Tax Reform - What's on the Table and What Might It Mean for You and Your Clients?

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Introduction[1]

President Bush and others have talked about reforming the tax code in the hopes of making it simpler and fairer while also promoting economic growth and job creation. Will such reform be fundamental, such as moving from an income tax to a national consumption tax? Or, will reform mean significant modifications to the income tax to make it look more like a consumption tax (such as by exempting some investment income) or to have it be a simpler income tax? With calls to make earlier tax cuts permanent, but with a very high revenue cost, some type of reform may be promoted as a revenue neutral alternative to our current system.

As happens about once every decade, fundamental tax reform has returned to the national political agenda.[2] Unlike many tax discussions that take place in Congress, discussions of replacing the federal income tax with a sales tax, a value-added tax or a flat tax are often reported as front page news. Thus, your clients may get quite interested and have questions for you. This outline and presentation are

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[1] Portions of these materials are based on an article by the author in the May 2005 *Tax Adviser*, as well as materials prepared by an AICPA Tax Reform Task Force of which the author is a member. The author maintains a Tax Reform website at http://www.cob.sjsu.edu/facstaff/nellen_a/txrefupd.html.

[2] For example, in 1977, Treasury Secretary William Simon issued the Treasury's *Blueprints for Basic Tax Reform* which proposed to stop tinkering with the tax system and instead design an entirely new system. In 1980, Congressman Ullman's Tax Restructuring Act of 1980 (H.R. 7015), proposed income tax changes as well as a 10% VAT; Cong. Rec. 4/2/80, pg. 7481. Major reform was also discussed in the mid-1990's, with various hearings held by Congressman Archer in the House Ways and Means and work by the National Commission on Economic Growth and Tax Reform formed by Senator Dole and Congressman Gingrich.

designed to help you answer these questions and educate your client as to what tax reform might mean to them, to businesses, and to the economy.

This outline looks at the following aspects of tax reform:

1) Why tax reform is on the national political agenda
2) Income tax versus consumption tax
3) Design features versus type of tax
4) The Advisory Panel's two proposals
5) How to evaluate tax reform proposals
6) Where to find more information

The accompanying slide presentation has additional information about the President's Advisory Panel and specific ideas on how to help clients understand tax reform and what it means for them.

Why Tax Reform is on the National Political Agenda

Key reasons offered for revamping or replacing the federal income tax include: simplification and economic growth. In announcing his plan for tax reform in 2004, President Bush suggested that there was a need to "fundamentally reform the tax code to make it simpler, fairer, and pro-growth."[3] Some of the specific concerns often cited about our income tax include that it discourages savings, taxes corporate income twice, provides a preference for corporate debt over equity (because interest is deductible, but dividends are not), taxes inflationary gains, includes too many tax preferences that distort decision-making, and creates a significant tax gap (difference between taxes that are owed and taxes that are voluntarily paid). Some people also suggest that the income tax is not transparent enough because numerous deductions, credits and exemptions, phase-outs and the alternative minimum tax, make it difficult for taxpayers to know their marginal tax rate. These reasons are explained in more detail next.

1. *The current system is too complex*

For example,

- The National Taxpayer Advocate lists "the confounding complexity of the tax code" as the most serious problem facing taxpayers today.[4]
- The instruction booklet for the 2004 Form 1040EZ is 36 pages. The 1040A has 72 pages of instructions. The IRS estimates that it will take 10 hours and 25 minutes to prepare Form 1040A, not including the schedules.[5]
- Most taxpayers do not prepare their federal income tax returns themselves. In 2003, 56% of individuals and over 85% of businesses hired someone to prepare their tax returns. For taxpayers claiming the earned income tax credit (EITC) over 70% used a paid preparer. In addition, 75% of taxpayers owing alternative minimum tax (AMT) used a paid preparer.[6]
- A 2005 survey of individual taxpayers by CCH found that the majority of those surveyed did not understand commonly encountered rules for calculating taxable income. For example, only 16% of those surveyed knew that a homeowner must live in their residence for two out of five years in order to exclude gain upon sale. Only 27% knew that distributions from Roth IRAs were

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[3] White House press release of 9/2/04.

[4] National Taxpayer Advocate report to Congress for 2004; available at http://www.irs.gov/pub/irs-utl/ntafy2004annualreport.pdf.

[5] 2004 Instructions to Form 1040A, page 57.

[6] 2004 National Taxpayer Advocate report, *supra*, pages 4 – 5.

excludable from income. And, only 8% of those surveyed could identify that there is an AMT formula that omits certain tax preferences from the determination of AMT.[7]

- About 15 to 25% of eligible individuals do not claim the EITC.[8]
- "The number of pages in the Internal Revenue Code and regulations has more than doubled over the past twenty years. Today's 'short' income tax form takes more than 11 hours to prepare - about the same as the 'long form' did a decade ago."[9]
- Taxpayers worked over 3.5 billion hours in 2004 to complete their income tax forms – about 26 hours on average.[10]

The problem of the federal income tax being too complex has been a topic of discussion for many years. The Tax Reform Act of 1976 (P.L. 94-455) called for the Joint Committee on Taxation (JCT) to study the problem. In September 1977, the staff of the JCT issued a report to the congressional tax committees explaining why the tax law had become complex and made suggestions for simplification.[11] Twenty years later, Congress requested that the JCT study problems of the tax law by issuing to each Congress (when funded to do so), a report on the overall state of the Federal tax system including possible simplification proposals.[12] In April 2001, the JCT issued an immense 3-volume report, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification* (JCS-3-01) which reviews the entire code and explains sources of complexity and possible solutions. Within two months of the issuance of the JCT's report, the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) was enacted which *increased* the complexity of the income tax law through new provisions, phase-outs and varying effective dates, although all provisions of the Act expire after 2010 (yet another example of complexity – temporary provisions).

The costs of complexity have been noted by the Advisory Panel and others. In an April 13, 2005 statement from the members of the Advisory Panel, they note that the cost to the U.S. economy is about $140 billion annually which is about $1,000 per family.[13]

2. The level of savings in the U.S. is too low

The current U.S. tax system is viewed as not encouraging savings because it taxes earnings from savings. Household savings rates are lower for the U.S. than for many other countries. OECD data for 2003 for selected countries are provided below. The OECD describes household savings as a key domestic source of investment. Household savings is computed as disposable income from wages, unincorporated businesses, investment and the imputed rents paid by owner-occupiers of housing, less cash outlays for consumer goods and services and the imputed rents that owner-occupiers pay to themselves. [14]

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[7] CCH, "CCH Complete Tax Survey Suggests Taxpayers Confused by Tax Code Complexity," 3/16/05; available at http://www.cch.com/press/news/2005/20050316t.asp.

[8] Advisory Panel's Final Report, page 68.

[9] White House press release of 9/2/04 stating President Bush's plan to form a panel to study tax reform; available at http://www.whitehouse.gov/news/releases/2004/09/20040902-7.html

[10] The President's Advisroy Panel on Federal Tax Reform – Final Report, November 2005, page 2.

[11] JCT, *Issues in Simplification of the Income Tax Laws*, JCS-57-77, 9/19/77.

[12] P.L. 105-206, the IRS Restructuring and Reform Act of 1998 which added IRC §8022.

[13] The President's Advisory Panel on Federal Tax Reform, "America Needs a Better Tax System," available at http://taxreformpanel.gov/04132005.pdf.

[14] OECD, *Economic Situation, Analysis and Projections*, December 2004, Annex Table 23. Available at http://ninetta.sourceoecd.org/vl=937741/cl=41/nw=1/rpsv/factbook/02-02-03.htm.

Country	Household net saving rates % of disposable household income
Canada	1.4
France	11.1
Germany	10.7
Japan	6.3
United Kingdom	5.5 (gross savings)
United States	1.4

In addition, gross national savings[15] are lower for the U.S. than for other industrialized countries. OECD data for 2002 for the same countries are provided below:[16]

Country	Gross national saving % of nominal GDP
Canada	22.3
France	20.9
Germany	21.1
Japan	25.7
United Kingdom	14.9
United States	14.6

The Advisory Panel's Final Report notes that research indicates that a tax system "neutral between savings and current spending could increase the national savings rates by 12 to 31 percent over a period of 14 years." (page 91)

3. The current system impedes international competitiveness of U.S. firms

The U.S. tax system has differences from those of trading partners. For example, the U.S. has a worldwide tax system where all income is taxed no matter where it is earned. In contrast, many countries use a territorial system which only taxes income earned within the borders. Also, U.S. income taxes are not border adjustable, whereas indirect taxes, such as value-added taxes, can be imposed on imported goods and refunded for exports, in compliance with WTO agreements. Also, all OECD countries, other than the U.S., rely on a value-added tax, usually in addition to an income tax.[17]

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15 The Congressional Budget Office defines "national saving" as "total saving by all sectors of the economy: personal saving, business saving (corporate after-tax profits not paid as dividends), and government saving (the budget surplus). National saving represents all income not consumed, publicly or privately, during a given period." CBO website at http://www.cbo.gov/showdoc.cfm?index=6060&sequence=13 and http://www.oecd.org/dataoecd/5/48/2483858.xls.

16 OECD, *Economic Situation, Analysis and Projections*, December 2004, Annex Table 24. Available at http://www.oecd.org/dataoecd/5/48/2483858.xls.

17 OECD, *Consumption Tax Trends*, 1995, pg. 11.

In July 2003, the Senate Finance Committee held a set of hearings on the competitiveness of U.S. firms from both the perspective of U.S.-based firms and U.S.-owned foreign operations. Several witnesses noted areas where U.S. tax laws had not kept up with changes in today's global marketplace and ways of doing business. As noted in testimony by the Assistant Secretary of the Department of the Treasury: "Many areas of our tax law are in need of reform to ensure that our tax system does not impede the efficient, effective, and successful operations of U.S. companies and the American workers they employ in today's global marketplace."[18]

4. The tax gap is too large

The IRS estimates that for 2001, the tax gap (the difference between taxes owed and taxes paid on time) was between $312 billion to $353 billion for all types of taxes. This means that the rate of non-compliance with federal taxes is between 15% and 16.6%. The IRS estimates that its enforcement and collection efforts eventually bring the uncollected amount down to between $257 and $298 billion.[19] The National Taxpayer Advocate notes that with 130 million individual taxpayers in the U.S., on average, each of these individuals pays about $2,000 annually to "subsidize" this non-compliance. The IRS estimates that 67% of this tax gap is due to non-filing and under-reporting by sole proprietors whose income is not subject to W-2 and 1099 reporting. The National Taxpayer Advocate also notes that the tax gap has grown at "ever-expanding rates" in the past 20 years. The gross tax gap was estimated at $76 billion in 1981, $127 billion in 1992 and $310 in 2001. Thus, the gap increased 67% from 1981 to 1992, but from 1992 to 2001, increased 144%[20]

The 2004 annual report of the IRS Oversight Board noted that public attitudes towards cheating on tax returns have worsened since 1999. In 1999, 11% of Americans indicated that it was okay to cheat at least a little on their tax return, that number was 13% in 2002 and 17% (almost one in five people) in 2003.[21]

5. The system is not neutral

The current U.S. tax system is frequently used to create incentives to either encourage a particular activity or discourage a particular activity (that is, it is not neutral). Just about any economic, social or environmental "problem" can be alleviated to some degree through a tax provision. For example, an excise tax on certain types of chemicals that cause pollution or a tax credit for purchasing energy-efficient equipment will alleviate some environmental problems, but will cause the tax law to impact decision-making by taxpayers and increase the complexity of the tax law. In stating his intention to study tax reform, President Bush stated: "The current tax code is a maze of special interest loopholes that causes America's taxpayers to spend more than six billion hours every year on paperwork and other headaches."[22]

The cost of preferential rules in the tax system is rarely weighed against alternatives for reaching the same goal, either when they are added, or in future years. For example, does the cost to the government of the exclusion for interest income on state and local bonds cost the federal government more than the benefit derived by the state and local governments? If the cost to the federal government is larger, a direct subsidy from the federal government to the state and local governments would be

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[18] Testimony of Pamela Olson, Assistant Secretary, Department of the Treasury, Washington, DC; Senate Finance Committee hearing - An Examination of U.S. Tax Policy and Its Effect on the Domestic and International Competitiveness of U.S.-Owned Foreign Operations, July 15, 2003; available at http://finance.senate.gov/sitepages/2003HearingF.htm/hearings2003.htm. An earlier hearing on July 8, 2003 examined U.S. Tax Policy and Its Effect on the Domestic and International Competitiveness of U.S.- Based Operations.

[19] IRS, "Understanding the Tax Gap," FS-2005-14, March 2005; available at http://www.irs.gov/newsroom/article/0,,id=137247,00.html.

[20] National Taxpayer Advocate report to Congress for 2004, pages 5 – 6, 66, 211, 229; available at http://www.irs.gov/pub/irs-utl/ntafy2004annualreport.pdf.

[21] IRS Oversight Board, FY2005/Special Report of March 2004, pages 19 - 20; available at http://www.treas.gov/irsob/documents/fy2005-budget-report.pdf.

[22] White House press release of 9/2/04; available at http://www.whitehouse.gov/news/releases/2004/09/20040902-7.html

"cheaper" than having a tax preference for bond interest. However, such analysis is rarely performed due to its difficulty and the ease of adding preferences to the tax law. Also, once a tax preference is added to the tax law, there is not systematic approach to evaluating them regularly for effectiveness and value. Such preferences get added to the list of "tax expenditures" and measured frequently, but with no evaluation of their value.[23]

Some preferences have evolved to the point of, arguably, losing sight of their underlying purpose. For example, a home mortgage deduction is allowed to encourage home ownership. However, the current tax rule allows for deduction of mortgage interest on two homes, rather than just one, and on debt up to $1.1 million, far greater than the average home cost in the U.S. This rule also allows an interest deduction for home equity loans which have nothing to do with acquiring a home, but allow homeowners to deduct interest on loans used for personal expenditures – something a non-homeowner is unable to do. The charitable contribution deduction yields the same benefit to an individual making a donation to a private university or symphony orchestra as for someone donating to an organization to help those who might be viewed as more in need of philanthropic support (such as people who are poor or ill). In addition, a desire to help families and individuals pay for higher education has yielded several different provisions all aimed at the same goal. How many different types of preferences are needed for one goal?

With respect to the likely impact of the tax rules on investments, the Advisory Panel's Final Report notes the following effective tax rates on different investments (page 71):

Owner-occupied housing	0%
Non-corporate business	17%
Corporate business	26%
Investment by the business sector	22%
Economy-wide total	14%

6. The measure of income has imperfections

The measurement of income is not a precise science. Thus, challenges to the determination of the tax base in an income tax system can almost always be called into question. In addition, determining who the taxpayer is – individuals, a married couple or a family unit, can also raise questions. Some of the features of the Federal income tax that are sometimes questioned include the following:

- § Double taxation of corporate income.
- § Encouragement of corporate debt over corporate equity through a deduction for interest, but not for dividends.
- § Limitations on capital losses.
- § Taxation of inflationary gains.
- § Preferential treatment of certain types of income, such as fringe benefits, tax-exempt bond interest, and capital gains.
- § Lack of basic conformity with accounting principles, such as disregard for the matching principle.
- § Depreciable lives provided in the tax law do not always tie to the economic life of assets.
- § Many married taxpayers are subject to higher tax rates as married taxpayers than if they each filed as single (the *marriage penalty*).
- § Investment of some children is taxed at the parent's higher tax rate (the *kiddie tax*).
- § There are not effective reporting mechanisms for all types of income which causes some of that income to go unreported (one of the causes of the tax gap).

[23] The final report of The President's Advisory Panel on Federal Tax Reform notes that for FY 2006-2010, the largest tax expenditure are health deductions, incentives for home ownership and retirement saving provisions (page 27).

7. The federal income tax violates the equity and fairness principle

The selective nature of deductions, exemptions and credits arguably causes taxpayers with similar levels of economic income to pay different amounts of tax. For example, an individual with significant medical expenses might get a deduction whereas an individual with an equal amount of education expenses will not get a deduction and so will pay more tax even thought their income and cash availability amounts are similar.

Also, the deduction of state income and property taxes (although not for AMT) provides a bigger benefit to high tax states that is in effect subsidized by taxpayers in other states.

Also, the exclusion for health insurance provides a more significant tax benefit to the insured than if they had to buy a policy on their own with after-tax dollars. Thus, even if they have similar income levels, the individual with employer-provided health care has a lower tax obligation.

Income Tax versus Consumption Tax

A point often overlooked in fundamental tax reform discussions is that most proposals call for replacing the income tax with a consumption tax. Some of the proposals, such as the flat tax proposal (such as that introduced by former Congressman Armey) look like an income tax, but are really a consumption tax. Following are explanations of the income tax and possible reforms to it, as well as the basics of a consumption tax and possible proposals.

An *income tax* is a tax based on revenue less cost of goods sold and allowable deductions. The formula is similar to financial accounting. Common questions that arise in creating an income tax include: What is income? Should a broad economic concept be used that would include such items as government provided benefits, imputed rental value of owner-occupied housing, and gifts received? What expenses should be allowed to reduce income? Should rates be progressive or flat?

President Bush's Advisory Panel was charged to come up with at least one proposal based on the income tax. Such a proposal might be one with significant modifications to the income tax such as compressing the rate structure so there are fewer rates, eliminating many credits and deductions while lowering tax rates to allow for simplification and revenue neutrality, and making the system return free for many individuals. Information on these types of modifications can be obtained from the Joint Committee on Taxation's (JCT) 2001 simplification study (http://www.house.gov/jct/pubs01.html), the 2005 JCT report on reforming tax expenditures (http://www.house.gov/jct/s-2-05.pdf) and Treasury's 2003 report on return-free tax systems (http://www.treas.gov/offices/tax-policy/library/noreturn.pdf).

A *consumption tax* is a tax on spending rather than on income; income is taxed when spent (consumed), not when it is saved. Common forms of a consumption tax are the sales tax and value-added tax. A consumption tax exempts savings, and allows businesses to currently deduct investment in capital (such as land, building and equipment), rather than depreciating the cost over a period of years. Such expensing removes the expected future income from that investment from taxation.

If consumption is taxed, it can either be done directly (from the payer's perspective), such as with a sales tax, or indirectly (by taxing Income less Savings). There are two ways to measure consumption as Income less Savings: a) all income less savings ("cash-flow approach"), or b) earned income only ("tax prepayment approach"). Of course, this simple equation can become complicated when a taxpayer borrows money for consumption. Following are some simple examples using a 20% tax rate to illustrate the equality of the cash flow and tax prepayment approaches to taxing consumption.[24]

> *Cash flow approach*: Individual earns $25,000 and saves $1,000 in an account earning 5%. The $1,000 savings deduction produces a tax benefit of $200 ($1,000 x 20% tax rate). One year later, Individual withdraws the $1,000 + the $50 interest, and includes $1,050 in his tax base producing

[24] From Joint Committee on Taxation, ***Description and Analysis of Proposals to Replace the Federal Income Tax***, 6/5/95, JCS-18-95, pages 52 – 54; available at http://www.house.gov/jct/s-18-95.pdf.

an additional tax of $210 ($1,050 x 20%). The net proceeds of the transaction is $1,050 - $210 = $840.

Tax prepayment approach: Same facts as above. Individual pays $200 tax on the $1,000 saved, and thus saves only $800. One year later, he withdraws $840 ($800 + 5% interest) and pays no tax on any of this amount, thus netting $840 as in the earlier example. This approach is used in the flat tax proposals of former Congressman Armey and economists Hall and Rabushka. A current example is H.R. 1040 of the 109th Congress.

Instead of computing consumption as Income less Savings, a consumption tax can also be collected by applying the tax to every purchase of goods and services made by the final consumers - a sales tax. This is equivalent to taxing businesses on sales to nonbusinesses.[25] And, under a sales tax, it is businesses that complete the tax forms - not the consumers who are the ultimate taxpayers. Thus, it is considered an indirect tax. Currently in the U.S., most state sales tax systems also tax consumption by businesses. Thus, unlike a VAT, sales tax in the U.S. is a cascading tax. Some states have partially alleviated this by exempting manufacturing and R&D equipment from the sales tax. However, the intent behind such exemptions typically is not to alleviate the cascading effect, but to provide an incentive for businesses to locate in that particular state. Also, in the U.S., no state taxes all forms of consumption. Often, consumption of food, services, intangibles, and real estate are exempt.

A commonly cited economic benefit of a consumption tax over an income tax is that a consumption tax does not penalize a taxpayer who earns and saves in early years and then consumes in later years, relative to a taxpayer who does not postpone consumption. A consumption tax would treat taxpayers with either consumption pattern similarly. The unequal treatment of these taxpayers under an income tax stems from the fact that the early saver will pay tax on earnings from savings. Stated another way, the early consumer will have less income over his lifetime (less earnings from savings), which would impact lifetime income taxes, but not lifetime consumption taxes. Thus, the perceived benefit of a consumption tax relative to an income tax is that it will increase savings and investment.

Common questions that arise in designing a consumption tax include: Who is the taxpayer/consumer? For example, who is the consumer of a college education or child care? Is education an investment or consumption? Should any types of consumption (such as medical care and food) be exempt? Should rates be progressive or flat? How should regressivity[26] concerns be addressed?

Consumption tax proposals over the past several years include the flat tax, national retail sales tax, value-added taxes, a system based on the formula of income less savings, or an add-on consumption tax.

Design Features versus Type of Tax

The concerns with the current tax system that lead many people to call for its reform are ones that can exist under ***any*** type of tax system – they are mostly problems that stem from design decisions, not the basic type of tax itself. For example, while there is no dispute that the Federal income tax system is too complex, many would also describe state sales and use tax systems as complex. Does an income tax have to be complex? No. Our system has become complex for many reasons including some that have nothing to do with measuring income (for example: child credit, energy credits, the alternative minimum tax) Also, another concern with today's income tax is that there is a significant tax gap. However, a tax gap is not unique to an income tax, but exists with other taxes as well. Thus, it is important to note that

[25] This is also the approach of a value-added tax. Thus, it is also the approach of the Armey flat tax.

[26] A tax is regressive if a higher percentage of a lower income taxpayer's income goes towards paying the tax relative to a high income taxpayer. Sales taxes and gasoline excise taxes are regressive. For example, assume two individuals each buy the same quantity of gasoline and pay $100 of excise taxes. Individual A has income of $10,000 while individual B has $100,000 of income. For A, the gasoline tax represents 1% of his income, while it represents only 0.1% of B's income. In contrast, a tax is progressive if taxpayers with higher incomes pay a higher percentage of their income in taxes, relative to the percentage for lower income taxpayers. Our current federal income tax system is progressive.

the reasons often cited for major tax reform do not necessarily mandate that the income tax be repealed and replaced with a different tax.

The Panel's Two Proposals

The Final Report of the Advisory Panel, issued 11/1/05, is over 270 pages long! It contains a fair amount of background on issues leading to reform, consumption taxes and many of the details of the two proposals recommended by the Panel (but not all details). The report and testimony can be found at http://taxreformpanel.gov/.

Basics of the Two Proposals

The Panel proposes two possible alternatives to the current federal income tax: (1) Simplified Income Tax and (2) Growth and Investment Tax. A summary of each is provided below. Summary comparison tables from the Advisory Panel's Final Report are included at the end of this outline.

- Simplified Income Tax
  - See chart in next section for some common features this tax shares with the Growth and Investment Tax Plan.
  - See sample form 1040-Simple from the Advisory Panel's Final Report included at the end of this outline. The Panel expects that 75% of individuals would only need to file this form along with a Schedule A for the Family Credit.
  - A "streamlined version" of our current system. (p 59)
  - Fewer tax provisions in order to broaden the base, make the system simpler and to make it more equitable (fewer types of preferential income).
  - Double taxation almost completely removed by allowing dividends of U.S. corporations paid out of U.S. earnings to be non-taxable and only taxing 25% of capital gains from sale of stock of U.S. companies. Dividends representing foreign earnings are fully taxable.
  - Individuals continue to exclude interest income on tax-exempt bonds. Businesses would report such income since they can also deduct all interest expense.
  - Encourage savings through three types of plans: Save at Work, Save for Retirement, and Save for Family (see chart below for basics of these plans). Goal is to simplify plans so that they are more likely to be used. These provisions are also part of the Growth & Investment Tax Plan.
  - Sale of principal residence – increase the exclusion to $300,000 single and $600,000 married which would be the current amounts if the 1997 amounts were adjusted for inflation. The usage period is increased to 3 out of 5 years.
  - No more than 1/3 of an individual's income is to be subject to tax.
  - Business taxation – depends on size of business:
    - Small – gross receipts equal to or lesser than $1 million[27]
      - Intended to cover over 22 million non-corporate businesses which is over 95% of all businesses (page 127)
      - Cash method allowed (as under Rev. Proc. 2001-10)
      - Expensing of tangible and intangible assets other than land and buildings

[27] The Final Report refers to small under $1 million of gross receipts and medium as over $1 million. It is likely, that the Panel intends for exactly $1 million to be "small." A similar error is made regarding the definition of medium and it is likely that exactly $10 million of gross receipts is "medium." Gross receipts are measured based on the average prior 3-year period. Once a business falls into a category, it can no longer go back to a smaller category (page 128).

- Medium – gross receipts over $1 million and less than or equal to $10 million
  - Could use "simplified and expanded cash accounting" (page 128)
  - For inventory, can follow Rev. Proc. 2002-28
- Large – gross receipts over $10 million
  - Today, there are only about 150,000 active U.S. businesses of this size (page 129)
  - Flat tax rate of 31.5%
  - Taxed at entity level as corporations meaning that owners can exclude distributions of U.S. earnings and exclude 75% of capital gains on sale of interests in large businesses.
  - Partnerships, S corporations and LLCs of this size will have domestic earnings subject to tax at the entity level. Rationale to treat all large corporations the same is to allow fewer opportunities for tax shelters and simplify taxation of the owners.
  - All tax preferences eliminated except for accelerated depreciation including R&D credit, §199 deduction, and deductions for state and local taxes.
  - Panel recommends a study on use of financial statement income for tax purposes for further simplification.

§ Small and Medium Businesses

  § Subject to individual tax rates

  § Panel recommends that rules on contributions, distributions, liquidations and allocations of income for passthrough entities be simplified and that a partnership of only a married couple be allowed to be treated as a sole proprietorship. Apparent goal is to have all U.S. businesses subject to just a single layer of tax, at least for domestic earnings.

  § Special recordkeeping for small and medium businesses: Must use "designated bank accounts into which they would deposit all receipts and from which they would make business expenditures." No personal expenditures could be made from the account. Banks would have to give the business an annual summary of inflows and outflows which would also be reported to the IRS. Issuers of debit and credit cards would have to do the same reporting.

§ Simplified Cost Recovery System (pages 131-132)

- 4 asset categories per the chart below
- Small and medium businesses could use a simple system of adding new assets to the appropriate category rather than tracking assets by acquisition date. Proceeds of asset dispositions would all be included in taxable income. There would be no need to track separate assets.

	Category I	Category II	Category III	Category IV
Type of asset	Assets used in agricultural, mining, manufacturing, transportation, trade, and service sectors.	Assets used for energy production, a few other relatively long-lived utility properties, and most land improvements.	Residential buildings	Non-residential buildings and other long-lived real property
Annual recovery percentage	30%	7.5%	4%	3%

- International provisions
  - Active business income earned abroad taxed on territorial basis, so no U.S. tax when dividend paid to U.S. entity. However, dividends paid from foreign royalties and interest would be subject to U.S. tax.
  - Financial income earned abroad would be currently taxed in U.S. subject to foreign tax credit.
  - Residency test for foreign entities would be changed to provide that a business is a U.S. resident if the U.S. is its place of legal residency or if the U.S. is its place of "primary management and control."

- Growth and Investment Tax
  - See chart in next section for some common features this tax shares with the Simplified Income Tax Plan.
  - See sample tax form at the end of this outline.
  - Moves us in a "new direction" by reducing burden on savings and investment so as to boost economic growth without fundamentally changing how the tax burden is distributed. (p 59)
  - Moves us closer to a consumption tax. Is a combination of a "progressive tax on labor income and a flat-rate tax on interest, dividends, and capital gains" and "a single-rate tax on business cash flow." (page 151)
  - Dividends, capital gains and interest income (other than tax-exempt) is subject to 15% rate for individuals. "Given the opportunity and flexibility of [the] savings accounts, the Panel expects that relatively few families would pay the 15 percent ax on interest, dividends, and capital gains that would apply to assets held outside these accounts." (page 160)
  - Business "cash flow" subject to tax = gross receipts less cost of materials, labor, and purchases of business assets. Interest income and expense are omitted from the base. Thus, resembles a subtraction method VAT except that wages and other compensation are deductible (similar to the "flat tax"). This approach was used rather than a credit invoice VAT used more widely throughout the world because the subtraction VAT looks more like an income tax and existing tax system recordkeeping systems can continue to be used making a transition to this tax easier.
  - Flat business tax rate of 30%, except for sole proprietorships.
  - All business purchases are immediately expensed. The Final Report is not specific, but this should also mean that when these assets are sold, the entire sales proceeds goes into the tax base.
  - Special rules provided for financial institutions.
  - International transactions are taxed on the destination basis so that the tax is rebated on exports and imports are not deductible from the base. This approach taxes all domestic consumption equally. This is a common approach used by our major trading partners. The Final Report includes a discussion of origin versus destination basis and the advantages of the destination approach on pages 167 to 172.
  - Losses would not be refundable. The Panel recommends though that interest factor be added to loss carryforwards. Thus, assuming a 10% interest rate, a $10 million loss in Year 1 results in a $1.1 million loss offset in Year 2. This prevents companies form losing the time value of money on the losses not currently usable. Losses would carryforward indefinitely, but disappear of the company goes out of business. Rules similar to IRC §382 would be needed to prevent transfers of losses primarily to reduce the base of another company.

- § Transition recommendations for businesses:
  - Phase-out for depreciation deductions on existing depreciable assets.
  - Phase-out for interest expense deductions on existing debt.
  - 4-year phase-in for border-tax adjustments (tax on imports).
  - Special rules for financial institutions.
  - Perhaps others for credits and other items.

  The panel notes the tension between transitional relief, tax rates and the economic growth and efficiency gains expected from a consumption tax.

For further details of both plans, see Chapters 5 to 7 and the Appendix of the report available at http://taxreformpanel.gov/final-report/.

Commonalities of the Two Proposals

Current	Proposed
Personal exemption Standard deduction Child credit Head-of-household filing status 10% bracket	Family Credit - for all individuals - no phase-outs - adjusted for inflation
EITC Refundable child credit	Work Credit - like the EITC, increases to a certain income level and then decreases until phased out - adjusted for inflation - taxpayer may request that IRS compute it.
Marriage penalty	Marriage penalty minimized by making provisions for married taxpayers double the single provision
AMT	No AMT - "most vivid example of the wasteful complexity that has been built into our system to limit the availability of some tax benefits." (p 85-86)
State income and property taxes deductible for itemizers.	No deduction for state taxes. - current system favors itemizers - current system results in residents of low tax states subsidizing residents of high tax states
Charitable contribution deduction - if itemize deductions - In 2003, about 74% of taxpayers claiming a charitable contribution deduction donated over 1% of AGI (p 76)	Charitable contribution deduction - only deduct donations that exceed 1% of income (limits need to document when all donations are small in total) - no need to itemize - may sell property and donate proceeds to charity without gain recognition if donation made within 60 days of the sale - if over age 65, may make tax-free distributions from IRA if made directly to qualified charity (rather than get the taxable distribution and then make the donation) - information reporting required for charitable contributions of $600 or higher

Current	Proposed
Home mortgage deduction - if itemize deductions - 2 homes - up to $1,100,000 of debt - home equity debt possible rather than non-deductible personal debt	Home credit - 15% of mortgage interest paid - limited to average regional price of housing ($227,000 to $412,000) - only for debt to acquire, build or substantially improve a principal residence - no need to itemize - 5-year phase-in recommended (pages 74 and 238) - benefits all homeowners rather than just the 35% that itemize today - reduce the inequity of current system where over 55% of the "cost" of mortgage interest deductions go to about 12% of taxpayers with cash income of $100,000 or more - eliminates the incentive to overinvest in housing and purchase of luxury homes and vacation homes subsidized by a tax deduction - eliminates the benefit homeowners get from the home equity loan rules while non-homeowners incur non-deductible personal interest
Health insurance - generally only allowed to use pre-tax dollars if provided by employer	Health insurance - All taxpayers may purchase with pre-tax dollars up to the amount of an average premium ($5,000 individual and $12,500) - Should make more taxpayers aware of the cost so they can make better insurance decisions. (p 82)
Retirement plans (IRAs, Roth IRAS, nondeductible IRAs, deferred executive compensation plans, and tax-free inside buildup of cash value of life insurance and annuities)	Save at Work Account - Replaces defined contribution plans. - Defined benefit plans remain. - Would be "pre-paid" for the Growth & Investment Tax Plan (made on an after-tax basis as with a Roth IRA of today). Under Simplified Income Tax Plan, would be pre-tax so that contributions are tax-free while distributions are taxable. - Many automatic features – almost a forced savings to prevent "bad" decisions by individuals such as not rolling over 401(k) accounts when change employers, not enrolling in a plan, etc. - Automatic payroll deduction. Save for Retirement Account - All taxpayers eligible with $10,000 annual contribution of after-tax dollars with earnings that are tax exempt. - Amount indexed for inflation annually. - Roth IRAs convert tax-free. - Traditional IRAs convert with 1-time tax charge. If not converted, are frozen – no more contributions. - Tax-free withdrawals allowed only after age 58 or for death or disability. Earlier distributions subject to 10% penalty.

Current	Proposed
Educational savings plans (Coverdell, 529, savings bonds)	Save for Family Account - For all taxpayers. - Annual $10,000 contribution limit; after-tax. - Grows tax-free. - Would also replace various health accounts and flexible spending arrangements. Can supplement the Save for Retirement Account. - Current educational and health savings could be convdrted; if not converted, are frozen and need to use a Save for Family Account for new contributions. - Amounts could also be used for home purchase. - Can withdraw $100/year for any reason. Any amount pulled out in excess of $1,000 that is not for a qualified purpose is taxable and subject an additional 10% tax (unless age 58 or older).
Temporary saver's benefit	Refundable Saver's Credit - For low-income taxpayers. - Maximum annual contribution is $2,000. - 25% credit, so maximum of $500 per year. - Phased-out for MFJ at $40,000 of income and $25,000 for single. - Must deposit into Save for Family or Save for Retirement Account. - Panel recommends that these assets be ignored in government means tested programs.
Fringe and other benefits – many are tax-exempt	Only certain in-kind benefits that are given to all employees by the employer are exempt. Rationale is to increase equity because under current system taxpayers with tax-free fringe benefits in lieu of taxable wages or directly buying the benefits, pay less tax. Inside buildup of life insurance plans would be subject to tax. Amounts deferred under nonqualified deferred compensation plans are includable in taxable income if not subject to a substantial risk of forfeiture. "Annuities, life insurance arrangements, and deferred compensation plans that currently are in existence would continue to be taxed under current-law rules." (page 124)

Comparing Key Feature of the Two Proposals with our Current System

See the attached tables from the Advisory Panel's final report (page xiv and xv) for an overview to key parts of the two proposals.

Other Possible Approaches

The Panel evaluated a value-added tax (VAT) and a national retail sales tax, but decided not to recommend either model. It also developed a Progressive Consumption Tax Plan that excluded capital income of individuals. However, it did not have the consensus of the Panel to be a final recommendation. There is discussion of it in Chapter 7 though along with the Growth & Investment Tax Plan. Chapter 8 discusses the VAT as the Panel believes that a partial Replacement VAT is "an option worthy of further discussion." (page 192) Chapter 9 discusses a national sales tax approach, but it was rejected by the Panel as a complete replacement because it would not meet the requirement of a progressive tax and the required relief, likely via a government cash grant program, would "inappropriately increase the size and scope of the government." (page 208)

Commentary and Questions

- § The tax law can be simplified! Consolidation of overlapping provisions and elimination of the AMT would be helpful steps. Is it enough?
- § Do we need new complications, such as likely exists with the three different savings plans? This will likely be confusing to most individuals and keep tax practitioners well-employed.
- § How much encouragement of savings should be built into the system? Where is the debate on how much paternalism we want in the tax code, such as is provided with the Save at Work accounts that are automatic unless the employee opts out?
- § How much revenue do we need to raise?
- § How much progressiveness is optimal? How do we know? The income gap between high income and low income continues to grow? Do we want to use the federal tax law to even this out?
- § Will there be economic growth? Economists Burman and Gale of the Tax Policy Center note that the proposals will likely have an adverse impact on the deficit in the long term and "hence on national savings, the proposals are as likely to reduce economic growth as to increase it, relative to current law."[28]
- § The tax law can be more equitable! Removing some of the preferences for certain types of income will be helpful. For example, the ability of some employees to buy health insurance with pre-tax dollars while others must pay for it on their own with after-tax dollars is not equitable. Also, allowing high income taxpayers to deduct state and local income and property taxes, but no one to deduct sales tax with deductions only available to itemizers is not equitable. Also, high tax states get a subsidy from low tax states. Also, allowing mortgage interest deductions on two homes and on up to $1,100,000 of debt which is well beyond the median price of a home in any US city is not a good use of government dollars.
- § If it is a good idea (if it is) to base the home credit on regional costs, why not other provisions such as the family credit, exclusion on sale of a principal residence, etc.? Or should there just be a single limit for the home credit?
- § Without casualty loss deduction, employee business expenses and medical deductions, will some taxpayers have an ability to pay problem in some years?
- § Studies have indicated that the research credit does result in more research being done in the US. What happens when the credit is eliminated?

How to Evaluate Tax Reform Proposals

There are many considerations in evaluating tax reform proposals. One approach recommended here is to consider the principles of good tax policy. The AICPA's Tax Policy Concept Statement 1 – *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals*, provides a helpful approach to evaluating and comparing proposals.[29] The framework uses the following ten principles of good tax policy:

1. "Equity and Fairness – Similarly situated taxpayers should be taxed similarly."

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[28] Leonard E. Burman and William G. Gale, "A Preliminary Evaluation of the Tax Refrom Panel's Report," Tax Notes, 12/5/05, page 1349, 1350; available at http://www.urban.org/UploadedPDF/1000854_Tax_Break_12-05-05.pdf.

[29] The statement is available at www.aicpa.org/download/members/div/tax/Tax_Policy_stmt1.pdf.

2. "Certainty – The tax rules should clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined." Lack of certainty in the tax system reduces the confidence taxpayers have that they have computed their tax liability correctly.
3. "Convenience of Payment – A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer."
4. "Economy in Collection – The costs to collect a tax should be kept to a minimum for both the government and taxpayers."
5. "Simplicity – The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner."
6. "Neutrality – The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum."
7. "Economic Growth and Efficiency – The tax system should not impede or reduce the productive capacity of the economy." Do the rules have minimum impact on economic decisions of taxpayers? "Economic growth suffers as taxpayers respond to the tax laws rather than to underlying economic fundamentals. These distortions waste economic resources, reduce productivity, and, ultimately lower living standards for all."[30]
8. "Transparency and Visibility – Taxpayers should know that a tax exists and how and when it is imposed upon them and others."
9. "Minimum Tax Gap – A tax should be structured to minimize non-compliance."
10. "Appropriate Government Revenues – The tax system should enable the government to determine how much tax revenue will likely be collected and when."

The September 2005 AICPA report – Understanding Tax Reform: A Guide to 21st Century Alternatives, includes a list of questions that should be asked to help determine if the above principles are met for any proposal. That list (pages 89 – 91 of the report) is included at the end of this outline.

Where to Find More Information

There are numerous government reports on tax reform, particularly from the Joint Committee on Taxation and the Congressional Research Service. There are also non-profit tax organizations, such as the Center for Budget & Policy Priorities and various trade associations that have position papers on tax reform approaches. Many of the government reports, as well as links to legislative proposals and President Bush's Advisory Panel on Federal Tax Reform, can be found at the author's tax reform website at **http://www.cob.sjsu.edu/nellen_a/txrefupd.html**. A web search on tax reform and a particular issue, such as housing or international competitiveness, should yield papers from organizations on these topics, as well.

30 The President's Advisory Panel on Federal Tax Reform – final report, page 36.