10 COMMON TAX MYTHS, DEBUNKED

WHAT YOU'LL LEARN

1. Identify some of the most common tax policy misconceptions and how to separate fact from fiction.
2. Discover why tax refunds shouldn't be celebrated, why you should pay your income tax bill, and why certain deductions are wrongly labeled "loopholes," among other useful facts.
3. Improve your ability to counter misleading arguments about the tax code.

MYTH 1: THE RICH DON'T PAY ANY TAXES IN THE U.S.

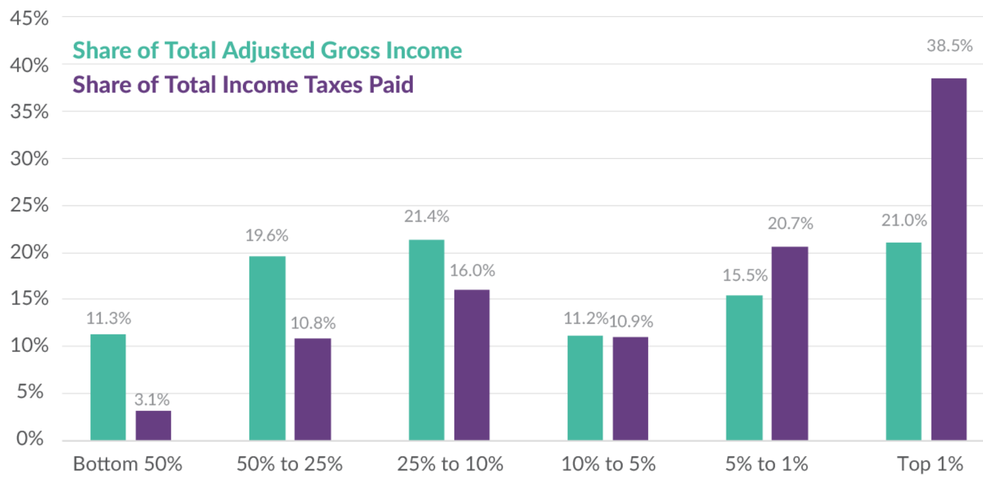
When it comes to this misconception, the opposite is true.

As with any progressive income tax system, U.S. taxpayers with higher incomes pay higher income tax rates. The result: half of U.S. taxpayers pay 97 percent of all income taxes.

The top 1 percent of earners alone pay over one-third of income taxes.

Half of Taxpayers Pay 97 Percent of All Income Taxes

Share of Income and Share of Federal Income Taxes Paid, by Income Group (2017)



Source: IRS, *Statistics of Income*, Individual Income Rates and Tax Shares (2019).

Of course, income taxes are only part of the story. Payroll taxes, sales taxes, and excise taxes are all regressive, meaning lower-income individuals contribute a greater share of their total income towards these taxes than do higher-income individuals.

So, what happens when you take into account *all* taxes paid? It turns out the U.S. federal tax system remains very progressive. Meaning, Americans with the highest incomes pay the largest share of all federal taxes.

Learn More

- Summary of the Latest Federal Income Tax Data
- Putting A Face on America's Tax Returns

MYTH 2: U.S. INCOME TAXES ON THE RICH WERE MUCH HIGHER IN THE 1950S.

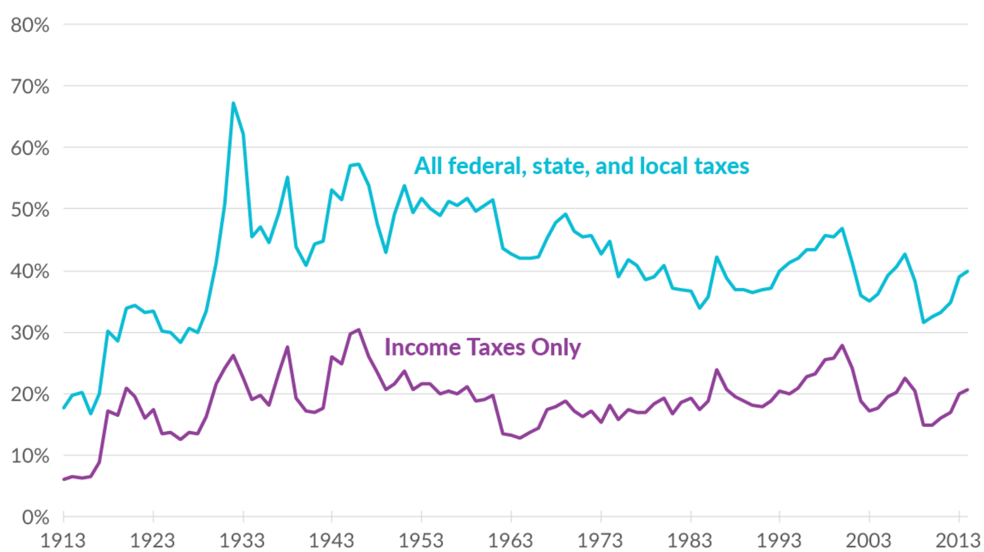
The idea that high-income Americans aren't paying nearly as much in income taxes as they used to has become a popular talking point.

Proponents of this view often point to the 1950s, when the top federal income tax rate was above 90 percent for most of the decade.

While marginal income tax rates have come down from their highs of 91 and 92 percent in the 1950s, changes in the tax base—how much and what types of income are subject to the tax—mean the effective tax rates on the wealthy—the rates they actually pay—haven't changed nearly as much.

In the 1950s, the top 0.1 percent of households faced average effective income tax rates of 21.0 percent, versus 20.7 percent as of 2014.

Average Effective Tax Rates on the Top 0.1 Percent of U.S. Households



Source: Piketty, Saez, Zucman, "Distributional National Accounts: Methods and Estimates for the United States, Appendix tables II: distributional series."

How could it be that a top marginal income tax rate over 90 percent resulted in an average income tax of only 21.0 percent during the 1950s? There are at least three reasons:

1. The 91 percent bracket of 1950 only applied to households with income over $200,000 (about $2 million in today's dollars). That means fewer than 10,000 households would have had enough income to fall into the 91 percent bracket to begin with!

2. Even among households that did fall into the 91 percent bracket, the majority of their income was not necessarily subject to that top bracket. After all, the 91 percent bracket only applied to income above $200,000, not to every single dollar earned by households.

3. Finally, it is very likely that the existence of a 91 percent bracket led to significant tax avoidance and lower reported income. There are many studies that show that, as marginal tax rates rise, income reported by taxpayers goes down.

Learn More

- Income Taxes on the Top 0.1 Percent Weren't Much Higher in the 1950s
- Putting A Face on America's Tax Returns

MYTH 3: THERE'S NO U.S. LAW REQUIRING YOU TO PAY INCOME TAX.

As a tax policy organization, we're often asked to demonstrate where in the law it says that people must pay income taxes and, when the Sixteenth Amendment is cited, which permits Congress to impose an income tax, we're often asked whether it was properly ratified.

While it is certainly important that taxpayers ask questions and know their rights, the truth is that the Sixteenth Amendment was ratified and became part of the U.S. Constitution in February 1913. Additionally, the U.S. Internal Revenue Code (IRC) clearly establishes the following:

- Imposes a tax on the taxable income of every individual (26 U.S.C. § 1)
- Defines taxable income as gross income minus allowed deductions (26 U.S.C. § 63)
- Defines gross income as "all income from whatever source derived" (26 U.S.C. § 61)
- Requires the filing of returns by every individual with gross income for the year, with few exceptions (26 U.S.C. § 6012)

Over the years, numerous court cases, representing just about every argument, have upheld the federal government's power to collect income taxes.

The Tax Foundation is no stranger to the complexity, unfairness, and economic burden income taxation imposes on the economy, but claiming the tax doesn't exist, or that the U.S. government has no authority to levy it, is probably not the best way to achieve better policy outcomes.

Learn More

- Text of the Sixteenth Amendment
- Internal Revenue Code, 26 U.S.C. § 1: Tax Imposed
- Internal Revenue Code, 26 U.S.C. § 63: Taxable Income Defined
- Internal Revenue Code, 21 U.S.C. § 63: Gross Income Defined
- Internal Revenue Code, 21 U.S.C. § 6012: Persons Required to Make Returns of Income

MYTH 4: A LARGE TAX REFUND IS CAUSE FOR CELEBRATION.

Everyone likes to receive money, but if you're one of the millions of taxpayers who received a tax refund last filing season, you should think twice about celebrating.

A large tax refund means more money is being withheld from your paycheck than needs to be. Indeed, for the 2018 tax year, the IRS issued more than $390 billion in refunds to more than 120 million taxpayers.

Some people may argue that this is a safe and easy way to save money, but think about it this way: if you receive a refund at the end of the tax year, that means you've been giving the government an interest-free loan all year.

And taking that a step further: wouldn't you be better off taking the amount you're overpaying and putting it in a savings account? Instead of the government earning interest on your money, you could be!

Learn More

- Your Tax Refund Doesn't Tell You How Much You Paid in Taxes

MYTH 5: THE STATE AND LOCAL TAX DEDUCTION (SALT) PROTECTS AGAINST DOUBLE TAXATION.

The Tax Cuts and Jobs Act of 2017 placed a $10,000 cap on the deduction for state and local taxes (SALT) as a means to broaden the individual income tax base and pay for reductions in individual income tax rates.

While many have viewed this as a positive reform, one argument that has stuck around in favor of reversing the change is that the SALT deduction is an essential protection against “double taxation.”

In fact, we often hear it argued that the coexistence of income taxes at the U.S. federal and state levels represents double taxation in and of itself.

The problem with that logic is that each level of government provides its own distinct package of services, which are each paid for separately via federal, state, and local taxes.

When two taxes levied by a single government, or similar types of governments (for instance, multiple states), fall disproportionately upon the same dollar of income, this represents a clear case of double taxation. For example, if an Idaho-based company earns $100 in New York, it should not pay income taxes on that $100 to both New York and Idaho. It should get a credit on its Idaho tax return for any income taxes paid in New York on that $100 of profits.

When different levels of governments levy taxes for distinct sets of services, the argument for a policy like the SALT deduction doesn’t hold up.

Learn More

- The State and Local Tax Deduction: A Primer
- Who Benefits from the State and Local Tax Deduction?

MYTH 6: MAJOR CORPORATIONS PAY NO TAX.

It’s true that in some years, certain corporations, often those that appear profitable, pay zero federal income taxes. That’s not due to any tricks or “loopholes” though. There are several legitimate reasons why a “profitable” corporation should not pay income taxes.

For the most part, this misconception comes down to two factors: a misunderstanding of how corporate income is *defined*, and a misunderstanding of how corporate income is *taxed*.

First, there’s reason to believe that many of the corporations you think of as being profitable won’t actually turn a profit this year. That’s because companies report what’s called “book income” on their financial statements, which follow typical U.S. accounting standards and are designed to make companies appear as profitable as possible to shareholders.

However, the tax code operates under different accounting rules. For tax purposes, governments use what’s called “taxable income,” which is defined by law and accounts for three important factors:

1. **A company’s net operating losses:** The U.S. tax code allows companies with losses in one tax year to deduct those losses from their profits in future tax years all the way down to zero, which prevents corporations with long-term net losses from being taxed.

2. **Where a company earns its profits:** Many large U.S. corporations conduct business in multiple countries, and the U.S. offers tax credits for the taxes they pay to foreign governments on their foreign income to mitigate double taxation.

3. **How much a company invests in equipment and machinery:** The most important difference between book income and taxable income has to do with the treatment of capital investment purchases, such as for new equipment and machinery. Under typical U.S. accounting standards, when a corporation makes a capital purchase, it is only able to treat a small fraction of that investment as a current-year expense and must write off that purchase over many years. By contrast, the U.S. tax code allows corporations to treat a much larger fraction of the same investment as a current-year expense, which means it can deduct that purchase from its taxes the same year it made the purchase.

So, next time you hear about a “profitable” company paying no income tax, chances are that it had a combination of both zero or negative book income and either net operating losses, significant foreign profits, sizable capital investments, or all of the above.

Learn More

- Taxable Income vs. Book Income: Why Some Corporations Pay No Income Tax
- U.S. Businesses Pay or Remit 93 Percent of All Taxes Collected in America
- Corporate Tax Rates around the World

MYTH 7: BUSINESS TAXES ONLY AFFECT BUSINESS OWNERS.

A common misunderstanding is that businesses bear the full burden of business taxes. That makes sense on its face, but in reality, economists agree that workers bear a significant portion of the burden as well.

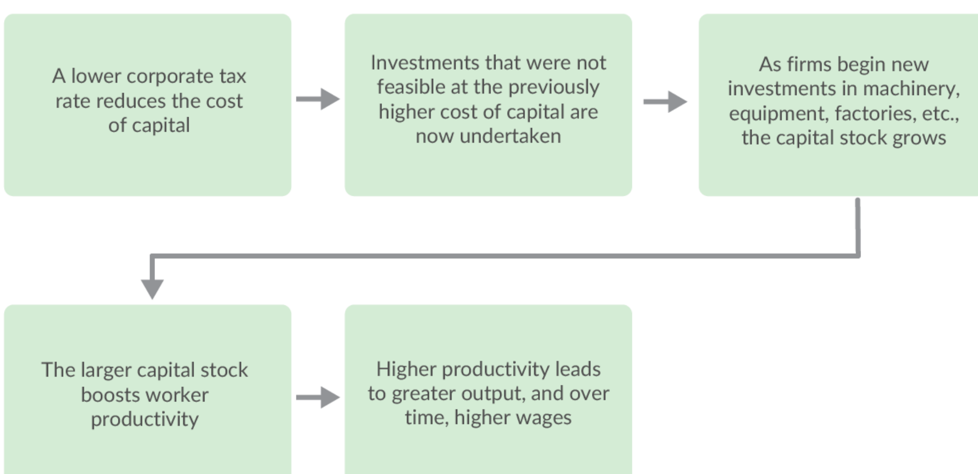
In fact, empirical studies show that workers (i.e., labor) bear more than 50 percent of the burden of the corporate income tax, and the U.S. Department of the Treasury, Congressional Budget Office, and Joint Committee on Taxation, Congress's official tax scorekeepers, all split the corporate tax burden between capital and labor in their estimates.

How is it possible that workers bear the brunt of a tax they don't even pay? The key lies in the difference between "legal" tax incidence—who is legally obligated to pay a tax—and what economists call "economic" tax incidence—who indirectly pays for a tax, often in the form of lower wages. To understand how this works, it's important to understand how taxes impact the way businesses make decisions.

Take a business owner considering whether to invest in upgraded computer equipment for her staff. In making that decision, she will weigh the overall cost of buying new computers against how much more productive she thinks they will make her staff and, by extension, how much revenue that will generate for her business. Taxes—sales and property taxes on the hardware, available deductions, income taxes on the resulting profit—will all play a big part in her cost calculation.

That's one reason business taxes affect more than just business owners. The higher business taxes are, the higher the cost of investing is and the less likely business owners are to invest in things like equipment, buildings, and trainings that will make their staff more productive. And the less productive workers are, the less their employers can afford to pay them in the long run.

How Lower Business Tax Rates Raise Worker Pay



Learn More

- The Benefits of Cutting the Corporate Income Tax Rate

MYTH 8: EXPENSING IS A LOOPHOLE.

When it comes to the tax code, a “loophole” is best understood as an omission or ambiguity in the law that unintentionally allows certain taxpayers to escape paying taxes.

To the contrary, expensing—the ability for companies to write off or deduct certain business expenses and investments—is a clear and intentional feature of the U.S. federal tax code as well as many others across the world.

In fact, most economists would describe expensing as a *desirable* feature of any modern tax code. When businesses calculate their income for tax purposes, they *should* subtract their costs because the corporate income tax is intended as a tax on business profits—i.e., revenues minus costs.

Additionally, allowing companies to fully and immediately deduct their investments—what’s known as “full” expensing—encourages investment and, in the long run, grows the economy at a relatively low cost to government revenues.

So, the next time you hear expensing described as a “loophole,” it’s worth questioning what’s motivating that choice of term. Regardless of what you think of a given policy, it’s unfair to classify it as a loophole if lawmakers clearly intended for it to be part of the tax code.

Learn More

- Understanding Why Full Expensing Matters
- Empirical Evidence Shows Expensing Leads to More Investment and Higher Employment
- The TCJA’s Expensing Provision Alleviates the Tax Code’s Bias Against Certain Investments

MYTH 9: TAX CUTS PAY FOR THEMSELVES.

It's sometimes argued that cutting taxes will spur so much economic growth and expand the tax base by so much that, at the end of the day, more revenue will be raised at a lower tax rate than was originally being brought in at a higher rate.

While this is theoretically possible, in practice, tax cuts do not typically pay for themselves in full.

Under normal circumstances, the revenue lost by cutting taxes will be greater than the revenue gained by growing the economy or reducing tax evasion.

That said, many tax cuts do *partially* pay for themselves, meaning economic growth and reduced tax avoidance cover a portion of forgone revenue.

The degree to which tax cuts pay for themselves depends on a number of factors, including how high the tax rate is that's being cut, how much it's cut by, and how responsive taxpayers are to that particular tax change.

Learn More

- Dynamic Scoring Made Simple

MYTH 10: OTHER COUNTRIES PAY TARIFFS.

Although tariffs are intended to increase consumption of goods manufactured at home by increasing the price of foreign-produced goods, they have a negative economic impact on all involved.

Tariffs may shield domestic industries from foreign competition in the short term, but they do so at the expense of others in the economy, including domestic consumers and other industries, which often rely on the goods being tariffed.

The result is that domestic taxpayers, especially those in the lower- and middle-income groups, rather than other countries, end up paying for tariffs in the form of higher prices and reduced economic output, employment, and wages.

Learn More

- Who Do They Harm? The Economic and Distributional Impact of the Trump Administration's Tariffs
- Primer: The Impact of Trade and Tariffs on the United States