock sales and capital gains realizations.
He also says tax rate increases may lead to reduced
compliance and greater tax evasion.
Two major tax cuts during the Bush presidency
provide natural experiments to test these ideas. As
the temporary tax cuts from the Economic Growth
and Tax Relief Reconciliation Act (EGTRRA) of 2001
and the Jobs and Growth Tax Relief Reconciliation
Act of 2003 approach their expiration date, tax
policy makers are extremely interested in how
higher-income taxpayers may respond to the pos-
sible expiration of these rate reductions. And with
the presidential campaign under way, this research
has more than just academic interest. Presidential candidates Sen. John McCain, R-Ariz., and Sen. Barack Obama, D-Ill., have different plans regarding the fate of the Bush tax cuts. McCain plans to extend the tax cuts across the board, while Obama plans to let them expire for high-income taxpayers.

The Economists’ Views

The presidential candidates would be well advised to pay attention to recent research coming from the administration and from academia when formulating their policies. For example, Seth Giertz, an economist at the Congressional Budget Office, showed that taking into account how taxable income responds to tax rate changes dramatically affects revenue estimates. (See his paper, “How Does the Elasticity of Taxable Income Affect Economic Efficiency and Tax Revenues and What Implications Does This Have for Tax Policy Moving Forward?”, recently presented at the American Enterprise Institute.)

Treasury economists Gerald Auten and Geoffrey Gee, along with Robert Carroll, former Treasury deputy assistant secretary for tax analysis, who is now with the Tax Foundation, presented a similar analysis on the taxable income response to the 2001 and 2003 tax cuts at the National Tax Association’s 38th annual spring symposium in May. The point of their paper, “The 2001 and 2003 Tax Rate Reductions: An Overview and Estimate of the Taxable Income Response,” was not to estimate revenue effects from rate cuts while holding the tax base constant, but to show how estimated taxable income responds to tax cuts. A key empirical issue the authors address is to what extent the lower tax rates resulted in higher taxable incomes than would have otherwise been reported.

Using a panel of individual tax returns for tax years 1999 through 2005, they found that taxable income is highly sensitive to changes in marginal tax rates. A 10 percent change in the marginal net-of-tax rate leads to a 3.5 percent change in taxable income. They also find that high-income taxpayers are relatively more sensitive to tax changes than low-income taxpayers. The paper finds a taxable income elasticity of 1.09 for taxpayers with incomes greater than $200,000.

This estimate is larger than those found by other analysts. For example, in a study of the U.S. tax reforms of the 1980s, Jonathan Gruber and Emmanuel Saez estimated that taxpayers with incomes above $100,000 (in 1992 dollars) have an elasticity of 0.57, compared with an elasticity of 0.4 for the entire population. Feldstein finds that an elasticity of 0.5 for middle- and upper-income taxpayers is a reasonable, although probably conservative, estimate. Bradley Heim, another Treasury economist, finds estimated elasticities ranging from 0.46 to 0.58, depending on the period studied.

More Choices

Giertz discussed the possible revenue and efficiency effects under alternative assumptions of the sensitivity of taxable income to tax rates. As a baseline, he estimates that allowing the individual income tax cuts to expire and assuming no behavioral response — that is, taxable income does not change — leads to $98.6 billion in additional revenue. Eliminating the 10 percent tax bracket accounts for 38 percent, or $43 billion, of the increase, and increasing the top rate from 35 percent to 39.6 percent accounts for 23 percent, or $26 billion, of the revenue increase.

If taxpayers are highly responsive to tax rate increases, the revenue gains may be much lower than expected. As Table 1 shows, the estimated revenue gain may fall from $98.6 billion under the baseline estimate to just $37.8 billion, or by more than 60 percent under the highest taxable income elasticity shown.

Figure 1 shows more generally how the revenue estimates depend on how sensitive taxpayers at different tax rates are to changes in their taxes. Because low-income taxpayers have few options about the source of their income, the revenue estimate falls only slightly as the elasticity increases.

<table>
<thead>
<tr>
<th>2005 MTR</th>
<th>Mechanical Estimate</th>
<th>0.2</th>
<th>0.5</th>
<th>1.0</th>
</tr>
</thead>
<tbody>
<tr>
<td>10%</td>
<td>$43,015</td>
<td>$42,732</td>
<td>$42,208</td>
<td>$41,501</td>
</tr>
<tr>
<td>25%</td>
<td>17,293</td>
<td>13,641</td>
<td>8,178</td>
<td>-937</td>
</tr>
<tr>
<td>28%</td>
<td>5,772</td>
<td>4,411</td>
<td>2,378</td>
<td>-1,013</td>
</tr>
<tr>
<td>33%</td>
<td>6,522</td>
<td>5,192</td>
<td>3,188</td>
<td>-123</td>
</tr>
<tr>
<td>35%</td>
<td>26,041</td>
<td>20,480</td>
<td>12,183</td>
<td>-1,647</td>
</tr>
<tr>
<td>Totals</td>
<td>98,643</td>
<td>86,456</td>
<td>68,145</td>
<td>37,780</td>
</tr>
</tbody>
</table>

(see the bars for the 10 percent tax bracket). By contrast, at the highest marginal tax rates, estimated revenue impact may be negative for all but the lowest-income taxpayers if taxable income elasticity is very high (see the bars for the 35 percent tax bracket). As Giertz points out, behavioral responses by the 0.7 percent of filers in the top income tax bracket account for 36 percent of the reduction in federal income tax revenue. Behavioral responses by the top two income tax brackets account for 44 percent of the reduced federal income tax revenue.

If the top two bracket taxpayers have an elasticity of 1, as suggested by Auten, instead of 0.5, as suggested by Feldstein, the projected revenue gain from allowing the Bush tax cuts to expire is cut in half, to just $48.5 billion. Moreover, the distributional impact of the tax increase also varies significantly with the estimated income elasticities, with the lower-income taxpayers bearing a relatively larger share of the burden as the elasticity increases across tax brackets. If the rates increase for only those taxpayers in the top two brackets, then revenue may actually fall if these taxpayers are highly sensitive to tax rate changes (see the last column of Table 1). These figures demonstrate what Slemrod meant when he said, “There are staggering policy implications to whether the taxable income elasticity is 0.4, 1.08, or something in between.” (See “Methodological Issues in Measuring and Interpreting Taxable Income Elasticities,” National Tax Journal, Dec. 1998.)

Sources of Income
Individual taxpayer data from the IRS provide the background to understanding why taxpayers in high tax brackets may be more responsive to changes in the income tax rates than taxpayers in low tax brackets. Figure 2 shows the distribution of several broad income types for two income classes.

Taxpayers with adjusted gross income between $50,000 and $100,000 receive about 80 percent of their income from salaries and wages. By contrast, taxpayers with AGI above $10 million receive just 18 percent of their income in salaries and wages. The opposite pattern appears with capital gains and dividends that qualify for a 15 percent tax rate instead of the 35 percent ordinary income rate. Low-income taxpayers receive just a fraction of their income in this form, compared with the highest-income taxpayers, who receive more than half of their income this way.

Role of Timing and Deductions
Many individuals have substantial control over when they report their income. Capital gains and stock-based compensation provide two examples of this flexibility. For example, individuals may time their capital gains realizations to minimize their tax
liability. Capital gains realizations often rise when capital gains tax rates are cut because of the “lock-in” effect that encourages investors to delay selling capital assets until rates fall. Other economists suggest that changes in the capital gains tax rate merely lead to timing differences so that the increased capital gain realizations over the long run do not offset the short-run losses from the tax cut.

High-income taxpayers may also alter the timing of when they receive their compensation. For example, using data for the very-highest-income taxpayers, many of whom receive compensation in the form of stock options, Austan Goolsbee, in a 2000 paper titled “What Happens When You Tax the Rich? Evidence From Executive Compensation,” found that those taxpayers’ taxable income may be very responsive in the short run to increases in marginal tax rates, as shown by the increase in stock option exercises in advance of the preannounced 1993 tax increase. But this effect is only temporary, as taxable income rises before an anticipated tax increase and then falls when the tax increase is implemented. From this pattern, Goolsbee concludes that the efficiency losses from making the income tax system more progressive may be smaller than suggested.

Taxpayers who itemize their tax deductions — that is, those whose eligible deductions exceed the standard deduction — also have flexibility over when to claim those deductions. Gruber and Saez found that taxpayers who itemize their deductions have particularly high taxable income elasticity, suggesting that they are able to adjust their taxable income to obtain a favorable tax position. By contrast, low-income taxpayers have a lower elasticity because they receive most of their earnings in the form of wages and salaries, over which they have less influence on the timing.

Recent IRS data on noncash charitable contributions provide a good example of the flexibility that taxpayers have over their deductions. (See the spring 2008 Statistics of Income Bulletin.) Because of concern that the estimated value of donated vehicles was inappropriately inflated, the American Jobs Creation Act of 2004 limited the tax deduction for vehicle donations to the lesser of fair market value or the gross proceeds the charity received when it sold the vehicle (there are a few exceptions to this rule, such as if the charity uses the vehicle itself). With the loss of this flexibility, itemizing taxpayers cut the number of their car donations from 900,000 to just under 300,000; the value of these donations fell by 81 percent, from $2.422 billion in 2004 to just under $500 million in 2005.

Figures 3a and 3b show the value and the average contributions for total noncash contributions and for all vehicle contributions from 2003 to 2005 (vehicles include cars, trucks, planes, and boats). The value of donated cars and vehicles fell 66 percent from 2004 to 2005, from $2.422 billion to just $610 million. While three years of data are not enough to conclusively prove that the tax law
change caused the decline in vehicle contributions, the fact that total noncash contributions increased during the same period suggests that the tax law change may explain much of the difference. (See Figure 3b.) Because taxpayers generally self-report the fair market value of these contributions, the decline in donations following the new restrictions on the value taxpayers may place on their donated vehicles suggests that taxpayers may have been overstating the value of their donated vehicles under prior law. (For details about the revised rules for contributions of vehicles, see Notice 2005-44, 2005-1 C.B. 1287, Doc 2005-12231, 2005 TNT 107-10.)

Changes in Individual Taxation
In its biannual Budget Outlook from 2007, the CBO identified several spending and tax policy options that affect individual taxpayers. The table included with Figure 4 summarizes 14 of these policies that affect individual income, with 8 policies involving tax increases; 2, tax cuts; 1, simplifying capital gains taxation; and 3, providing relief from the alternative minimum tax. The Joint Committee on Taxation prepared the revenue estimates. These estimates take into account that higher tax rates would encourage high-income taxpayers to shift income from taxable to nontaxable forms, such as toward tax-exempt bonds or toward tax-free fringe benefits, and to increase spending on tax-deductible items, such as charitable donations and home mortgage interest. Figure 4 shows the revenue estimates for these policies.

As an example, consider Option A, which increases all income tax rates by 1 percentage point. The JCT estimates that this policy would raise $445 billion over 10 years. By contrast, Option I makes the temporary tax cuts permanent and would reduce revenue by $1.2 billion over 10 years. Increasing the top two ordinary income tax rates by 1 percentage point would increase revenue by about $100 billion from 2008 to 2017 (Option E). Increasing the tax rate on joint filers’ ordinary taxable income over $1 million ($500,000 for others) by 5 percentage points would raise $224 billion over the same period. Reforming the AMT would reduce revenue from $522 billion to $668 billion.

These revenue estimates should be interpreted with caution. Tax proposals that increase taxes on high-income taxpayers are likely to raise less revenue than projected, while tax proposals that increase or reduce taxes across the board are likely to be closer to projections.

How the JCT Does the Numbers
The revenue estimates provided above originate with the JCT. JCT Chief of Staff Edward Kleinbard recently provided insight into the JCT’s revenue estimating process. He noted that the JCT’s tax model incorporates taxpayer behavior to estimate how taxpayers may respond to changes in tax policy, such as increases in capital gains tax rates.

(Text continued on p. 1237.)
Figure 4. Individual Income Tax Policies, Revenue Estimates for 2008-2017

Individual Tax Estimates From the Congressional Budget Office’s Budget Outlook 2007

Option 1. Increase Individual Income Tax Rates
- Option A: Raise all tax rates on ordinary income by 1 percentage point
- Option B: Raise all ordinary tax rates and AMT rates by 1 percentage point
- Option C: Raise all ordinary tax rates, AMT rates, and dividend and capital gains rates by 1 percentage point
- Option D: Raise the top ordinary tax rate by 1 percentage point
- Option E: Raise the top two ordinary tax rates by 1 percentage point
- Option F: Raise the top three ordinary tax rates by 1 percentage point
- Option G: Raise the top four ordinary tax rates by 1 percentage point
- Option H: Raise the tax rate on ordinary taxable income over $1 million for joint filers ($500,000 for others) by 5 percentage points

Option 2. Reduce Individual Income Tax Rates; Reform Capital Gains Tax
- Option I: Permanently extend the individual income tax provisions of EGTRRA
- Option J: Permanently extend the 0 and 15 percent tax rates for capital gains and dividends
- Option K: Replace multiple tax rates on long-term capital gains with a deduction of 45 percent of net realized gains

Option 3. Provide Relief From the Individual Alternative Minimum Tax
- Option L: Make the current exemption amounts permanent and index the AMT for inflation
- Option M: Apply some regular deductions and exemptions to the AMT
- Option N: Eliminate the AMT

Note: The estimates for Option I represent the change in the overall budget balance resulting from the sum of changes to both revenues and outlays. Source: The descriptions of the proposals are available in Congressional Budget Office, Budget Outlook 2007; the Joint Committee on Taxation provided the revenue estimates.
What the estimates do not do, however, is assume that those responses increase national income — the JCT imposes a “fixed GNP” assumption as a general rule. They assume that national income remains constant or, in other words, they do not incorporate supply-side effects that suggest that tax cuts can lead to an increase in the size of the economy.

As Kleinbard acknowledged, elasticities are tricky to measure, noting, for example, that taxpayer response to a $1-per-gallon gas tax increase is not necessarily twice that of a 50-cent-per-gallon increase. (For details on the JCT revenue estimating process, see “Inside the JCT Revenue Estimating Process,” presented to the New York State Bar Tax Section annual meeting, Jan. 30, 2008, available at http://www.jct.gov/Inside_Revenue_Estimating.pdf.)

As shown earlier, the JCT estimated in 2007 that permanently extending the individual income tax provisions of EGTRRA — except the reduced tax rates on capital gains and dividends — would reduce revenue by $98 billion during the first year, by $277.7 billion from 2008 to 2012, and by $994.2 billion from 2013 to 2017 for a total 10-year revenue loss of $1.222 trillion. Eliminating the AMT would cost roughly half that amount.

By contrast, the biggest revenue increase — $686 billion — would occur from an across-the-board 1 percentage point increase in ordinary income tax rates, AMT rates, and dividend and capital gains rates. Raising the tax rate by 5 percentage points for the wealthiest taxpayers would raise $224 billion over 10 years.

The analysis by Giertz, however, suggests that there may be significant uncertainty surrounding these estimates. For example, if taxable income is relatively sensitive to tax rate changes — say it falls by 5 percent for every 10 percent increase in the net of tax marginal rate — the estimated revenue gain would be only about 60 percent of the estimated revenue impact, assuming no response. As Giertz shows (see Table 1 above), if the tax rates return to their 2001 levels for just the top two tax brackets, revenue could fall if the taxable income of high-income taxpayers is highly sensitive to changes in tax rates.

Court Again Rules for Watchdog in Audit Data FOIA Case

By Sam Young — syoung@tax.org

A federal court again ordered the IRS to allow a watchdog group to review unredacted tables of statistics related to its enforcement activities, enforcing and expanding an order from 2006.

Judge Marsha J. Pechman of the Western District of Washington ruled that the IRS violated her 2006 order to enforce a consent order issued in 1976 and ordered it to provide copies of tables of statistics on audits, collections, and enforcement activities to Susan B. Long, codirector of the Transactional Records Access Clearinghouse (TRAC). The court also denied a request by the IRS to amend the 1976 order. (For the full text of the opinion, see Doc 2008-13280 or 2008 TNT 117-19. For the 1976 consent order, see Doc 2008-13289 or 2008 TNT 117-20.)

Background

In 1974 Long filed a Freedom of Information Act request for IRS records on its enforcement activities, including audits and collections. A 1976 consent order issued by the Western District of Washington ordered the IRS to make available to Long several specific records and “all statistical data regardless of format and particular categorization which are hereafter compiled and similar” to those records.

Long, who has served as codirector of TRAC since the organization was founded in 1989 and is now an associate professor at Syracuse University’s Martin J. Whitman School of Management, used those records for nearly 30 years to analyze the Service’s enforcement activities. But by 2002, the agency had ceased complying with the 1976 order, she claimed.

The IRS’s position is undermined by evidence that the IRS has previously provided data compilations that included ‘cell of one’ entries, the court said.

In January 2006 Long filed a motion with the Western District of Washington requesting an order that the IRS comply with the 1976 order. The court ruled that the data Long sought, Audit Information Management System Table 37, were similar to the records cited in the 1976 decision and ordered the Service to make them available.

The Service argued that Table 37 included cells containing data on only one or two taxpayers and