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FACT SHEET: A Simpler, Fairer Tax Code That Responsibly Invests in Middle Class Families

Middle class families today bear too much of the tax burden because of unfair loopholes that are only available to the wealthy and big corporations. In his State of the Union address, the President will outline his plan to simplify our complex tax code for individuals, make it fairer by eliminating some of the biggest loopholes, and use the savings to responsibly pay for the investments we need to help middle class families get ahead and grow the economy.

The President will put forward reforms that include eliminating the biggest loophole that lets the wealthiest avoid paying their fair share of taxes:

- **Close the trust fund loophole – the single largest capital gains tax loophole – to ensure the wealthiest Americans pay their fair share on inherited assets**. Hundreds of billions of dollars escape capital gains taxation each year because of the "stepped-up" basis loophole that lets the wealthy pass appreciated assets onto their heirs tax-free.

- **Raise the top capital gains and dividend rate back to the rate under President Reagan**. The President's plan would increase the total capital gains and dividends rates for high-income households to 28 percent.

- **Reform financial sector taxation to make it more costly for the biggest financial firms to finance their activities with excessive borrowing**. The President will propose a fee on large, highly-leveraged financial institutions to discourage excessive borrowing.

By ensuring those at the top pay their fair share in taxes, the President's plan responsibly pays for investments we need to help middle class families get ahead, like his recent proposal to make two years of community college free for every student willing to do the work. The savings will pay for additional reforms that will help the paychecks of middle-class and working families go further to cover the cost of child care, college, and a secure retirement:

- **Provide a new, simple tax credit to two-earner families**. The President will propose a new $500 second earner credit to help cover the additional costs faced by families in which both spouses work — benefiting 24 million couples.

- **Streamline child care tax incentives to give middle-class families with young children a tax cut of up to $3,000 per child.** The President's proposal would streamline and dramatically expand child care tax benefits, helping 5.1 million families cover child care costs for 6.7 million children. The proposal will complement major new investments in the President's Budget to improve child care quality, access, and affordability for working families.

- **Simplify, consolidate, and expand education tax benefits to improve college affordability**. The President's plan will consolidate six overlapping education provisions into just two, while improving the American Opportunity Tax Credit to provide more students up to $2,500 each year over five years as they work toward a college degree – cutting taxes for 8.5 million families and students and simplifying taxes for the more than 25 million families and students that claim education tax benefits.

- **Make it easy and automatic for workers to save for retirement**. The President will put forward a retirement tax reform plan that gives 30 million additional workers the opportunity to easily save for retirement through their employer.

These new policies build on longstanding proposals to extend important tax credit improvements for working families, expand the Earned Income Tax Credit, provide quality preschool for all four-year-olds, and raise revenue to reduce the deficit by curbing inefficient tax breaks that primarily benefit the wealthy. In addition, the President has put forward a framework for fixing the business tax system on a revenue-neutral basis and using the transition revenue to pay for investments in infrastructure.

Eliminating the Biggest Loopholes that let the Wealthiest Avoid Paying Their Fair Share of Taxes and Reforming Financial Sector Taxation

Reforming the Taxation of Capital Gains

Rather than make it easier for middle-class families to make ends meet, our tax system has changed over time in ways that make it easier for the wealthy to avoid paying their fair share. Though President Obama restored top tax rates on the highest income Americans to their levels under President Clinton, high-income tax rates remain historically low, especially on capital income. Capital income taxes are also much lower than tax rates on income from work, which explains how the highest-income 400 taxpayers in 2012 – who obtained 68 percent of their income from capital gains – paid income tax at an effective rate of 17 percent, even though the top marginal income tax rate was 35 percent.

The problem is that the U.S. capital income tax system is too broken to address this unfairness just by raising tax rates. Current rules let substantial capital gains income escape tax altogether. Raising the capital gains rate without also addressing these loopholes would encourage wealthy individuals to take further advantage of the opportunities the current system provides to defer and avoid tax.

The largest capital gains loophole – perhaps the largest single loophole in the entire individual income tax code – is a provision known as "stepped-up basis." Stepped-up basis refers to the fact that capital gains on assets held until death are never subject to income taxes. Not only do bequests to heirs go untaxed, but the "tax basis" of inherited assets used to compute the gain if they are later sold is immediately increased ("stepped-up") to the value at the date of death – making the capital gain income forever exempt from taxes. For example, suppose an individual leaves stock worth $50 million to an heir, who immediately sells it. When purchased, the stock was worth $10 million, so the capital gain is $40 million. However, the heir's basis in the stock is "stepped up" to the $50 million gain when he inherited it – so no income tax is due on the sale, or ever due on the $40 million of gain. Each year, hundreds of billions in capital gains avoid tax as a result of stepped-up basis.

The President's proposal would close the stepped-up basis loophole by treating bequests and gifts other than to charitable organizations as realization events, like other cases where assets change hands. It would also increase the total top capital gains and dividend rate to 28 percent – the rate under President Reagan. (The top rate applies to couples with incomes over about $500,000.) It would:

- <u>Almost exclusively impact the top 1 percent</u>. 99 percent of the impact of the President's capital gains reform proposal (including eliminating stepped-up basis and raising the capital gains rate) would be on the top 1 percent, and more than 80 percent on the top 0.1 percent (those with incomes over $2 million). Under the President's proposal, wealthy people would still get a preferential rate on their income from investments, but they would no longer be able to accumulate extra wealth by paying no capital gains tax whatsoever.

- <u>Address a basic unfairness in the tax system</u>. Most middle-class retirees spend down their assets during retirement, which means they owe income taxes on whatever capital gains they've accrued. But the wealthy can often afford to hold onto assets until death – which is what lets them use the stepped-up basis loophole to avoid ever having to pay tax on capital gains.

- Unlock capital for productive investment. By letting very wealthy investors make their capital gains disappear at death, stepped-up basis creates strong "lock-in" incentives to hold assets for generations, even when resources could be reinvested more productively elsewhere. The proposal would sharply reduce these incentives, making it a pro-growth way to raise revenue.

- Protect the middle-class and small businesses To ensure that it would impose neither tax nor compliance burdens on middle-class families, the President's proposal includes the following protections:
  - For couples, no tax would be due until the death of the second spouse.
  - Capital gains of up to $200,000 per couple ($100,000 per individual) could still be bequeathed free of tax. Note that, since capital gains generally represent only a fraction of an asset's value, this exemption would allow couples to bequeath more than $200,000 without owing taxes. The exemption would be automatically portable between spouses.
  - In addition to the basic exemption, couples would have an additional $500,000 exemption for personal residences ($250,000 per individual). This exemption would also be automatically portable between spouses.
  - Tangible personal property other than expensive art and similar collectibles (e.g. bequests or gifts of clothing, furniture, and small family heirlooms) would be tax-exempt. In addition to avoiding any tax burden on these transfers, this exclusion would prevent families from having to value and report them.

  As a result of these provisions, only a tiny minority of small businesses could possibly be affected by the repeal of stepped-up basis. However, the President's proposal also includes extra protections that ensure no small family-owned business would ever have to be sold for tax reasons:

  - No tax would be due on inherited small, family-owned and operated businesses - unless and until the business was sold.
  - Any closely-held business would have the option to pay tax on gains over 15 years.

Imposing a Fee on Large Financial Institutions

The President's proposal would make it more costly for the largest financial firms to finance their activities by borrowing heavily. Specifically, the President's proposal would impose a 7 basis point fee on the liabilities of large U.S. financial firms: the roughly 100 firms in the nation with assets over $50 billion. The President's proposal would attach a cost to leverage for the largest financial firms, leading them to make decisions more consistent with the economy-wide effects of their actions, which would in turn help reduce the probability of major defaults that can have widespread economic costs. This approach is broadly consistent with a proposal from former Ways and Means Chairman Camp's tax reform plan that would have imposed an excise tax on large financial firms.

Reforming the Tax System to Better Support and Reward Work

Creating a New "Second Earner Credit" for Married Couples Where Both Spouses Work

Two-earner couples can face high penalties for working. When both spouses work, the family incurs additional costs in the form of commuting costs, professional expenses, child care, and, increasingly, elder care. When layered on top of other costs, including federal and state taxes, these work-related costs can contribute to a sense that work isn't worth it, especially for parents of young children and couples caring for aging parents. While women, including married women, are increasingly family breadwinners, the fact remains that they are still much more likely to be the ones who withdraw from the labor force in these circumstances, taking a toll on their future job options and earnings, and hurting our overall economic growth.

Building on Congressional proposals from members of both parties, the President is proposing to address these challenges with a new second earner credit that recognizes the additional costs faced by families in which both spouses work. A total of 24 million couples would benefit from this proposal, which would provide a new, simple second earner credit of up to $500. Families would claim a credit equal to 5 percent of the first $10,000 of earnings for the lower-earning spouse in a married couple, and the maximum credit would be available to families with incomes up to $120,000, with a partial credit available up to $210,000. 80 percent of two-earner married couples would benefit from the new credit.

Expanding the EITC for Workers without Children and Noncustodial Parents

The President's plan to help working families get ahead incorporates his proposed childless worker EITC expansion, reducing poverty and hardship for 13.2 million low-income workers struggling to make ends meet while promoting employment. The President's proposal would double the EITC for workers without qualifying children, increase the income level at which the credit phases out, and make it available to workers age 21 and older. Ways and Means Committee Chairman Ryan has endorsed the President's proposed expansion, while other members of Congress have put forward similar proposals.

The President also continues to propose making permanent improvements to the EITC and CTC that augment wages for 16 million families with 29 million children each year. These improvements provide additional benefits to low-income working parents, families with three or more children, and married families, but are currently scheduled to expire at the end of 2017. Allowing these benefits to expire would result in a roughly $1,700 tax increase for a full-time minimum wage worker with two children. Research has consistently shown that the helping low-wage working families through the EITC and CTC not only boosts parents' employment rates and reduces poverty, but has positive longer-term effects on children, including improved health and educational outcomes.

Making Child Care, Education, and Retirement Tax Benefits Work for Middle-Class Families

Simplifying and Expanding Child Care Tax Benefits

With the cost of infant and toddler care rivaling the cost of college in many states, the average child care tax benefit of $550 falls well short of what is needed to provide meaningful help to working families. The Child and Dependent Care Tax Credit and child care flexible spending accounts are also unnecessarily complex, often requiring significant paperwork and advanced planning for families to receive the full benefits.

The President's tax proposal would streamline child care tax benefits and triple the maximum child care credit for middle class families with young children, increasing it to $3,000 per child. The President's child care tax proposals would benefit 5.1 million families, helping them cover child care costs for 6.7 million children (including 3.5 million children under 5), through the following reforms:

- Triple the maximum Child and Dependent Care Tax Credit (CDCTC) for families with children under 5, increasing it to $3,000 per child. Families with young children face the highest child care costs. Under the President's proposal, they could claim a 50 percent credit for up to $6,000 of expenses per child under 5 – covering up to half the cost of child care for preschool age children.

- Make the full credit available to most middle-class families. Under current law, almost no families qualify for the maximum CDCTC. The President's proposal would make the maximum credit – for young children, older children, and elderly or disabled dependents – available to families with incomes up to $120,000, meaning that most middle-class families could easily determine how much help they can get.

- Eliminate complex child care flexible spending accounts and reinvest the savings in the improved CDCTC. The President's proposal would replace the current system of complex and duplicative incentives with one generous and simple child care tax benefit.

The President's child care tax proposal will complement major new investments in the President's Budget to improve child care quality, access, and affordability for working families.

Consolidating and Improving Education Tax Incentives

While the creation of the American Opportunity Tax Credit in 2009 made college more affordable for millions of students and their families, our system of tax incentives for higher education is complex, and families are sometimes unable to take full advantage of these benefits. In fact, the Government Accountability Office (GAO) found that 27 percent of families who claimed one tax benefit would have been better off claiming another, while 14 percent of eligible families failed to claim any benefit at all.

Building on bipartisan reform proposals, the President's education tax reform plan would simplify, consolidate, and better target tax-based financial aid. The President's plan would cut taxes for 8.5 million families and students, simplify taxes for the more than 25 million families and students that claim education tax benefits, and provide students working toward a college degree with up to $2,500 of assistance each year for five years. These education tax reforms would complement the President's other proposals to make college more affordable, including continuing historic increases in the Pell scholarship program and making a quality community college education free for responsible students. Together, these proposals would benefit students, families, and the broader economy by helping more students earn a postsecondary credential. The President's education tax reform plan would:

- **Simplify, consolidate, and better target tax benefits through an improved AOTC**
    - Consolidate duplicative and less effective education benefits into a permanent, improved AOTC. Under current law, the AOTC is scheduled to expire after 2017 and revert to the less generous Hope tax credit. Under the President's plan, the AOTC would be a permanent feature of the tax code, so that students in school today would not have to worry that these benefits will expire before they graduate; the credit would also grow with inflation. The Lifetime Learning Credit and the tuition and fees deduction would be consolidated into the more generous AOTC.
    - Increase the refundable portion of the AOTC to $1,500. The President's plan adopts Congressional proposals – from members of both parties – to increase the refundable portion of the AOTC so that more working families and students can qualify. Like legislation that passed the House in 2014, the President's plan would increase the refundable portion from a

maximum of $1,000, or 40 percent of the total AOTC benefit, to a flat maximum of $1,500.

- Expand AOTC eligibility for non-traditional students. Currently, students must be at least half-time to qualify for the AOTC, and families can claim the credit for no more than four years. Under the President's plan, part-time students would be eligible for a $1,250 AOTC (up to $750 refundable) and all eligible students would be able to claim the AOTC for up to five years.

- **Make it easier for students and families to apply for tax credits**

  - Improve information reporting. The proposal would require colleges and universities to provide students with the tuition and fee information needed to claim the AOTC.

  - Simplify taxes for approximately 9 million Pell Grant recipients. Currently, eligible families leave tens of millions of dollars of AOTC credits on the table because the rules related to Pell Grants and the AOTC are so complicated. Like bipartisan Congressional proposals, the President's plan would exempt Pell Grants from taxation and the AOTC calculation, making it easier for Pell recipients to claim the tax benefits already available to them.

- **Better target and simplify tax relief for student debt and college savings**

  - Eliminate tax on student loan debt forgiveness under Pay-As-You-Earn (PAYE) and other income-based repayment plans. The President has worked to make student debt affordable for struggling borrowers by offering PAYE: an income-based repayment plan that lets borrowers limit student loan payments to no more than 10 percent of their discretionary income and qualify for forgiveness after 20 years of repayments. The Department of Education is currently amending its rules to extend this option to all direct student loan borrowers. However, under current law, PAYE participants who qualify for debt forgiveness after 20 years could face a large tax bill – likely a surprise to most borrowers, and for others a concern in choosing PAYE. The President's plan would continue to propose to exempt student loan forgiveness from taxation.

  - Repeal the complicated student loan interest deduction for new borrowers. The student loan interest deduction is complicated – so much so that many eligible borrowers fail to claim it – and provides very limited assistance ($100 on average) to a broad group of borrowers, rather than targeting more meaningful assistance to those borrowers struggling to afford their student loan payments. The President's plan would retain the student loan interest deduction for current borrowers. But for new borrowers, his plan would repeal this complicated tax break and instead provide more generous and more targeted tax relief through the improved AOTC while students are in school and through PAYE once they graduate.

  - Limit upside-down education savings incentives and consolidate them into a single benefit. The President's plan would consolidate education savings incentives into one vehicle and redirect the savings into the better targeted AOTC. Specifically, the President's plan will roll back expanded tax cuts for 529 education savings plans that were enacted in 2001 for new contributions, and – like Chairman Camp's tax reform plan – repeal tax incentives going forward for the much smaller Coverdell education savings program.

Reforming Retirement Tax Incentives and Expanding Savings Opportunities

Americans face a daunting array of choices when it comes to retirement savings. While some workers are automatically enrolled in a retirement savings plan by their employer (with an option to opt out), others have to open an account, manage contributions, and research and select investments on their own. Meanwhile, tax loopholes have allowed some high-income Americans to accumulate tens of millions of dollars in tax-preferred accounts that were intended to help workers save for a secure retirement, not to provide tax shelters for the wealthiest few.

The President's retirement tax reform proposals would dramatically expand access to employer-based retirement savings options, whether a new "auto-IRA," 401(k), or other employer plan. These proposals would give 30 million additional workers access to a workplace savings opportunity and would complement the President's actions over the past year to make saving for retirement easier by creating the simple, risk-free, and low-cost "myRA" starter savings vehicle. The President's reforms to make the system more robust for middle-class workers would be paid for by closing retirement tax loopholes for the wealthy. The President's retirement tax reform plan would:

- Automatically enroll Americans without access to a workplace retirement plan in an IRA. Under the proposal, every employer with more than 10 employees that does not currently offer a retirement plan would be required to automatically enroll their workers in an IRA. Auto-IRAs would let workers opt out of saving if they choose but would also let them start saving without sorting through a host of complex options. Auto-IRA proposals have been endorsed by independent scholars across the ideological spectrum, including those affiliated with AARP, the Brookings Institution and the Heritage Foundation.

- Provide tax cuts for auto-IRA adoption, as well as for businesses that choose to offer employer plans or switch to auto-enrollment. To minimize the burden on small businesses, the President's auto-IRA proposal would provide any employer with 100 or fewer employees who offers an auto-IRA a $3,000 tax credit. The President also proposes to triple the existing "start up" credit, so small employers who newly offer a retirement plan would receive a $4,500 tax credit – more than enough to offset administrative expenses. And because auto-enrollment is the most effective way to ensure workers with access to a plan participate, small employers who already offer a plan and add auto-enrollment would get an additional $1,500 tax credit.

- Ensure long-term, part-time workers can contribute to their employer's retirement plan. Only 37 percent of part-time workers have access to a workplace retirement plan. That's partly because employers offering retirement plans are allowed to exclude employees who work less than 1,000 hours per year, no matter how long they've worked for the employer. The President proposes to expand access for part-time workers by requiring employers who offer plans to permit employees who have worked for the employer for at least 500 hours per year for 3 years or more to make voluntary contributions to the plan.

- Prevent wealthy individuals from using loopholes to accumulate huge amounts of tax-favored retirement benefits. Tax-preferred retirement plans are intended to help working families save for retirement. But loopholes in the tax system have let some wealthy individuals convert tax-preferred retirement accounts into tax shelters, including 300 extraordinarily wealthy individuals who have accumulated more than $25 million each in IRAs. The President's plan would prohibit contributions to and accruals of additional benefits in tax-preferred retirement plans and IRAs once balances are about $3.4 million, enough to provide an annual income of $210,000 in retirement.

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