A Proposal to Simplify President Biden's Personal Income Tax Plan and Replace the Cap on SALT Deductions

STEVE WAMHOFF and MATTHEW GARDNER

SUMMARY

In this paper, we describe a tax policy idea that would simplify President Biden's plan to raise personal income taxes for those with annual incomes greater than $400,000. Our proposal would replace the cap on state and local tax (SALT) deductions with a broader limit on tax breaks for the rich that would raise more revenue than the personal income tax hikes that Biden proposed during his campaign. Our proposal would also achieve Biden's goals of setting the top rate at 39.6 percent and raising taxes only on those with income exceeding $400,000.

A new alternative tax that we call a High-Income Tax (HIT) would replace the cap on SALT deductions and the Alternative Minimum Tax (AMT). Taxpayers would pay whichever is higher, the regular personal income tax or the HIT. The HIT would equal 39.6 percent of adjusted gross income (AGI), the basic measure of income that everyone calculates on their income tax form.

The HIT would exempt the first $400,000 of AGI and this exemption would phase out for taxpayers with AGI between $400,000 and $600,000. This means that a taxpayer whose AGI exceeds $600,000 would have no exemption and their entire AGI would be subject to the 39.6 percent HIT. (The thresholds would be adjusted annually for inflation.) As explained further on, the exemption calculation would be based on the taxpayer's average AGI over several years to make the HIT more difficult to avoid.

The only break allowed against the HIT would be a credit equal to 28 percent of charitable giving. For the HIT (but not the regular income tax), this proposal would expand the definition of AGI to include capital gains on assets given away or left to heirs.

This would accomplish most of the personal income tax increases that Biden proposes. But, unlike Biden's proposals, most of the HIT could be enacted with just a few pages of legislation that require a simple calculation by well-off taxpayers. This proposal would, however, raise much more revenue because it is more aggressive in eliminating tax breaks for the very rich.

While the HIT is a moderate proposal that leaves the top tax rate no higher than it was before the 2017 tax law, it lays the groundwork for bolder progressive tax reform in the future. For example, if lawmakers decide to enact tax rates that are higher than 39.6 percent, it makes sense to add those rates to the HIT.

BACKGROUND

In October, an Institute on Taxation and Economic Policy (ITEP) **report** found that President Biden's tax proposals would raise income taxes and/or payroll taxes on just 1.9 percent of taxpayers in the United States with little variance across states. Our revised estimates using the most recent economic data similarly conclude that 1.8 percent of taxpayers would face higher personal income taxes and/or payroll taxes under President Biden's plan.

President Biden's plan includes increases in several taxes—the personal income tax, the Social Security payroll tax, the corporate income tax, and the estate tax. Elsewhere we have suggested improvements to other parts of Biden's tax plan. For example, we recently **wrote** in the American Prospect of executive actions that the new president could use to improve the corporate income tax until Congress enacts legislation to do so.

The proposal described here is designed to replace Biden's personal income proposals that raise revenue. (This proposal does not touch on Biden's proposals to provide personal income tax *cuts* such as his proposal to increase the Child Tax Credit, which ITEP has previously **analyzed**.)

This paper focuses on Biden's personal income tax increases partly because they are the most complex of his proposals and they could be improved with simplification.

THE BIDEN PLAN

The most important personal income tax increases in Biden's plan are the following:

- **Limiting certain tax breaks enacted as part of the Trump tax law for those with incomes of more than $400,000.**
    - **Restoring the personal income tax rates for taxable income exceeding $400,000 to their pre-Trump levels.** Whereas currently taxable income exceeding $400,000 is subject to rates of 35 and 37 percent, under Biden's proposal it would be subject to rates of 33, 35 and 39.6 percent.[1]
    - **Restoring the limit on itemized deductions (often called Pease after the lawmaker who drafted it), which applied before the Trump tax law was enacted, for those with taxable income exceeding $400,000.** This provision reduces itemized deductions by 3 percent of a taxpayer's income above a set limit, which under Biden's plan would be $400,000, but never eliminates more than 80 percent of a taxpayer's itemized deductions.
    - **Limit the 20 percent deduction for certain passthrough business income for those with taxable income exceeding $400,000.** Passthroughs are businesses whose profits are reported on the personal tax returns of the owners and not subject to the corporate income tax. Proponents of the passthrough deduction often describe it as helping small businesses, but most of its benefits go to the richest 1 percent.

- **For those with taxable income exceeding $1 million, eliminate the special, low personal income tax rate for capital gains and stock dividends and eliminate the rule that exempts capital gains on assets left to heirs.[2]** Currently, capital gains (profits from selling assets) and stock dividends are subject to the personal income tax at much lower rates than other types of income, with a top rate of 20 percent. Most of the benefits of the special rates for capital gains and dividends go to the richest 1 percent.
- **Limit itemized deductions to provide no more than 28 cents in tax savings for each dollar of deductions.** Without such a limit, anyone paying a marginal tax rate higher than 28 percent would save more than 28 cents for each dollar of deductions.[3]

ITEP's updated estimates of the most important personal income tax increases in the Biden tax plan are illustrated in Figure 1 (pg. 4). Because some of his proposed tax increases would fall on capital gains, this analysis accounts for the behavioral effects that Congress's official revenue estimators (the Joint Committee on Taxation) believe would limit the revenue impact of higher tax rates on that type of income. This is another way of saying the estimates account for the ways that rich people would avoid paying higher rates on capital gains income.[4]

FIGURE 1

Revenue Impact of Personal Income Tax Increases in Biden Tax Plan in Tax Year 2022

Figures in billions of dollars

Restore personal income tax rates for taxable income exceeding $400,000	$28.0
Restore limit on itemized deductions for those with taxable income exceeding $400,000	$21.1
Limit the 20 percent deduction for pass-through businesses for those with taxable income exceeding $400,000	$30.1
Eliminate the low personal income tax rate for capital gains and dividends for taxable income exceeding $1 million and limit the exemption for capital gains on assets left to heirs	$101.0
Limit itemized deductions to provide no more than 28 cents in tax savings for each dollar of deductions for taxable income exceeding $400,000	$15.3
Behavioral effects of higher taxes on capital gains	$ –58.5
Total Personal Income Tax Increase	**$137.0**

SOURCE: Institute on Taxation and Economic Policy tax model, December 2020

The analysis finds that in tax year 2022, Biden's significant personal income tax increases would raise $137 billion.

But most of that revenue could be lost if Congress amends Biden's plan to repeal the cap on SALT deductions. Repealing the SALT cap would drain $91 billion of the revenue from Biden's plan.

The SALT cap, enacted as part of the Trump-GOP tax law, effectively requires residents of jurisdictions with higher state and local taxes (e.g., "blue states") to pay for the Trump tax cuts. However, ITEP has repeatedly warned lawmakers that repealing or suspending the SALT cap without making other changes would provide a massive tax break for the rich.

House Democrats recently included a provision suspending the cap for 2020 as part of a COVID relief package. ITEP estimated that 62 percent of the benefits would go to the richest 1 percent and 86 percent would go to the richest 5 percent. There is no state where this is a primarily middle-class issue. In every state and the District of Columbia, more than half of the benefits would go to the richest 5 percent of taxpayers. In all but six states, more than half of the benefits would go to the richest 1 percent.

A High-Income Tax (HIT) Can Accomplish the Same Goals and Raise More Revenue

Biden's proposed personal income tax increases described previously would require complex legislation that would be difficult for lawmakers to explain and would also require many opaque calculations by taxpayers.

However, the goals of most of these proposals could be achieved with a few pages of legislation requiring high-income people to do a simple calculation. The proposal we describe would simplify the tax system by replacing the cap on SALT deductions and the Alternative Minimum Tax (AMT) with a simpler alternative tax that we call a High-Income Tax (HIT).

As described in the previous section, the $400,000 exemption from the HIT would be phased out for taxpayers whose AGI (averaged over several years) is between $400,000 and $600,000. The HIT would equal 39.6 percent of AGI in excess of the exemption. AGI for the purposes of the HIT would be expanded to include capital gains on assets given away or left to heirs. The only tax break expressly allowed against the HIT would be a credit equaling 28 percent of charitable donations.[5] (The HIT would implicitly allow existing tax breaks that affect the calculation of AGI, such as provisions allowing accelerated depreciation.)

The HIT would effectively accomplish all of Biden's personal income tax increases that are described, meaning there would be no need for legislation specifically addressing each of them.

The HIT would go further than what President Biden proposed during the campaign and, in fact, it would phase out (for the rich) all tax breaks that appear on the form 1040 after the calculation of AGI.

For example, the HIT would remove the benefit of lower-income tax brackets for the very rich, who would otherwise continue to pay lower tax rates on some portion of their income.

To take another example, the HIT would go further than President Biden's proposals in limiting itemized deductions for the rich. The Biden tax plan would reinstate the Pease limit on itemized deductions, leave the AMT in place, limit tax savings of each dollar of itemized deductions to 28 cents, and continue to limit deductions for SALT to $10,000 (although Congressional Democrats want to repeal this last limit). The HIT would be simpler but more aggressive because it would phase out itemized deductions and reinvent only one of them, the charitable deduction, as a 28 percent credit.

The tax incentive for charitable giving is arguably the itemized deduction that matters most for the rich under current law. (The deduction for SALT is limited to $10,000 and the deduction for mortgage interest is limited to interest on mortgages of no more than $750,000.) The charitable deduction is the most politically protected. Under the HIT, this tax incentive would be preserved but limited in a way that is similar to what President Biden proposed. The very rich would save 28 cents in taxes for each dollar of charitable giving, just as they would under the Biden tax proposal.

The HIT plan would repeal the SALT cap and the AMT and replace them with a more general limit on tax breaks for the rich that does not target blue states and that only applies to those with incomes exceeding $400,000.

ITEP's analysis finds that this proposal—requiring high-income people to pay whichever is higher, the HIT or the regular personal income tax—would raise $251 billion in tax year 2022, considerably more than the $137 billion that ITEP estimates would be raised by President Biden's main proposals to increase personal income taxes as described.

FIGURE 2

Revenue Impact of the High-Income Tax (HIT) in Tax Year 2022

Figures in billions of dollars

Require taxpayers to pay whichever is higher, the regular personal income tax or the HIT	$315.6
Behavioral effects of higher taxes on capital gains	$ −65.0
Total Tax Increase	**$250.7**

SOURCE: Institute on Taxation and Economic Policy tax model, December 2020

The most uncertain part of these estimates are the behavioral effects of higher rates on capital gains, but these effects do not change the fact that the HIT would raise more revenue. Excluding these behavioral effects, the HIT would raise $316 billion while the Biden tax proposal would raise $196 billion.

Figures 3 and 4 (pg. 7) illustrate the distributional impacts of President Biden's proposed personal income tax increases and the HIT. His proposals would raise personal income taxes on 0.5 percent of taxpayers. (As mentioned earlier, ITEP finds that the combination of Biden's personal income tax increases and payroll tax increases would raise taxes for 1.8 percent of taxpayers.) The HIT would raise taxes on 1.3 percent of taxpayers. The HIT would affect more taxpayers because it interprets Biden's pledge to hike taxes on no one with income under $400,000 (probably the only thing that most people know about Biden's tax plan) to apply to AGI rather than taxable income. But as illustrated in Figure 4, the HIT would be very concentrated on high-income people just as Biden's proposals would be.

This proposal would also cut taxes for 8 percent of taxpayers. These are taxpayers with AGI below $400,000 and who benefit from repeal of the cap on SALT deductions and repeal of the AMT.

FIGURE 3

Impacts of Biden's Proposed Personal Income Tax Increases in Tax Year 2022 in the United States

Income Group	Income Range	Average Income	Tax Change 1000's	Average Tax Change	Tax Change as % of Income	Share of Tax Change	Share with Tax Hikes
Poorest 20%	Less than $21,600	$11,300	$0	$0	0.0%	0%	0.0%
Second 20%	$21,600 to $40,800	$31,000	$0	$0	0.0%	0%	0.0%
Middle 20%	$40,800 to $67,100	$52,900	$0	$0	0.0%	0%	0.0%
Fourth 20%	$67,100 to $116,600	$88,300	$0	$0	0.0%	0%	0.0%
Next 15%	$116,600 to $261,400	$165,300	$ +25,400	$0	0.0%	0%	0.2%
Next 4%	$261,400 to $638,000	$379,000	$ +2,664,300	$ +410	0.1%	1%	20.4%
Richest 1%	$638,000 or more	$1,909,700	$ +192,823,800	$ +119,400	6.3%	99%	92.7%
ALL		**$95,000**	**$ +195,513,500**	**$ +1,200**	**1.3%**	**100%**	**1.8%**

SOURCE: Institute on Taxation and Economic Policy tax model, December 2020

FIGURE 4

Impacts of the High-Income Tax (HIT) in Tax Year 2022 in the United States

Income Group	Income Range	Average Income	Tax Change 1000's	Average Tax Change	Tax Change as % of Income	Share of Tax Change	Share with Tax Hikes
Poorest 20%	Less than $21,600	$11,300	$ –400	$0	0.0%	0%	0.0%
Second 20%	$21,600 to $40,800	$31,000	$ –16,800	$0	0.0%	0%	0.0%
Middle 20%	$40,800 to $67,100	$52,900	$ –117,600	$0	0.0%	0%	0.0%
Fourth 20%	$67,100 to $116,600	$88,300	$ –1,533,300	$ –50	-0.1%	0%	0.0%
Next 15%	$116,600 to $261,400	$165,300	$ –11,955,200	$ –490	-0.3%	-4%	0.0%
Next 4%	$261,400 to $638,000	$379,000	$ +8,860,600	$ +1,370	0.4%	3%	10.1%
Richest 1%	$638,000 or more	$1,909,700	$ +320,411,000	$ +198,400	10.4%	102%	88.8%
ALL		**$95,000**	**$ +315,648,300**	**$ +1,950**	**2.0%**	**100%**	**1.3%**

SOURCE: Institute on Taxation and Economic Policy tax model, December 2020

QUESTIONS ABOUT THE HIT

How can the HIT simplify the tax code if it leaves in place complicated provisions that allow tax breaks and merely imposes a limit on top of them that taxpayers must calculate near the bottom of their 1040?

The HIT does not create an ideal tax system, but it creates one that is simpler than current law and simpler than Biden's proposed personal income tax increases.

Biden's proposals would leave in place the cap on SALT deductions, although congressional Democrats want to repeal it. The Biden plan would also leave in place the complicated Alternative Minimum Tax (AMT), which limits itemized deductions and many other breaks. On top of that, his plan would reinstate the Pease provision, which reduces itemized deductions by 3 percent for AGI above a certain threshold, but never reduces itemized deductions by more than 80 percent. Biden would also create another limit (first proposed by the Obama administration) to allow no more than 28 cents of tax savings for each dollar of itemized deductions. Anyone with a marginal tax rate above 28 percent would normally save more than 28 cents for each dollar of deductions, but the ultimate effect is complicated due to the other limits already described. In fact, these various limits interact with each other in such complex ways that virtually no one would calculate their ultimate effect without tax accounting software.

The many tax breaks that are supposed to be incentives to engage in some socially desirable behavior cannot possibly be effective when taxpayers are unsure if they will benefit from them after the various limits (Pease, AMT, the 28 percent limit) are applied.

The HIT makes all this unnecessary. It requires a simple calculation. The taxpayer first determines how large a HIT exemption they are entitled to, and if their AGI exceeds $600,000, they are entitled to no exemption from the HIT. Their tentative HIT liability equals 39.6 percent of AGI in excess of their exemption, minus 28 percent of the charitable donations that would otherwise be claimed as charitable deductions. They then pay whichever is higher, their tentative HIT liability or their liability under the regular personal income tax.

What additional tax reforms could be made in addition to, and possibly along with, the proposal described here?

First, the tax credit for charitable giving, the only tax break expressly allowed against the HIT, could be improved to provide a more effective incentive. For example, lawmakers could consider limiting the credit to charitable giving that exceeds a certain percentage of a taxpayer's AGI. Most high-income households would probably make some amount of charitable donations even in the absence of any tax incentive. Limiting the tax credit to charitable giving in excess of some percentage of AGI could focus the tax subsidy on the marginal giving that is more likely to be influenced by tax considerations.

Second, most attempts to repeal or limit tax breaks that affect the calculation of AGI would require additional legislative language. For purposes of the HIT, the definition of AGI would be expanded to include unrealized capital gains on assets that are given away or left to heirs upon the taxpayer's death. Other than that, the HIT would not change the definition of AGI.

It would therefore not affect tax breaks like section 1031, which allows so-called "like-kind exchanges" used by investors to avoid reporting capital gains generated from real estate sales as income. For purposes of the HIT, lawmakers could choose to define AGI to include the profits from these transactions, which would have the effect of repealing section 1031 as Biden proposed during his campaign.

Other techniques that wealthy business owners and investors use to manipulate their profits and losses to ensure that profits never appear in their AGI would also be unaffected by the HIT as it is described here. Donald Trump is the most famous example of this sort of tax avoidance, which could be addressed through additional legislation.[6]

Third, if lawmakers decide to enact tax rates that are higher than 39.6 percent, it makes sense to add those rates to the HIT, which has a broader base than the regular personal income tax and therefore is more difficult to avoid.

The HIT exemption of $400,000 would be phased out for taxpayers with AGI between $400,000 and $600,000. Why should this phase-out be calculated based on the average AGI over several years rather than simply using the taxpayer's AGI in the current tax year?

AGI for the purposes of determining the exemption would be averaged over several years to prevent taxpayers in the phase-out range (meaning taxpayers with AGI between $400,000 and $600,000) from engaging in gaming and planning to avoid a tax increase.

If the phase-out was calculated using AGI from the current tax year, taxpayers in the phase-out range could face a very high effective marginal rate and could have the ability to rearrange their affairs to avoid paying it.

For taxpayers in this scenario, an additional dollar of income would increase the income subject to the HIT by three dollars (because it would increase AGI by one dollar while reducing the applicable exemption by two dollars.) Because the HIT has a rate of 39.6 percent, this means an additional dollar of income could increase taxes by 39.6 percent of three dollars, which is $1.19, meaning the effective marginal rate could reach as high as 119 percent for some taxpayers. Such high effective marginal tax rates could increase the incentives for taxpayers to use convoluted arrangements to avoid realizing or reporting income.

But if the exemption is phased out based on the taxpayer's average AGI over, say, 8 years, then any decision the taxpayer makes in a particular year has little effect on their exemption and it would be much more difficult to plan around any resulting tax increase. Under this rule, an additional dollar of income in a given year could increase the income subject to the HIT by just $1.25 (because it would increase AGI by one dollar while reducing the applicable exemption by 1/8 of two dollars). Because the HIT's rate of 39.6% multiplied by $1.25 is about 50 cents, this means the effective marginal tax rate would be, at most, 50 percent.

Also, because the income of many high-income people is somewhat volatile, it might be difficult for most well-off people to know in advance that their AGI will be in the phase-out range for several years in a row, making it difficult to plan their affairs to avoid it.

A transition rule could be used for the first several years that the HIT is in effect to accommodate the fact that many people today believe that they should retain their tax returns for only three years. For the first year the HIT is in effect, the exemption could be calculated using AGI average over four years (the current tax year plus three previous years). Each year the HIT is in effect, the average could be extended to include another year until it includes eight years. This would give taxpayers time to adjust to the fact that they need to retain their tax returns for a longer period.

ENDNOTES

1 We interpret Biden's proposal for rates to mean that the floors for the top two income tax brackets would be lower, as they were under prior law, which would mean more taxpayers would pay at the top two marginal income tax rates.

2 Congress's official revenue estimator, the Joint Committee on Taxation (JCT) assumes that capital gains income is very elastic in its relationship with the tax rate imposed on it. The higher the tax rate on capital gains, the more people with assets will use various techniques to avoid paying the increased rate. One of those techniques is to simply hold onto an asset until the end of one's life and pass it on to heirs. The tax rules currently exempt any capital gains on assets owned by a taxpayer at the time of death. But Biden's plan would repeal this tax break as well. Biden's plan would include unrealized capital gains on assets as taxable income on the final personal income tax return filed for a taxpayer after he or she dies. It is generally assumed that this would be similar to a proposal made by the Obama administration which maintained the exemption for middle-income taxpayers and also exempted assets that a taxpayer leaves to their spouse. This analysis does not include any revenue or distributional impact of taxing gains at death (which is uncertain in the short-run) but takes into account how taxing gains at death would reduce the ability of taxpayers with assets to avoid the rate increase on capital gains.

3 Under Biden's plan, there would be four income tax brackets with rates higher than 28 percent: 32, 33, 35 and 39.6 percent. However, Biden says he would raise taxes only for those with income exceeding $400,000. We therefore assume this change applies only to taxable income that would be, in the absence of itemized deductions, in the 33 percent bracket or higher given that the 33 percent bracket applies to taxable income of $400,000 under his plan.

4 According to a review of JCT's methods by the Congressional Research Service (CRS), at current tax rates, capital gains income has an elasticity of 0.68 in the long-term. (See "Capital Gains Tax Options: Behavioral Responses and Revenues," updated May 20, 2020. **https://fas.org/sgp/crs/misc/R41364.pdf**) For a very small rate increase this means that the amount of capital gains income realized will drop by 0.68 times the increase in the tax rate. Revenue raised would therefore be (1-0.68) times the static revenue estimate, or just 32 percent of the static revenue estimates. For a more significant rate increase such as the one Biden proposes, the math is more complicated. It is not entirely clear how much this elasticity would be reduced by taxing gains at death. The Tax Policy Center **assumes** that taxing gains at death would reduce the elasticity to 0.4. We adopt this assumption for our analysis. JCT assumes that the short-term elasticity for capital gains is even more dramatic than the long-term effect. This analysis uses the long-term elasticity (as reduced by the proposal to tax gains at death) in order to present a more representative example of the likely impact in a typical year.

5 For purposes of this 28 percent credit, charitable donations would be limited to a fraction of AGI just as they are under current law for the itemized deduction for charitable giving. Usually this fraction is 60 percent. This would make is relatively easy for taxpayers to calculate because eligible charitable donations would be defined the same way for the regular income tax's itemized deduction and for the credit against the HIT.

6 See Steve Wamhoff, "How True Tax Reform Would Eliminate Breaks for Real Estate Investors Like Donald Trump," Institute on Taxation and Economic Policy, December 1, 2017. **https://itep.org/how-true-tax-reform-would-eliminate-breaks-for-real-estate-investors-like-donald-trump/**