Simple, Fair, and Pro-Growth:

Proposals to Fix America's Tax System

Report of the President's Advisory Panel on Federal Tax Reform

November 2005

The President's Advisory Panel on Federal Tax Reform

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In addition, we would like to acknowledge the assistance of the Council of Economic Advisors, the Government Accountability Office, the Organization for Economic Cooperation and Development, the nearly 100 witnesses who appeared at the Panel meetings, and the thousands of interested parties who contributed their views and insights to the Panel.

The President's Advisory Panel on

Federal Tax Reform

www.taxreformpanel.gov

November 1, 2005

The Honorable John W. Snow
Secretary of the Treasury
The Department of the Treasury
1500 Pennsylvania Avenue
Washington, DC 20220

Dear Mr. Secretary:

President George W. Bush formed this Panel to identify the major problems in our nation's tax code and to recommend options to make the code simpler, fairer, and more conducive to economic growth. The Panel heard from nearly 100 witnesses and received thousands of written comments. Together, these witnesses and these comments described the unacceptable state of our current tax system. Yet this tax code governs virtually every transaction in the world's largest economy, affecting the daily lives of nearly 300 million people.

Our tax code is rewritten so often that it should be drafted in pencil. Each year, the tax code is adjusted to meet multiple policy goals – some are broadly shared, but many are not. Myriad tax deductions, credits, exemptions, and other preferences may be a practical way to get policy enacted, but it is a poor way to write a tax code. Whether the government spends more or extends a special tax break, the effect is the same: everyone else must pay higher taxes to raise the revenue necessary to run the government.

During the past few decades, panels have been formed repeatedly, legislation introduced annually, and hearings scheduled regularly to study our tax code and recommend changes. In 1986, a bipartisan effort yielded the last major tax reform legislation. But because of the ever-present tendency to tinker with the tax code, we must redouble our efforts to achieve fundamental reform.

Since the 1986 tax reform bill passed, there have been nearly 15,000 changes to the tax code – equal to more than two changes a day. Each one of these changes had a sponsor, and each had a rationale to defend it. Each one was passed by Congress and signed into law. Some of us saw this firsthand, having served in the U.S. Congress for a combined 71 years, including 36 years on the tax-writing committees. Others saw the changes from different perspectives – teaching, interpreting, and even administering the tax code. In retrospect, it is clear that frequent changes to the tax code, no matter how well-intentioned, ultimately undermine the integrity of the code in real and significant ways.

As we moved forward with recommendations for reform, we followed the President's instructions to emphasize simplicity, fairness, and to remove impediments to growth. Achieving all of these principles is no easy task. We recognized from the start of our meetings that while it is relatively straightforward to point out flaws in a tax system and to express a desire for change, it is much more challenging to settle on a specific solution. There are difficult trade-offs. While we have differed at times and we may not all agree with every word in this report, we all fully endorse it.

We unanimously recommend two options to reform the tax code. We refer to one option as the Simplified Income Tax Plan and the other option as the Growth and Investment Tax Plan. Both of them are preferable to our current system. Both satisfy the President's directive to recommend options that are simple, fair, and pro-growth.

The Simplified Income Tax Plan dramatically simplifies our tax code, cleans out targeted tax breaks that have cluttered the system, and lowers rates. It does away with gimmicks and hidden traps like the Alternative Minimum Tax. It preserves and simplifies major features of our current tax code, including benefits for home ownership, charitable giving, and health care, and makes them available to all Americans. It removes many of the disincentives to saving that exist in our current code, and it makes small business tax calculations much easier. It also offers an updated corporate tax structure to make it easier for American corporations to compete in global markets.

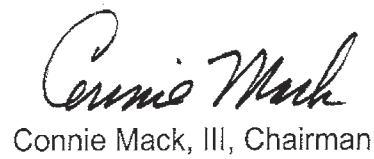
The second recommended option, the Growth and Investment Tax Plan, builds on the Simplified Income Tax Plan and adds a major new feature: moving the tax code closer to a system that would not tax families or businesses on their savings or investments. It would allow businesses to expense or write-off their investments immediately. It would lower tax rates, and impose a single, low tax rate on dividends, interest, and capital gains.

As directed by the President, our recommendations have been designed to raise approximately the same amount of money as the current tax system. The issue of whether the tax code should raise more or less revenue was outside of our mandate. Regardless of how one feels about the amount of revenue required to fund our government, all should agree that the tax system needs a solid and rational foundation.

We recognize that our report is just the beginning of the process to fix our broken tax system. The hardest work lies ahead. As a bipartisan Panel, we have heard from witnesses and elicited proposals from members of both major parties. We hope that the Administration and the Congress will carry forward this spirit of bipartisanship.

The effort to reform the tax code is noble in its purpose, but it requires political willpower. Many stand waiting to defend their breaks, deductions, and loopholes, and to defeat our efforts. That is part of the legislative process. But the interests of a few should not stand in the way of the tax code's primary goal: to raise funds efficiently for the common defense, vital social programs, and other goals of shared purpose. If we agree the goals serve us all, we must also agree that the costs must be fairly borne by all.

This report aims to give voice to the frustrated American taxpayer and to provide a blueprint for lasting reform. We look forward to a national debate and a better tax system.



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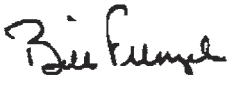

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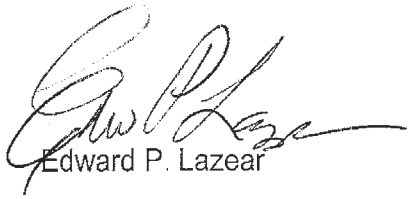

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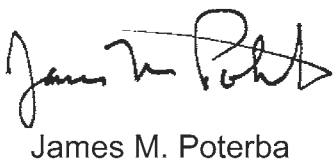

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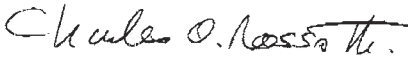

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Executive Summary

President George W. Bush created the President's Advisory Panel on Federal Tax Reform in January 2005. The President instructed the Panel to recommend options that would make the tax code simpler, fairer, and more conducive to economic growth.

Since then, the Panel has analyzed the current federal income tax system and considered a number of proposals to reform it. During the course of the Panel's work, some themes emerged that guided its deliberations:

- We have lost sight of the fact that the fundamental purpose of our tax system is to raise revenues to fund government.
- Tax provisions favoring one activity over another or providing targeted tax benefits to a limited number of taxpayers create complexity and instability, impose large compliance costs, and can lead to an inefficient use of resources. A rational system would favor a broad tax base, providing special treatment only where it can be persuasively demonstrated that the effect of a deduction, exclusion, or credit justifies higher taxes paid by all taxpayers.
- The current tax system distorts the economic decisions of families and businesses, leading to an inefficient allocation of resources and hindering economic growth.
- The complexity of our tax code breeds a perception of unfairness and creates opportunities for manipulation of the rules to reduce tax. The profound lack of transparency means that individuals and businesses cannot easily understand their own tax obligations or be confident that others are paying their fair share.
- The tax system is both unstable and unpredictable. Frequent changes in the tax code, which often add to or undo previous policies, as well as the enactment of temporary provisions, result in uncertainty for businesses and families. This volatility is harmful to the economy and creates additional compliance costs.
- The objectives of simplicity, fairness, and economic growth are interrelated and, at times, may be at odds with each other. Policymakers routinely make choices among these competing objectives, and, in the end, simplification is almost always sacrificed. Although these objectives are often in tension, meaningful reform can deliver a system that is simpler, fairer, and more growth-oriented than our existing tax code.

With these themes in mind, the Panel evaluated a number of reform proposals to find out whether they would meet the President's goals for current and future generations of Americans. After 12 public meetings in five states and Washington D.C., the Panel reached consensus to recommend two tax reform plans. The Panel's recommended plans, labeled the Simplified Income Tax Plan and the Growth and Investment Tax Plan, include the following major features:

- Simplification of the entire tax system and streamlined tax filing for both families and businesses.
- Lower tax rates on families and businesses, while retaining the progressive nature of our current tax system.
- Extension of important tax benefits for home ownership and charitable giving to all taxpayers, not just the 35 percent who itemize; extension of tax-free health insurance to all taxpayers, not just those who receive insurance from their employers.
- Removal of impediments to saving and investment.
- Elimination of the Alternative Minimum Tax, which is projected to raise the taxes of more than 21 million taxpayers in 2006 and 52 million taxpayers by 2015.

The two plans differ in the taxation of businesses and capital income. Although they use different approaches, the plans share a common goal of providing simple and straightforward ways for Americans to save free of tax and lower the tax burden on productivity-enhancing investment by businesses.

A table outlining both tax reform plans follows this summary.

The Panel also developed and considered a progressive consumption tax plan that would be administered using the infrastructure of our familiar tax system, but was unable to reach a consensus to include it as a recommendation. The Panel also considered ideas for a value-added tax and a national retail sales tax, and decided not to recommend either approach.

The Simplified Income Tax Plan and the Growth and Investment Tax Plan put forward by the Panel achieve the goals set by the President in a number of ways.

They reduce complexity by:

- Allowing every taxpayer to use a simple tax form, which is less than half the length of the current Form 1040.
- Combining 15 different tax provisions for at-work saving, health saving, education saving, and retirement saving into three simple saving plans.
- Eliminating a complicated set of phase-outs that leave taxpayers wondering whether they are eligible to benefit from numerous provisions.
- Replacing a confusing, full-page worksheet for seniors reporting Social Security income with a simple computation that is no more than six lines.
- Replacing the complicated rules for small business with a system that is based on the records their owners already keep.

They improve fairness by:

- Ensuring that tax benefits are easily understood and accessible, thereby increasing confidence in the tax system.
- Making most tax benefits available to all taxpayers, not just the 35 percent who itemize.
- Shifting some tax preferences from deductions, which tend to benefit high-income households, to tax credits, which benefit all taxpayers equally.
- Reducing marriage penalties by ensuring that the rate brackets, the Family Credit, and the taxation of Social Security benefits for married couples are twice the amounts for singles.
- Transforming the earned income tax credit and savers credit into provisions that are more accessible and beneficial to low income taxpayers.
- Closing loopholes and eliminating special tax breaks that allow the well-advised to avoid paying their fair share.
- Maintaining the progressive nature of our tax system.

They promote economic growth by:

- Reducing the double-tax on corporate profits earned in the United States.
- Promoting savings throughout our economy, especially at the household level.
- Equalizing the tax treatment of several forms of corporate financing, raising the incentives for companies to issue equity rather than debt to finance growth.
- Reducing the likelihood that households or businesses will alter economic behavior because of special tax preferences or benefits.
- Lowering the top marginal rates on individuals and businesses.
- Reducing the paperwork burden for small businesses, and providing them an immediate write-off for all purchases of new tools and equipment.
- Updating our international tax system.

These benefits will follow only from a fundamental reform of the tax code. In isolation, some of the recommended pieces may be controversial, but taken as a whole, they accomplish the Panel's objectives. Each plan is designed to be comprehensive and should be viewed as an integrated package. The Panel believes that without large-scale changes, and continued commitment to avoiding complexity and special tax breaks, the tax code will become even more confusing, unfair, and damaging to our economy. We urge the Administration and Congress to consider these recommendations carefully and to move forward with reform.

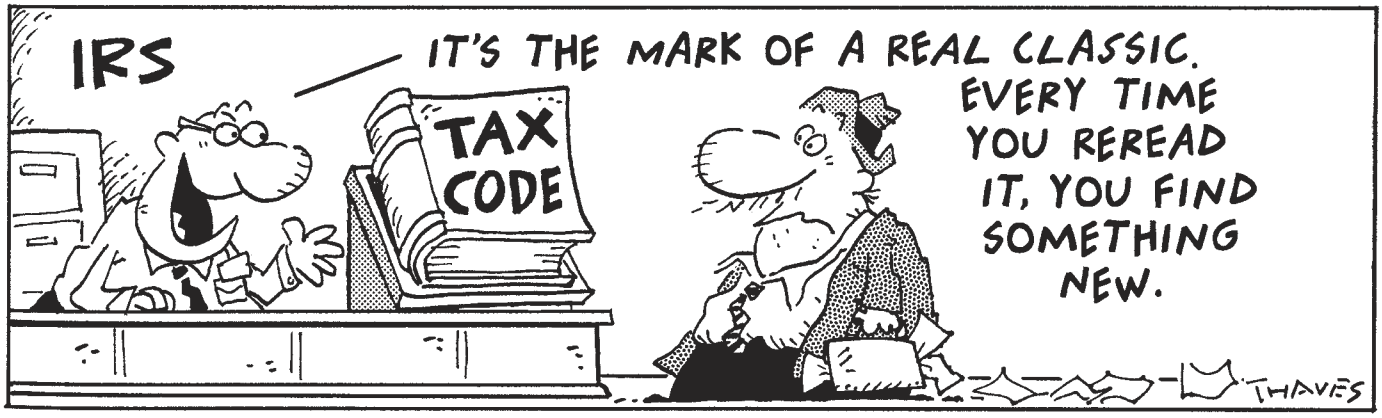
The Current Tax System	
Provisions	**Current Law (2005)**
Households and Families	
Tax rates	Six tax brackets: 10%, 15%, 25%, 28%, 33%, 35%
Alternative Minimum Tax	Affects 21 million taxpayers in 2006; 52 million taxpayers in 2015
Personal exemption	$3,200 deduction for each member of a household; phases out with income
Standard deduction	$10,000 deduction for married couples filing jointly, $5,000 deduction for singles, $7,300 deduction for heads of households; limited to taxpayers who do not itemize
Child tax credit	$1,000 credit per child; phases out for married couples between $110,000 and $130,000
Earned income tax credit	Provides lower-income taxpayers refundable credit designed to encourage work. Maximum credit for working family with one child is $2,747; with two or more children is $4,536
Marriage penalty	Raises the tax liability of two-earner married couples compared to two unmarried individuals earning the same amounts
Other Major Credits and Deductions	
Home mortgage interest	Deduction available only to itemizers for interest up to $1.1 million of mortgage debt
Charitable giving	Deduction available only to itemizers
Health insurance	Grants tax-free status to an unlimited amount of premiums paid by employers or the self-employed
State and local taxes	Deduction available only to itemizers; not deductible under the AMT
Education	HOPE Credit, Lifetime Learning Credit, tuition deduction, student loan interest deduction; all phase out with income
Individual Savings and Retirement	
Defined contribution plans	Available through 401(k), 403(b), 457, and other employer plans
Defined benefit plans	Pension contributions by employers are untaxed
Retirement savings plans	IRAs, Roth IRAs, spousal IRAs – subject to contribution and income limits
Education savings plans	Section 529 and Coverdell accounts
Health savings plans	MSAs, HSAs, and Flexible Spending Arrangements
Dividends received	Taxed at 15% or less (ordinary rates after 2008)
Capital gains received	Taxed at 15% or less (higher rates after 2008)
Interest received (other than tax-exempt municipal bonds)	Taxed at ordinary income tax rates
Social Security benefits	Taxed at three different levels, depending on outside income; marriage penalty applies
Small Business	
Tax rates	Typically taxed at individual rates
Recordkeeping	Numerous specialized tax accounting rules for items of income and deductions
Investment	Accelerated depreciation; special small business expensing rules allow write-off of $102,000 in 2005 (but cut by ¾ in 2008)
Large Business	
Tax rates	Eight brackets: 15%, 25%, 34%, 39%, 34%, 35%, 38%, 35%
Investment	Accelerated depreciation under antiquated rules
Interest paid	Deductible
Interest received	Taxable (except for tax-exempt bonds)
International tax system	Worldwide system with deferral of business profits and foreign tax credits
Corporate AMT	Applies second tax system to business income

How the Tax Code Would Change		
Provisions	**Simplified Income Tax Plan**	**Growth and Investment Tax Plan**
Households and Families		
Tax rates	Four tax brackets: 15%, 25%, 30%, 33%	Three tax brackets: 15%, 25%, 30%
Alternative Minimum Tax	Repealed	
Personal exemption	Replaced with Family Credit available to all taxpayers: $3,300 credit for married couples, $2,800 credit for unmarried taxpayers with child, $1,650 credit for unmarried taxpayers, $1,150 credit for dependent taxpayers; additional $1,500 credit for each child and $500 credit for each other dependent	
Standard deduction		
Child tax credit		
Earned income tax credit	Replaced with Work Credit (and coordinated with the Family Credit); maximum credit for working family with one child is $3,570; with two or more children is $5,800	
Marriage penalty	Reduced; tax brackets and most other tax parameters for couples are double those of individuals	
Other Major Credits and Deductions		
Home mortgage interest	Home Credit equal to 15% of mortgage interest paid; available to all taxpayers; mortgage limited to average regional price of housing (limits ranging from about $227,000 to $412,000)	
Charitable giving	Deduction available to all taxpayers (who give more than 1% of income); rules to address valuation abuses	
Health insurance	All taxpayers may purchase health insurance with pre-tax dollars, up to the amount of the average premium (estimated to be $5,000 for an individual and $11,500 for a family)	
State and local taxes	Not deductible	
Education	Taxpayers can claim Family Credit for some full-time students; simplified savings plans	
Individual Savings and Retirement		
Defined contribution plans	Consolidated into Save at Work plans that have simple rules and use current-law 401(k) contribution limits; AutoSave features point workers in a pro-saving direction (Growth and Investment Tax Plan would make Save at Work accounts "prepaid" or Roth-syle)	
Defined benefit plans	No change	
Retirement savings plans	Replaced with Save for Retirement accounts ($10,000 annual limit) available to all taxpayers	
Education savings plans	Replaced with Save for Family accounts ($10,000 annual limit); would cover education, medical, new home costs, and retirement saving needs; available to all taxpayers; refundable Saver's Credit available to low-income taxpayers	
Health savings plans		
Dividends received	Exclude 100% of dividends of U.S. companies paid out of domestic earnings	Taxed at 15% rate
Capital gains received	Exclude 75% of corporate capital gains from U.S. companies (tax rate would vary from 3.75% to 8.25%)	Taxed at 15% rate
Interest received (other than tax exempt municipal bonds)	Taxed at regular income tax rates	Taxed at 15% rate
Social Security benefits	Replaces three-tiered structure with a simple deduction. Married taxpayers with less than $44,000 in income ($22,000 if single) pay no tax on Social Security benefits; fixes marriage penalty; indexed for inflation	
Small Business		
Tax rates	Taxed at individual rates (top rate has been lowered to 33%)	Sole proprietorships taxed at individual rates (top rate lowered to 30%); Other small businesses taxed at 30%
Recordkeeping	Simplified cash-basis accounting	Business cash flow tax
Investment	Expensing (exception for land and buildings under the Simplified Income Tax Plan)	
Large Business		
Tax rates	31.5%	30%
Investment	Simplified accelerated depreciation	Expensing for all new investment
Interest paid	No change	Not deductible (except for financial institutions)
Interest received	Taxable	Not taxable (except for financial institutions)
International tax system	Territorial tax system	Destination-basis (border tax adjustments)
Corporate AMT	Repealed	

Chapter One

The Case for Reform

Frank and Ernest



If you were to start from scratch, the current tax code would provide a guide on what to avoid in designing an income tax system. Instead of a sleek and simple system designed to raise revenue for our national defense, social programs, and other vital public services, we have a system so complex that almost $150 billion is spent each year by U.S. households, businesses, and the federal government, just to make sure taxes are tallied and paid correctly. This is more than the sum spent each year on televisions, household electricity, or cereal. Instead of a system that ensures that all pay their fair share, we have a system so confusing that two million taxpayers collectively paid over $1 billion more in taxes by making a wrong decision about the basic choice of itemizing or taking the standard deduction, according to a recent study. Instead of a tax system that draws revenue efficiently from the base of the nation's considerable economy, we have a tax code that distorts basic economic decisions, sets up incentives for unwise or unproductive investments, and induces people to work less, save less, and borrow more. By some estimates, this economic waste may be as much as $1 trillion dollars each year.

The father of modern economics, Adam Smith, said the free market is the "invisible hand" guiding every economic event. In today's U.S. economy, the tax code is the true force. The tax code penalizes savings, contributes to the ever-increasing cost of health insurance, and undermines our global competitiveness. The tax code touches all of life's major events: It tells us the best time to be born, the best time to marry, and the best time to retire.

In short, our current tax code is a complicated mess. Instead of clarity, we have opacity. Instead of simplicity, we have complexity. Instead of fair principles, we have seemingly arbitrary rules. Instead of contributing to economic growth, it detracts from growth. Time and again, witnesses told the Panel about these failings in the tax code.

Complexity

There is no clearer proof of the complexity of the tax code than the collective anxiety felt by Americans every April as the tax filing deadline approaches. For many, filing taxes consists first of procrastination. Then there is the inevitable search for slips of paper containing once-meaningful but now unintelligible financial transactions. Then comes the maze of lengthy instructions complex enough that even highly schooled professionals have to reread the directions several times. Those directions send taxpayers on a search through baffling schedules and detailed worksheets requiring many illogical and counterintuitive computations. And in the end, most taxpayers give up, and visit a tax preparer who promises to make sense of the whole process - for a price.

No matter how much you earn, chances are you do not clearly understand how to figure out your taxes. A recent poll of those with an annual income of $20,000 or less (usually the families with the simplest tax forms) showed that about 80 percent found the tax system either very complex or somewhat complex. That figure rises to nearly 100 percent for taxpayers with incomes exceeding $150,000. The process is so bad that one-third of Americans surveyed believe that completing the annual tax return is more onerous than actually paying large amounts of money in taxes.

To determine something as basic as figuring out the tax implications of having a child, you need to review numerous rules and complete many separate sets of computations. Figuring out whether you can claim the child tax credit, for example, requires the skills of a professional sleuth: You need to complete eight lines on a tax form, perform up to five calculations, and fill out as many as three other forms or schedules. Further research, reading, and computation may be needed to determine whether you can claim head of household filing status, an exemption for a dependent, the child and dependent care credit, the earned income tax credit, or tax credits related to your child's education, to name only some of the possibilities.

Last year, Americans spent more than 3.5 billion hours doing their taxes, the equivalent of hiring almost two million new IRS employees – more than 20 times the agency's current workforce. If the money spent every year on tax preparation and compliance was collected – about $140 billion each year or over $1,000 per family – it could fund a substantial part of the federal government, including the Department of Homeland Security, the Department of State, NASA, the Department of Housing and Urban Development, the Environmental Protection Agency, the Department of Transportation, the United States Congress, our federal courts, and all of the federal government's foreign aid. On average, Americans spend the equivalent of more than half of one work week – 26 hours – on their taxes each year (not to mention the amount of time they work to pay the taxes themselves).

In 2003, about 60 percent of household filers gave up trying to do the work themselves and hired a preparer. About a quarter relied on a computer and purchased software. A small fraction got help from volunteers. And 13 percent of Americans completed their own calculations and filed their taxes the old-fashioned way: with pen and paper.

Complying with the tax code is frequently more burdensome for those with the least ability to pay. For example, the earned income tax credit (EITC) is an important initiative, provided through our tax code to help low-income working families move out of poverty. The EITC differs from other entitlement programs in that it is only available to lower-income workers. Initially, EITC benefits increase as an individual's earnings increase, but then the benefits phase out at higher income levels. These rules are so complex that nearly three-quarters of those families claiming it hire a tax preparer. This makes little sense: These families typically earn less than $35,000. The extra cost of paying a preparer to claim the EITC benefit may offset a significant portion of the benefit itself – and to the family struggling to stay out of poverty, those dollars are scarce. Policy experts regularly praise the EITC's effectiveness, but as a matter of tax administration, it is complicated and inefficient.

The tax code places an undue burden on another critical sector of our society: the small businesses that create a majority of new jobs in our economy. The 31 million taxpayers who reported self-employment income or employee business expenses spent an average of 45 hours and $360 in out-of-pocket compliance costs, compared with 20 hours and $105 in out-of-pocket costs for the 103 million Americans who did not report self-employment income. Studies have found that the smaller the business, the higher the cost of complying with the tax code per dollar of revenue.

Confusion and Unfairness

Did I pay too much? Did I pay too little? Who will notice? These three questions play out in the minds of all taxpayers when they file their forms by April 15 each year. And as journalists and tax analysts have repeatedly shown over the years, rarely will two tax preparers working on the same tax return come up with the same amount of taxes due. There is little confidence that we really know how much we should be paying in taxes in any given year. It is not just a matter of doing arithmetic. According to a recent survey, more than two-thirds of respondents incorrectly answered basic filing questions about the tax implications of selling a home, claiming a dependent, saving for education and retirement, receiving capital gains, and paying the Alternative Minimum Tax. To be sure, some of these issues are complex. But our tax code should aspire to be clear and transparent, not allow confusion to multiply. Taxpayers should be able to understand the tax code's basics.

The result of this fog of ignorance typically isn't overpayment, which occurs occasionally, but underpayment, which happens regularly. This underpayment is measured by what is known as the "tax gap." The tax gap represents the difference between the tax that taxpayers should pay and what they actually pay on a timely basis. The IRS estimates that in 2001, between $281 and $322 billion went unreported on individual and business tax returns. This translates to a tax hike of more than $2,000 each year for honest taxpayers. Research shows non-compliance has been steadily rising over the past two decades, a troubling indicator that our tax code's growing complexity is inviting more cheating.

But taxpayers think that with the myriad of targeted exclusions, deductions, and credits, others may not be paying their fair share – so why should they? Some call this "the cheat or chump syndrome." In addition, clever tax advisors mine the complexity of the tax code to develop and market tax shelters and other schemes clearly designed to manipulate the tax code's hidden loopholes for their clients' exclusive benefit. The perception that the tax code is unfair and easily manipulated undermines voluntary compliance – the foundation of our tax system.

An Arbitrary and Unequal System

A tax code, like any law, should rest squarely on the notion that it will remain largely the same, from year to year, from person to person. In a court of law, there is an expectation by the judge, jury, and all other parties that the law will be equally and fairly applied based on well-established and consistent judicial principles. Yet our tax code shares few, if any, of these features.

Taxpayers cannot plan ahead. The tax system is a kaleidoscope of shifting credits, rates, and benefits because many of the tax code's most prominent features – the tax rate for ordinary income, the child tax credit, the lower tax on dividends and capital gains – may shift wildly from one year to the next, and in some cases simply expire. For example, tax relief passed by Congress in 2001 and 2003 is scheduled to fade away. While some believe Congress will not allow this to happen, no one can say for sure. As Box 1.1 indicates, all individual tax rates are scheduled to rise. The lowest bracket, currently set at 10 percent, will disappear and the top tax rate will climb from 35 to 39.6 percent after 2010. The child tax credit and the deduction for IRA contributions will be cut. Taxpayers have recently seen their taxes on dividends and capital gains reduced but will see them sharply increased in 2008, when those taxes are scheduled to rise again.

Box 1.1. Commonly Applicable Income Tax Provisions Scheduled to Expire

- Reduced Individual Tax Rates on Ordinary Income
- Marriage Penalty Relief
- Increased Child Tax Credit
- Increased IRA Contribution Limit
- Reduced Individual Tax Rate on Dividend Income
- Reduced Individual Tax Rate on Capital Gains
- Investment Incentives for Small Business

This uncertainty has clear effects. If you own a small business and are contemplating an investment in new equipment, the tax provision that quadruples the portion of that investment that can be written-off immediately is an incentive to go forward with the investment. Yet because of the scheduled expiration in 2007 of this provision, your decision to invest may be rushed. Such an investment – timed as it is to a provision in the tax code rather than to economic fundamentals – may turn out to be ill-advised and waste economic resources. In any case, the tax code's constant phase-ins and phase-outs are a nuisance at best, and a negative force at worst, in the daily economic lives of American families and businesses.

The tax code treats similar taxpayers in different ways. Taxpayers with the same income, family situation, and other key characteristics often face different tax burdens. Such differing treatment creates a perception of unfairness in our tax code. For example, taxpayers in states with high state and local income and property taxes receive higher deductions than taxpayers who live in lower-tax states with fewer state-provided services. Taxpayers with substantial employer-provided health insurance benefits receive in-kind compensation that is not taxed, while taxpayers who buy the same health insurance on their own usually pay tax on the income used to purchase the insurance. And Social Security benefits are taxed at a higher rate for married seniors than for those not married. How much or little taxpayers pay in tax is sometimes dependent on where they happen to live, the choices made by their employers, and whether they are married.

The differences in treatment are not always set by design. Rather, the different amounts similarly situated taxpayers often pay is sometimes a reflection of the tax code's complexity. While some taxpayers may take advantage of special provisions that are available to them, others do not. Someone who claims legal credits and deductions has done nothing wrong, yet unequal outcomes suggest that our tax code unfairly benefits those with the time and resources to make sense of it. This situation conflicts with basic principles of equity and erodes public confidence in the system.

The tax code treats similar income differently. As part of our system of progressive taxation, income is taxed at increasing rates as a taxpayer's annual income increases. This creates a tax rate called the "marginal rate." The marginal tax rate is the rate paid on the last dollar of income earned – it measures how much tax you pay on additional,

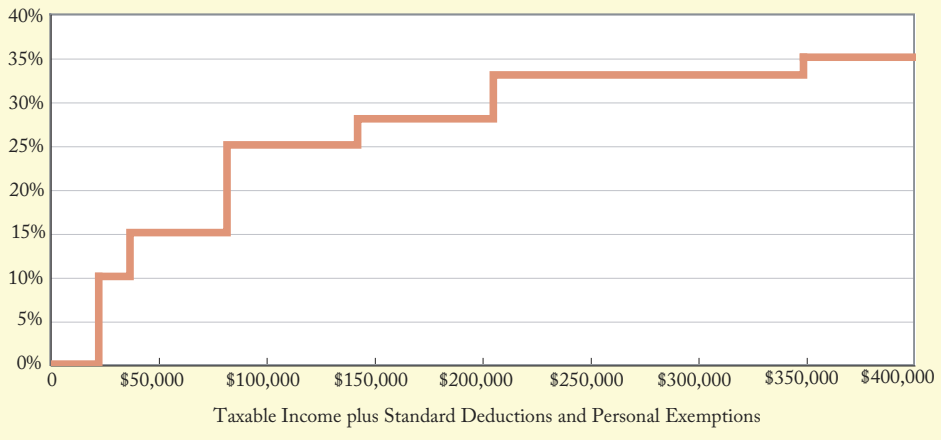
or marginal, income. The basic tax rate schedule taxes the first $7,300 of taxable income for single individuals at a 10 percent rate. The next $22,400 is taxed at a 15 percent rate. Each block of income is taxed at a higher marginal rate, until a taxpayer reaches the $326,450 level, above which income is taxed at the highest rate of 35 percent.

At first glance, this appears to be a fairly straightforward approach to taxation, but it is not so simple in reality. The effective marginal tax rate can differ substantially from the schedule of basic tax rates described above. This element is complicated by various exclusions, deductions, and credits, and the web of accompanying phase-ins and phase-outs. Some credits and deductions are available to people only when they earn more or less than a certain amount of income. The idea behind setting a limitation on the income one can earn before claiming certain deductions and credits is to target the benefits to those perceived to have the greatest need. But that creates a set of counterintuitive and counterproductive economic consequences that may keep many families from trying to earn more than they currently do.

Let's say you are just offered a great job at $120,000 a year. You are married with one child and your current salary is $80,000. You take the job, right? Not necessarily. The increase in salary might cause you to lose some of the child credit – and subject you to other provisions that increase your total tax bill even more, such as the Alternative Minimum Tax. In all, the pre-tax jump in your new salary may be $40,000, but it could end up costing you an extra $9,203 in tax – meaning that your salary would rise by 50 percent while your tax liability would increase by 140 percent. Not surprisingly, some workers figure this out quickly and avoid taking on work that may pay more, simply because of how the tax code penalizes that extra effort.

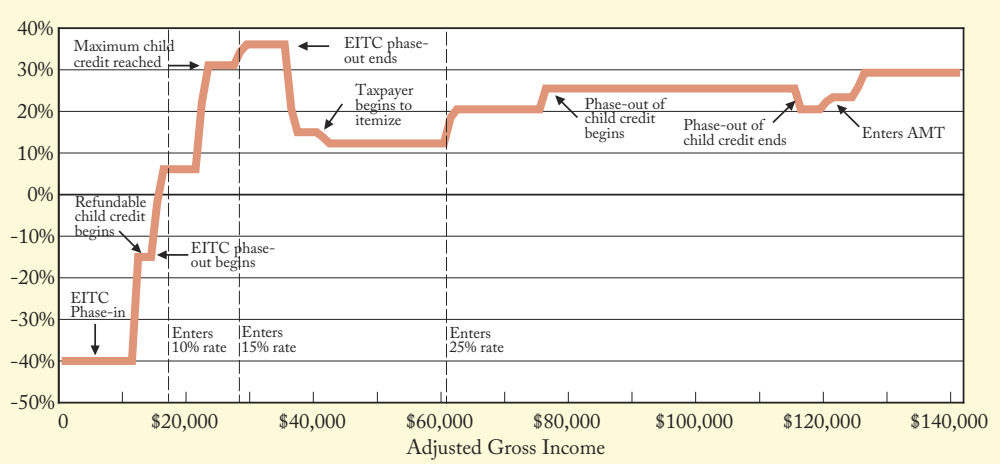
Two charts below illustrate the problem for a hypothetical taxpayer – a single mother with two children. Figure 1.1 shows how she would face a gradually increasing tax rate as she earned additional income if the tax system consisted only of our current schedule of basic tax rates described above, plus the standard deduction and personal exemption.

Figure 1.1. Tax Rate Schedule for a Hypothetical Head of Household with Two Children in 2005



In contrast to this system, Figure 1.2 illustrates the reality of our current system. Low-income taxpayers face very high marginal tax rates, even higher than those with substantially larger incomes. Moreover, even small changes in income can cause large changes in marginal tax rates. For example, our single mother with two children enjoys a *negative* tax rate on each extra dollar of earnings up to $11,000 because she receives a $40 tax credit for every $100 earned through the EITC. As she earns more, however, her tax rate rises sharply. At an income level of $25,000, she pays $31 of tax on each additional $100 earned. So instead of receiving $140 in total wages and tax benefits for each extra $100 earned, she now receives only $69 on every extra $100 of earnings. Figure 1.2 shows how this taxpayer's tax rate shifts as she moves up the economic ladder – and not always in the way you would imagine.

Figure 1.2. Marginal Effective Federal Income Tax Rates for Hypothetical Head of Household with Two Children in 2005



Note: Calculations are for a head of household with two children under 17. Itemized deductions are assumed to be 18 percent of income.
Source: Department of the Treasury, Office of Tax Analysis.

This shifting treatment of one's last dollar of income – far more complex than the basic tax rate schedule – catches many taxpayers by surprise. Yet this shifting treatment does not affect only low-income workers. For example, a married couple with $87,000 of income – somewhat above the national average – and a child in college would be eligible for a tax credit, known as the HOPE credit, to offset education expenses. But if this family has an additional $20,000 in gains from selling stock to pay tuition, they would no longer be eligible for the HOPE credit. Guided by a tax advisor, this family could hold off on selling the stock to maintain HOPE credit eligibility. That is clearly to the family's benefit: The HOPE credit's value, at up to $1,500, is certainly a tidy return for keeping the the stock in their investment account for an extra year. Because the tax code uses income to determine a family's eligibility for federal assistance – and views wealth as immaterial – this family receives a benefit that a less well-advised family does not.

It could be that some well-meaning lawmaker wanted to avoid handing out federal tax credits to high-earning families. But even the best intentions cannot guard against the law of unintended consequences. One such consequence is handing a tax credit to a family that didn't really need it and would have sent their child to college anyway. In this case, the government spent money on a tax benefit that did not change the behavior that it was designed to affect – and thus provided a windfall to the family. Another unintended consequence is that these credits may lead to a higher cost of education for those who do not receive the credits. There is some evidence, for instance, that the credit may encourage colleges and universities to increase tuition, thereby capturing some of the benefit of the credit. A third consequence is that everyone else's taxes are higher.

The Tax Code in Our Lives

Earlier in this chapter, we referred to the "invisible hand," as described by Adam Smith. He observed that the invisible hand of free markets is the force through which individuals and businesses put economic resources to their greatest value. The tax code, however, gets in the way of free commerce and reduces our economic capacity in countless ways. Take health care, for instance. Our tax code treats health care benefits with great deference; they are not treated as income, so those companies that offer health insurance coverage do so as a tax-free benefit to their employees. But that generosity removes many incentives for cost controls, driving up health care costs for everyone, including those whose employers do not offer the same benefits. With virtually no low-cost option for health insurance available, many go without. This situation – a nation divided between those with "Cadillac" insurance coverage and those with none – is exacerbated by our tax code.

The tax code reaches into daily events, and by multiplication of rules and conditions, makes itself into an economic hazard. Yet there are examples of the tax code's failure to account for economic progress when it does occur. In the case of our technology industries, we have a sector of the economy larger in size than health care, and crucial to future job growth and living standards. These technology-based industries depend heavily on how our tax code defines the useful life of all technology. These definitions, laid out in depreciation schedules, permit purchasers of computers and other high-technology equipment to take a deduction against their income for the cost of that equipment over a period of time. The depreciation schedules for technology have always been a source of some controversy; companies routinely discard new computers and other technological equipment after only three years while the depreciation schedules call for a five-year lifespan. Why? Congress based the current depreciation schedule for computers on studies of the useful lives of surplus government typewriters from the late 1970s. Only in our tax code can a late-1970s typewriter be viewed as the same as a high-end, multimedia laptop.

Consider the tax code's impact on savings and consumption: Jack and Jill both earn a dollar and pay 25 cents in taxes on it. Jack spends his 75 remaining cents, while Jill saves it. If Jill's savings gather interest of 20 cents over the next ten years, she will have 95 cents in her savings account. But she will have to pay taxes on the interest income of 20 cents – an extra 5 cents in taxes. In short, Jack pays 25 cents in taxes on his money, while Jill ends up paying 30 cents – simply because she saved while he did not. While the difference may not matter much, spread throughout a $12 trillion economy and tens of trillions of economic decisions (including decisions about how to save for education, health, and retirement), the tax penalty on savings has enormous effects. The nation's personal savings rate, for example, is less than 2 percent. The low savings rate can be explained by many factors, and the tax code is hardly the sole culprit. However, if we want to improve the savings rate, eliminating the tax penalty on savings might be an obvious place to start.

In short, the tax code presents an obvious target for change. Its complexity, lack of clarity, unfairness, and disproportionate influence on behavior lead taxpayers to frustration and many reformers to other lines of work. But we cannot leave this work undone. Without reform, the tax code will consume more energy, more time, more worry, and more economic resources. The effort to reform this complicated mess starts with understanding how we got here. Our tax code has been shaped by goals other than simplicity, by intentions other than helping the taxpayer plan ahead, and by objectives other than expanding our economy. Years of active meddling may have left our tax code in shambles, but it has taught us a valuable lesson: If we are not simplifying our tax code, it is likely to become more complex, more unfair, and less conducive to our economy's future growth. Reform is the only thing that works.

Box 1.2. The Alternative Minimum Tax: A Cautionary Tale

The Alternative Minimum Tax (AMT) is a vivid example of why our tax code is dysfunctional. The minimum income tax, the predecessor to today's AMT, was first enacted in1969 after reports showed a few hundred very wealthy Americans not paying income taxes. Like the minimum income tax of 1969, the AMT is intended to ensure that taxpayers pay at least some income tax and share in the cost of maintaining our government.

But the AMT has a significant flaw: Its definition of high income was never indexed for inflation. Thus, the threshold for AMT liability in 2006 – $45,000 in income for married couples after allowing for AMT deductions – is nearly the same as the $40,000 threshold that was in place in 1982, when the AMT first came into effect. If this figure had been inflation–adjusted, the exemption would be $82,000. Today, many middle-income Americans are above that $45,000 exemption level.

The failure to index AMT income levels for inflation is significant. The AMT, whatever its original strengths and weaknesses, was for many years only a problem for a few thousand high-income families. Now, it is a headache for nearly four million American families and, as shown in the chart below, is projected to affect more than 50 million taxpayers by 2015.

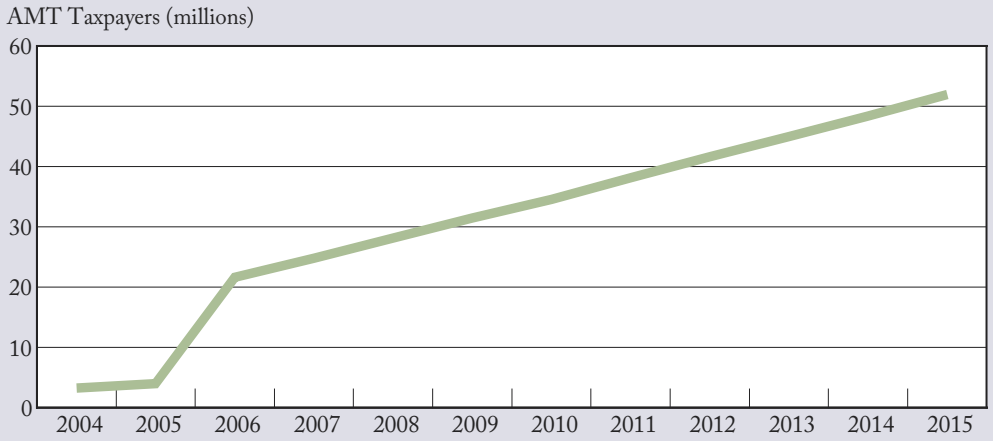
The AMT constitutes a second, parallel tax structure that has its own exemptions, tax rates, and tax credits, and that employs a definition of income broader than that of the regular income tax. Certain deductions available in the "regular" tax code are not available to AMT taxpayers. Taxpayers who have families are especially hurt by the AMT; the marriage penalty is worse under the AMT, and the child-related benefits are lower.

Because of the growing reach of the AMT, millions of taxpayers must now fill out a 12-line worksheet, read 8 pages of instructions, and complete a 55-line form to determine whether they must pay the AMT. Only after making this separate set of calculations to see which tax-owed figure is higher, can a taxpayer file a return – paying the higher amount. Not surprisingly, many taxpayers seek expertise in navigating this maze – 75 percent of AMT taxpayers hire a professional to do their returns for them.

So far, lawmakers have dealt with the problem by passing temporary fixes or "patches" to the AMT to limit its reach on most middle-income families. But after 2005, when the current fix expires, the number of taxpayers projected to be affected by the AMT will rise sharply from 4 million in 2005 to 21.6 million in 2006. Not only will these taxpayers be required to make a second set of calculations to determine their AMT liability, but they will also pay an average of $2,770 more in taxes. By 2015, 52 million taxpayers – 45 percent of all taxpayers with income tax – are projected to be affected by the AMT.

The AMT will increasingly affect upper-middle-income taxpayers – 13 percent of taxpayers with incomes between $100,000 and $200,000 will pay their taxes under the AMT system in 2005, but just one year later, more than 75 percent of taxpayers in this income group will do so.

Taxpayers Subject to the AMT



Note: Assumes 2001 and 2003 tax cuts are made permanent and the temporary AMT provisions are allowed to expire in 2005.
Source: Department of the Treasury, Office of Tax Analysis.

Perhaps not surprisingly, the individual AMT has failed to achieve its goal of making sure all well-to-do Americans pay taxes. The Treasury Department projects that in 2006, in spite of the AMT over 6,600 taxpayers with income greater than $200,000, and over 1,300 taxpayers with income over $700,000, will pay no tax through various combinations of legitimate tax avoidance. What began as a vehicle to focus fairness on a handful of taxpayers has turned into a complex, unfair, and inefficient burden on millions of Americans; few, if any, of those paying the AMT are the intended targets of the tax. The AMT is a salient example of a policy or government program gone astray with unintended consequences carrying malign impacts.

In addition, the corporate AMT subjects many corporations to a second, parallel tax. Like the individual AMT, the corporate AMT has been used to pare back, rather than repeal, tax benefits by partially penalizing businesses that claim tax incentives. Under the corporate AMT, corporations are required to keep an entirely different set of books and records and to calculate their tax liability under two very different complex sets of rules – the regular income tax rules with rates up to 35 percent and the corporate AMT rules with rates up to 20 percent – and then pay the larger of the two amounts.

The corporate AMT is an accounting and administrative nightmare that requires businesses to recompute many deductions using less generous rules. Two witnesses described to the Panel how the existence of these two radically different tax codes with dozens of complex differences between them makes rational tax planning, administration, and compliance exponentially more difficult. In addition, the corporate AMT may exacerbate economic downturns by making corporations that are realizing losses under the regular income tax pay additional taxes when they are losing money.

Chapter Two
How We Got Here

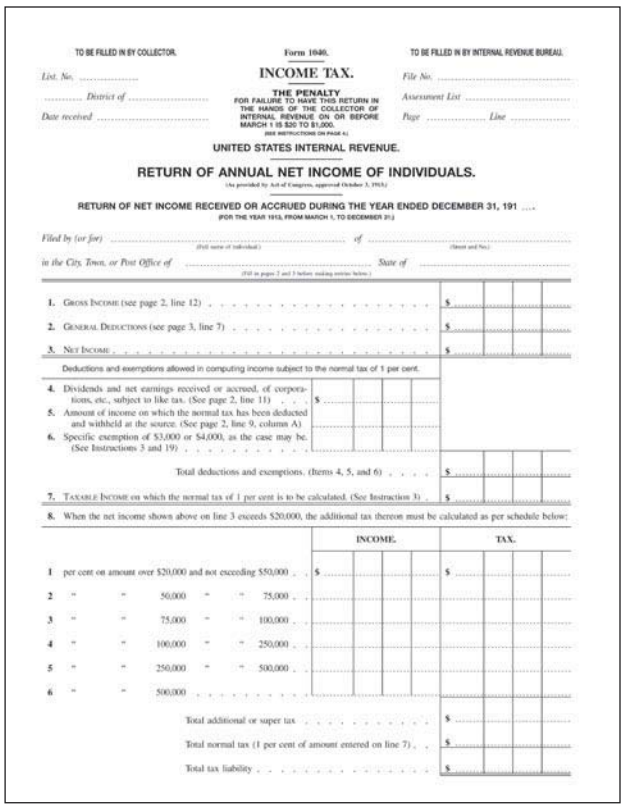
The tax system is closely intertwined with American society; it not only reflects events of the day, but also shapes the society in which we live. It has broad effects – some intentional and some accidental, some short term and some long term. Over the years, many trends have contributed to the problems in our current system. To appreciate the Panel's options for reform, it is useful to understand the broad historical outlines of the U.S. tax system.

Among the most important trends that have marked the federal income tax since its inception have been its ever growing reach; not only has it steadily affected increasing numbers of Americans, but it is now used to carry out a multitude of policy objectives that go well beyond merely collecting revenues needed to fund our government. And as the tax code has developed, little effort has been given to comprehensively examining the system to make sure that it is simple, efficient, and transparent.

There are already many comprehensive histories of the tax code, and this report does not attempt to duplicate, or even summarize, those works. Instead, this chapter highlights historical developments relevant to the Panel's work.

For much of its history the United States did not have an income tax. Except for a brief period during and immediately after the Civil War, the nation relied almost exclusively on tariffs – taxes on imported goods – to support government functions. A lively constitutional debate, including a decision by the Supreme Court in 1895, weighed against the creation of an income tax.

But in 1913, the Sixteenth Amendment was ratified, ending all debate about whether an income tax was constitutional. A few months later, Congress enacted an income tax. At its inception, less than 1 percent of Americans paid the individual income tax. Most Americans were exempt from paying the tax because their income did not exceed a relatively high threshold, and even those who were subject to the tax paid at modest rates. By the 1920s, tax rates had increased and a majority of government revenue came from income taxes that helped fund what was still a small federal government.



TO BE FILLED IN BY COLLECTOR. Form 1040. TO BE FILLED IN BY INTERNAL REVENUE BUREAU.

List. No. ..... INCOME TAX. File No. .....

..... District of ..... THE PENALTY FOR FAILURE TO HAVE THIS RETURN IN THE HANDS OF THE COLLECTOR OF INTERNAL REVENUE ON OR BEFORE MARCH 1 IS $20 TO $1,000. Assessment List .....

Date received ..... Page ..... Line .....

(SEE INSTRUCTIONS ON PAGE 4.)

UNITED STATES INTERNAL REVENUE.

RETURN OF ANNUAL NET INCOME OF INDIVIDUALS.

(As provided by Act of Congress, approved October 3, 1913.)

RETURN OF NET INCOME RECEIVED OR ACCRUED DURING THE YEAR ENDED DECEMBER 31, 191 ....

(FOR THE YEAR 1913, FROM MARCH 1, TO DECEMBER 31.)

Filed by (or for) ..... of .....

(Full name of individual.) (Street and No.)

in the City, Town, or Post Office of ..... State of .....

(Fill in pages 2 and 3 before making entries below.)

1. Gross Income (see page 2, line 12) . . . . . $
2. General Deductions (see page 3, line 7) . . . . . $
3. Net Income . . . . . $

Deductions and exemptions allowed in computing income subject to the normal tax of 1 per cent.

4. Dividends and net earnings received or accrued, of corporations, etc., subject to like tax. (See page 2, line 11) . . . . $
5. Amount of income on which the normal tax has been deducted and withheld at the source. (See page 2, line 9, column A)
6. Specific exemption of $3,000 or $4,000, as the case may be. (See Instructions 3 and 19) . . . . .

Total deductions and exemptions. (Items 4, 5, and 6) . . . . $

7. Taxable Income on which the normal tax of 1 per cent is to be calculated. (See Instruction 3) . . $

8. When the net income shown above on line 3 exceeds $20,000, the additional tax thereon must be calculated as per schedule below:

		INCOME.	TAX.
1	per cent on amount over $20,000 and not exceeding $50,000	$	$
2	" " 50,000 " " 75,000		
3	" " 75,000 " " 100,000		
4	" " 100,000 " " 250,000		
5	" " 250,000 " " 500,000		
6	" " 500,000		

Total additional or super tax . . . . . $
Total normal tax (1 per cent of amount entered on line 7) . . $
Total tax liability . . . . . $

1913 Form 1040

The income tax was initially a "class tax" paid mostly by wealthy Americans. But during the 1930s, the federal government established withholding of payroll taxes in order to fund the new Social Security system, thereby creating a means to collect income tax from the many Americans who receive wages from an employer.

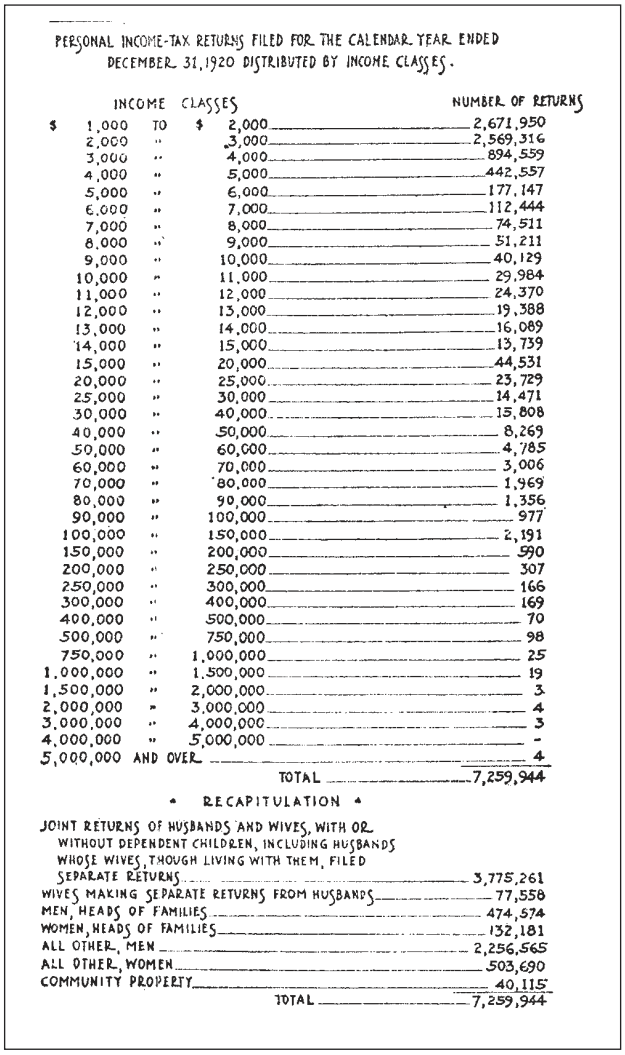
World War II created a pressing need for greater government revenues, and the income tax was greatly expanded to fill the shortfall. The threshold for paying taxes was dramatically reduced, subjecting millions of families to the income tax for the first time. At the same time, wage withholding was expanded to require employers to collect not only Social Security taxes, but also income taxes on employees' wages. By the end of World War II, almost 75 percent of Americans were subject to the income tax, compared with only 5 percent in 1939. The income tax had been transformed from a "class tax" on the wealthiest Americans into a "mass tax" paid by most Americans to fund what had become a substantially larger federal government.

Unlike the aftermath of previous wars, such as the Civil War and World War I, when income taxes were either abolished or reduced, the end of World War II did not prompt the federal government to lower tax rates. Instead, the federal government continued to use receipts from the income tax to maintain much of its wartime size. The income tax remained a major factor in America's economy, and unintended consequences became a hallmark of tax policy.

During the war, the National Labor Relations Board followed an earlier IRS ruling that excluded employer-paid health insurance from income and exempted employer-paid health insurance from wage and price controls. As a result of this decision, employers looking to attract and keep talented workers made greater use of health insurance benefits and other non-cash wages. When World War II ended and price controls were removed, health insurance remained a tax-favored form of compensation for the vast majority of Americans. The decision to exclude health care benefits – originally made when the tax code affected only a small fraction of Americans – had far-reaching consequences, which are detailed later in this report.

Starting in the 1960s, another broad trend in tax policy accelerated: the use of the tax code to achieve policy goals other than raising government revenue. Rather than the largely unintended consequence of some earlier tax writing efforts, this trend reflected a deliberate intent. It strengthened throughout the 1960s and 1970s, with the creation of individual retirement accounts (IRAs) in 1974; the earned income tax credit (EITC), which provides low-income working Americans with a tax benefit, in 1975; and 401(k) retirement accounts in 1978.

Tax changes motivated by non-tax economic or social policy goals became so commonplace that, beginning in 1974, provisions in the tax code to promote these goals were tracked in a "tax expenditure budget." A tax expenditure is a tax incentive that provides special tax treatment to a particular type of activity. Many of these tax incentives could have been structured as a direct government spending program. Either way, it costs the government money to provide benefits, which must be financed with higher taxes elsewhere. Over the past several decades, the number and estimated cost of tax expenditures has grown considerably.



PERSONAL INCOME-TAX RETURNS FILED FOR THE CALENDAR YEAR ENDED DECEMBER 31, 1920 DISTRIBUTED BY INCOME CLASSES.

INCOME CLASSES			NUMBER OF RETURNS
$ 1,000	TO	$ 2,000	2,671,950
2,000	"	3,000	2,569,316
3,000	"	4,000	894,559
4,000	"	5,000	442,557
5,000	"	6,000	177,147
6,000	"	7,000	112,444
7,000	"	8,000	74,511
8,000	"	9,000	51,211
9,000	"	10,000	40,129
10,000	"	11,000	29,984
11,000	"	12,000	24,370
12,000	"	13,000	19,388
13,000	"	14,000	16,089
14,000	"	15,000	13,739
15,000	"	20,000	44,531
20,000	"	25,000	23,729
25,000	"	30,000	14,471
30,000	"	40,000	15,808
40,000	"	50,000	8,269
50,000	"	60,000	4,785
60,000	"	70,000	3,006
70,000	"	80,000	1,969
80,000	"	90,000	1,356
90,000	"	100,000	977
100,000	"	150,000	2,191
150,000	"	200,000	590
200,000	"	250,000	307
250,000	"	300,000	166
300,000	"	400,000	169
400,000	"	500,000	70
500,000	"	750,000	98
750,000	"	1,000,000	25
1,000,000	"	1,500,000	19
1,500,000	"	2,000,000	3
2,000,000	"	3,000,000	4
3,000,000	"	4,000,000	3
4,000,000	"	5,000,000	-
5,000,000 AND OVER			4
		TOTAL	7,259,944

RECAPITULATION

JOINT RETURNS OF HUSBANDS AND WIVES, WITH OR WITHOUT DEPENDENT CHILDREN, INCLUDING HUSBANDS WHOSE WIVES, THOUGH LIVING WITH THEM, FILED SEPARATE RETURNS	3,775,261
WIVES MAKING SEPARATE RETURNS FROM HUSBANDS	77,558
MEN, HEADS OF FAMILIES	474,574
WOMEN, HEADS OF FAMILIES	132,181
ALL OTHER, MEN	2,256,565
ALL OTHER, WOMEN	503,690
COMMUNITY PROPERTY	40,115
TOTAL	7,259,944

Internal Revenue Service, Statistics of Income, 1920

Even when Congress and the Administration corrected certain problems in the tax code, they often created other problems at the same time. For example, in 1981, Congress passed and President Reagan signed a tax bill that indexed tax brackets for inflation, ending what was called "bracket creep." Bracket creep occurred when inflation pushed up taxpayers' wages. Because tax brackets were not adjusted for inflation, this amounted to an inflation-aided tax hike every year, even if a taxpayer's purchasing power stayed the same or actually fell. Furthermore, lawmakers were able to spend the proceeds from these higher taxes without having to actually vote to increase rates.

While fixing the bracket creep problem, the 1981 tax bill also included various narrowly tailored tax incentives, and these special interest provisions, including further benefits for real estate investment, helped drive greater use of tax shelters. By 1982, one poll showed that 86 percent of Americans believed that most higher-income people got out of paying much of their taxes by hiring tax accountants and lawyers who showed them how to use loopholes in the tax law, while lower and middle-income people simply took the standard deduction and paid what they owed.

In his 1984 State of the Union address, President Reagan called on the Treasury Department to prepare a plan to overhaul the entire tax code. After two years of analysis, debate, and bipartisan compromise, President Reagan signed the Tax Reform Act of 1986. The 1986 Act reduced the top marginal individual tax rate from 50 percent to 28 percent and increased the standard deduction. The top corporate tax rate was reduced from 50 percent to 34 percent.

The 1986 Act broadened the tax base by repealing more tax preferences than had been eliminated in all tax legislation enacted between 1913 and 1985, including the long-term capital gains exclusion, the investment tax credit, the two-earner deduction, state and local sales tax deductions, and the deduction for credit card interest. Deductions for passive losses, medical expenses, business meals and entertainment, and miscellaneous expenses also were limited. These changes and others made by the 1986 Act simplified the tax code, broadened the income tax base, allowed for lower marginal tax rates, and curtailed the use of individual tax shelters.

While the 1986 Act was a historic event, it did not produce a lasting transformation of the tax system. The 1986 Act left in place or added various complicated tax benefits, including such items as exclusions for employer-provided fringe benefits, state and local tax deductions, tax-deferred annuities, new mortgage interest deduction rules, and complicated rules for determining alternative minimum tax liability. Many point to the 1986 Act as the high point of contemporary tax reform – and they may well be right – but its limitations suggest that truly sweeping comprehensive reform faces formidable political obstacles.

The reforms of the 1986 Act were intended to create a simpler, more stable, and pro-growth federal income tax system based on lower rates and more uniform taxation of all sources of income, while retaining a progressive tax rate structure. But since 1986, the promise of a more simple and sustainable system has been undone. Throughout the 1990s, income tax rates rose, and many special individual and business tax provisions were enacted, narrowing the tax base. The piecemeal addition of these new benefits was shaped by new budget rules aimed at forcing lawmakers to limit the scope of tax legislation. Rather than limiting the number of new provisions, however, the budget rules led to a greater use of phase-outs, restrictions, and eligibility criteria that compounded the complexity of the tax code.

During the 1990s, the EITC was revised to account for family size and was extended to cover low-income single workers with no children. A higher level of Social Security benefits became subject to tax, and a complicated three-tier system was enacted for calculating how much would be taxed. On the business side, Congress increased the corporate tax rate from 34 percent to 35 percent and either created or extended a number of special provisions for the energy sector, low income housing, research and development, and tax-free employee fringe benefits.

In 1997, Congress again enacted new tax credits for children and for education. A new type of retirement vehicle – called a Roth IRA – was created along with a new education savings account. Joining the medical savings accounts created in 1996, these accounts were the first of a slew of new provisions to promote savings, each with its own rules and limitations. The piecemeal addition of savings incentives with complicated rules made it increasingly hard for ordinary Americans to navigate the system while still allowing for well-advised taxpayers to take advantage of the code's many loopholes.

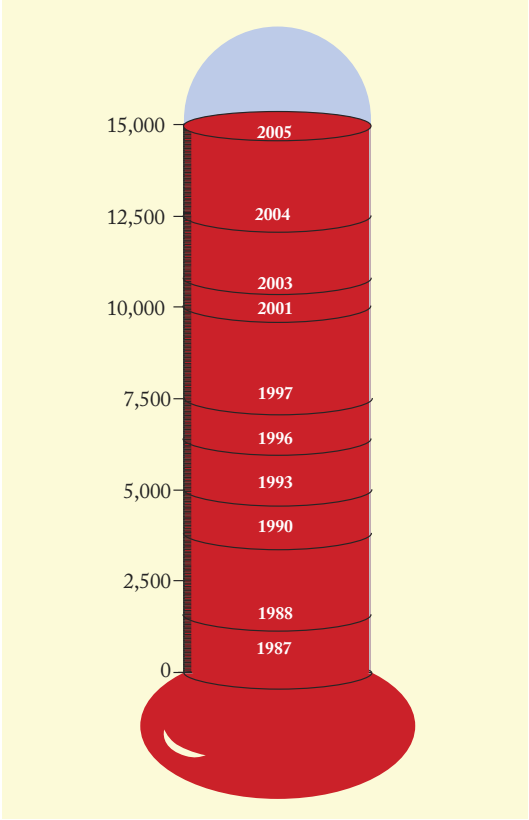
A number of significant changes to the tax code have been made in the last few years. Tax relief passed in 2001 lowered individual tax rates, doubled the child tax credit, raised limits for retirement plan contributions, provided marriage penalty relief, and introduced a deduction for college expenses and yet another education savings account. Two years later, further tax relief was signed that reduced the taxation of both dividends and capital gains to a uniform top rate of 15 percent, and increased the amount of depreciation or expensing that companies could take for business purchases. All of these provisions – rates and others – are temporary and expire over the next six years, substantially undermining the durability of the tax code and the certainty taxpayers need for planning.

Just last year, Congress enacted a "use it or lose it" tax holiday to encourage multinationals to bring back previously untaxed foreign earnings, and a special tax deduction targeted at domestic manufacturing. The manufacturing deduction is another example of a provision that is targeted at a specific type of activity, but that creates complexity for everyone. The provision allows businesses to deduct net income from the sale of goods, software, and film and sound recordings if they are manufactured or produced within the United States. To take advantage of the benefit, businesses need to allocate all of their receipts and expenses between those activities that are eligible for the preference and those that are not. Provisions like these are also difficult to administer. One witness observed that the prohibition on movies with sexually explicit content places IRS agents in the awkward position of screening movies to determine whether they qualify for the deduction.

Even as the Panel was conducting its deliberations, lawmakers continued to enact additional tax breaks for certain industries. Yet again, greater value was placed on creating targeted tax breaks than on establishing broad-based provisions that would apply to all businesses.

Today, our tax system bears little resemblance to the simple, low-rate system promised by the 1986 reform effort. Since 1986, there has been nearly constant tinkering – more than 100 different acts of Congress have made nearly 15,000 changes to the tax code, as shown in Figure 2.1. A number of new credits, deductions, and exemptions have been extended or layered on top of long-standing incentives in the tax code for such goals as encouraging savings, charity, and homeownership. A growing maze of tax rules and incentives target narrow classes of individuals; phase-outs, contribution limits, and complicated eligibility criteria circumscribe the scope of older programs. Changes in the global economy, including increasingly sophisticated financial instruments, the free flow of capital across borders, a globally competitive marketplace, and the expanding role of intangible assets in producing business income, have also made it harder to establish the rules required to accurately measure tax liability and fairly enforce the income tax.

Figure 2.1. Tax Law Changes Since 1986



Our tax code is in dire need of reform. Not only has it failed to keep pace with our growing and dynamic economy, frequent changes have made it unstable and unpredictable. History demonstrates that in the absence of a concerted effort to reform the tax system, it will become more complex and ungainly. Meaningful reform requires a comprehensive and forward-looking examination of our tax system. The Panel has been presented with a historic opportunity to do just that. The following chapters describe the Panel's findings, along with proposals designed to put our country on a path towards a better tax system for current and future generations.

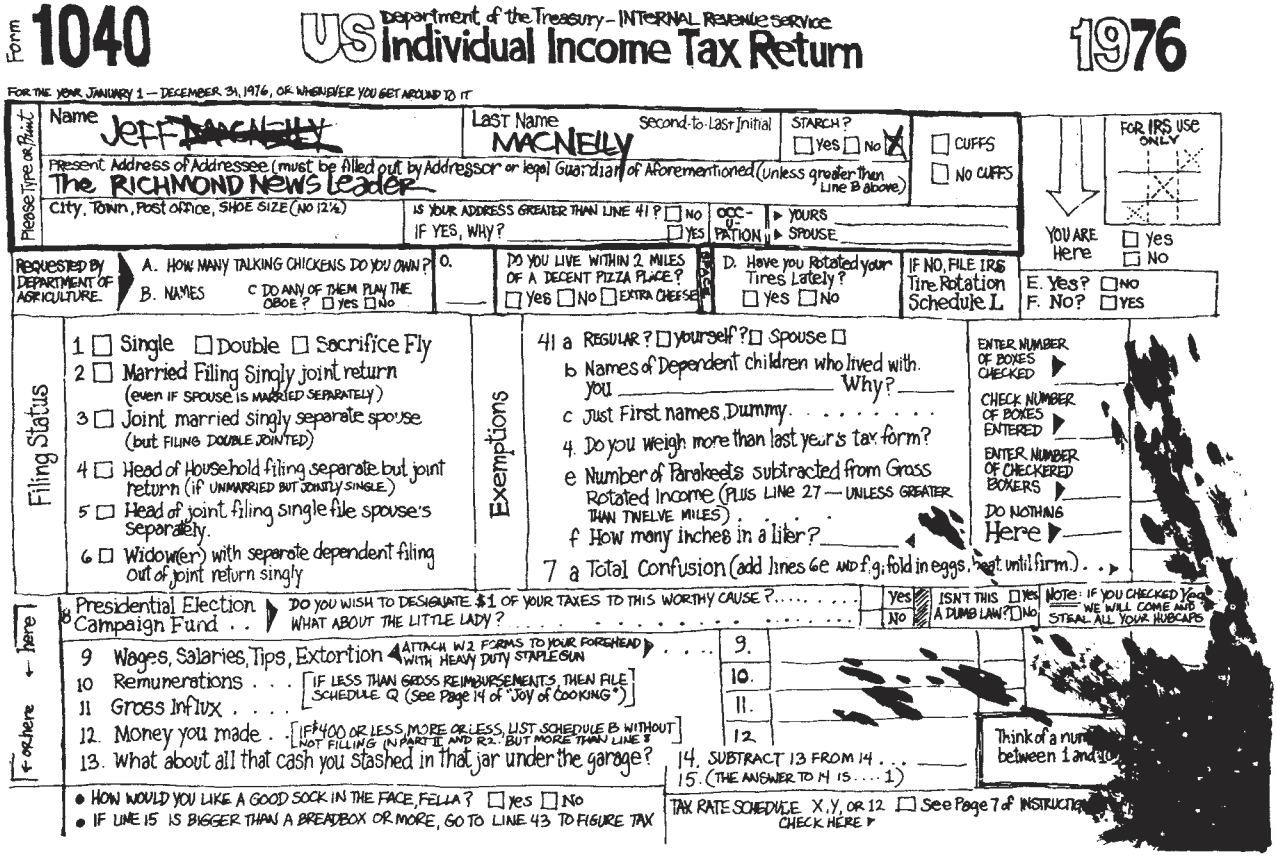
Box 2.1. International Trends

A wave of tax reforms has swept across the world in the last two decades. Since the United States reformed its tax system in 1986, almost every major developed economy has engaged in fundamental tax reform. The Panel heard that a common theme of these reform efforts was an attempt to lower tax rates and broaden the tax base.

Some countries have adopted flatter personal income tax systems by reducing the number of tax brackets in their systems. A number of countries in Eastern Europe – including Estonia, Georgia, Latvia, Slovakia, and Russia – have adopted a single uniform rate for taxing personal income. Other countries, such as Finland, Norway, and Sweden have moved towards dual personal income tax systems under which wage income is taxed at progressive rates and capital income (dividends, interest, etc.) is taxed at a single low rate. Countries have also lowered their corporate income tax rates and provided other tax relief for capital income. Finally, almost all developed economies and many developing ones have adopted a modified sales tax known as a value-added tax, or VAT.

Chapter Three

Tax Basics



Courtesy of www.jeff-macnelly.com

As the Pulitzer Prize-winning cartoon that opens this chapter suggests, our income tax system has become a running joke. Many Americans do not understand what determines their tax liability and why it may differ from their neighbors' tax bill. Few can understand why our tax returns require us to make the calculations that they do. Tax lawyers and scholars who testified at our meetings conceded even they do not understand the inner workings of the tax system. But understanding the mechanics of tax computation – under either our current system or other potential systems – is crucial to reforming the tax code. This chapter explains how to analyze the tax code – not just from the perspective of the government, but from the point of view of the taxpayer. It goes through the basic steps involved in calculating a tax bill (shown in Figure 3.1) to explain our current tax code and alternative tax systems. This brief tour will introduce important concepts used throughout the remainder of the report.

Designing a tax system involves choices. Defining the "tax base," or what will be taxed, setting a rate structure, and deciding how taxes will be collected determines much more than how much an individual or family pays. These decisions have consequences

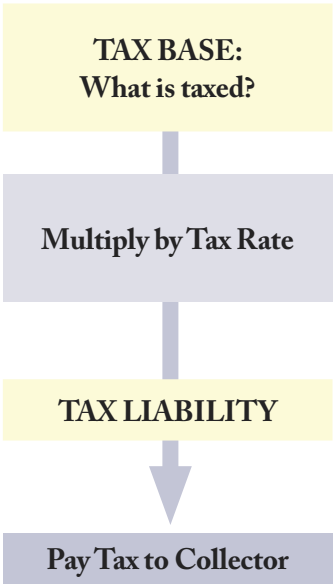
for how different economic activities are taxed or "what is taxed," how the tax burden is distributed across taxpayers, what are the administrative and compliance costs of the system, and how our tax system interacts with our $12 trillion economy.

The Tax Base

The ***tax base*** is the pool of economic activity from which tax revenue is gathered. All else being equal, the broader the tax base, the more revenue a tax system will collect at a given tax rate.

A ***comprehensive income tax base***, which is perhaps the broadest tax base, would include all forms of income. Most people think of income strictly in terms of wages. But a comprehensive measure of income also includes anything that allows you to spend more, either now or in the future. Capital gains and losses, dividends, rental income, and royalties all represent income that does not come in the form of wages.

Figure 3.1. Calculating the Taxpayer's Bill



Income can also include noncash increases to wealth, such as health care insurance or other fringe benefits provided by an employer. Some components of income are accruals that do not involve any current cash flows. For example, a stock that has risen in value allows its owner to spend more in the future, and so the increase in value every year should be considered income even if the asset has not been sold. In a comprehensive income tax base, the increase in value of all assets, including homes, would be subject to taxation. In the case of housing, homeowners would also have to declare as income the value they receive by living in their houses rather than renting them out – something economists call "imputed rental income." All expenses incurred in earning income would be subtracted from the base. Most agree that this construct – recognizing income not just as real but as potential – makes the comprehensive income tax base extremely difficult to implement in practice.

Comprehensive taxation of business income is similarly complex and difficult to implement. Businesses would include all sources of income (receipts from sales, returns on financial assets, etc.) and subtract all expenses incurred to earn income. While it is relatively easy to measure and subtract the cost of inputs that are used up during the year they are purchased, it is much more difficult to properly account for the cost of durable inputs, like machinery, that last for more than one tax period. A consistent definition of income would require that the business be allowed to subtract the decrease in economic value of machinery and other assets including "intangible" assets, such as advertising and copyrights. After all, this decrease in value, called ***economic depreciation***, represents an economic cost to the firm. Measuring economic depreciation for different assets is extremely difficult and is one of many intractable complexities encountered when using income as a tax base.

Is income the only possible tax base? Income is only one way to define a tax base. Another approach is to tax the value of goods and services that individuals purchase or consume. This approach is referred to as using a ***comprehensive consumption tax base***. The major distinction between a consumption tax base and an income tax base is the treatment of savings. Under the comprehensive consumption tax base, people are not taxed until they spend. Under the comprehensive income tax base, they are

taxed from the moment they earn anything – including the returns on saving and investment. As a result, many experts view the comprehensive consumption tax base as better for saving and capital formation, a key determinant of labor productivity and future living standards.

Some proponents of the comprehensive consumption tax base call it a "neutral tax system" because it treats a dollar spent today the *same* as a dollar saved and spent tomorrow. An individual who earns a dollar today, pays taxes on those wages, and then consumes the after-tax proceeds will not pay any further taxes. The earnings would be taxed only once under the consumption tax. In contrast, under an income tax, someone who earns the same amount today and pays the same taxes on wage income, but then decides to save the after-tax proceeds will be subject to a future tax on the investment income generated by this saving.

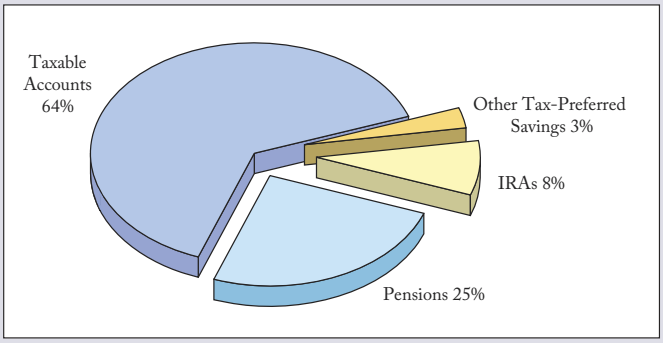
Under a consumption tax, businesses would subtract the cost of all purchases from other businesses, including an immediate write-off, known as "expensing," for all business assets. Similar to an individual's treatment under a consumption tax base, businesses would not include returns on financial assets, nor would they deduct their financing costs. As is explained later in this chapter, this is one way, but not the only way to tax consumption.

What tax base does the U.S. system use? Our tax base does not follow either model. As illustrated in Chapter One, it most closely resembles an income tax base system, but does not include certain forms of both cash and noncash income that would be part of a comprehensive income tax base. For example, employer contributions to health plans are not taxed in our current system. These ***exclusions*** significantly narrow the base. For example, the value of all noncash employee benefits in 2002 was approximately $1.1 trillion – equal to about 10 percent of the total size of the economy. Only a small fraction of that amount was subject to tax.

The current system also deviates from a pure income tax by excluding significant amounts of investment income through tax preferences for savings. This feature of our tax system resembles, or moves it towards, a consumption tax. In fact, over one-third of the proceeds from household savings are effectively exempt from taxation – meaning that these financial assets receive the equivalent of consumption tax treatment (see Box 3.1). The other two-thirds of household savings are taxed as they would be under an income tax. Several economists who testified before the Panel said that the current tax system is based on neither a pure income nor a pure consumption tax, but is really a ***hybrid tax system*** – a tax system with both income tax and consumption tax features.

Box 3.1. Taxes and the Return on Household Financial Assets

Relative to a pure income tax, the current U.S. tax system reduces the tax on the return to saving through tax-preferred savings accounts (e.g., IRAs, pensions, and college savings accounts), faster write-off of investment (e.g., expensing and accelerated depreciation), and lower tax rates on dividends and capital gains. As shown below, over one-third of the return on household financial assets is effectively exempt from taxation (excluding the effects of the corporate tax).

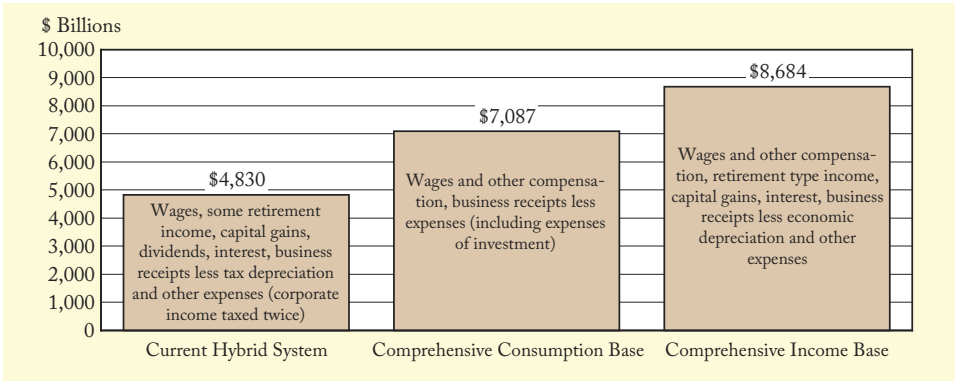


Source: Department of the Treasury, Office of Tax Analysis.

There are also some features of the current tax system that are inconsistent with both an income tax and a consumption tax. The lack of taxation on the implicit rental value of owner-occupied housing is an example. This tax provision is consistent with neither income nor consumption taxation. The double taxation of corporate profits - once when earned at the corporate level and again at the individual level when received by shareholders - is another example.

As summarized in Figure 3.2, our hybrid tax system has a much smaller tax base than it would under either a comprehensive income tax or a comprehensive consumption tax. Various exclusions, deductions, and credits leave the current hybrid tax base about half as large as a broadly defined income tax base. Our tax system also relies on depreciation rules that generally provide a more rapid, or accelerated, write-off of investment than on rules that try to replicate economic depreciation.

Figure 3.2. Alternative Tax Bases, 2001

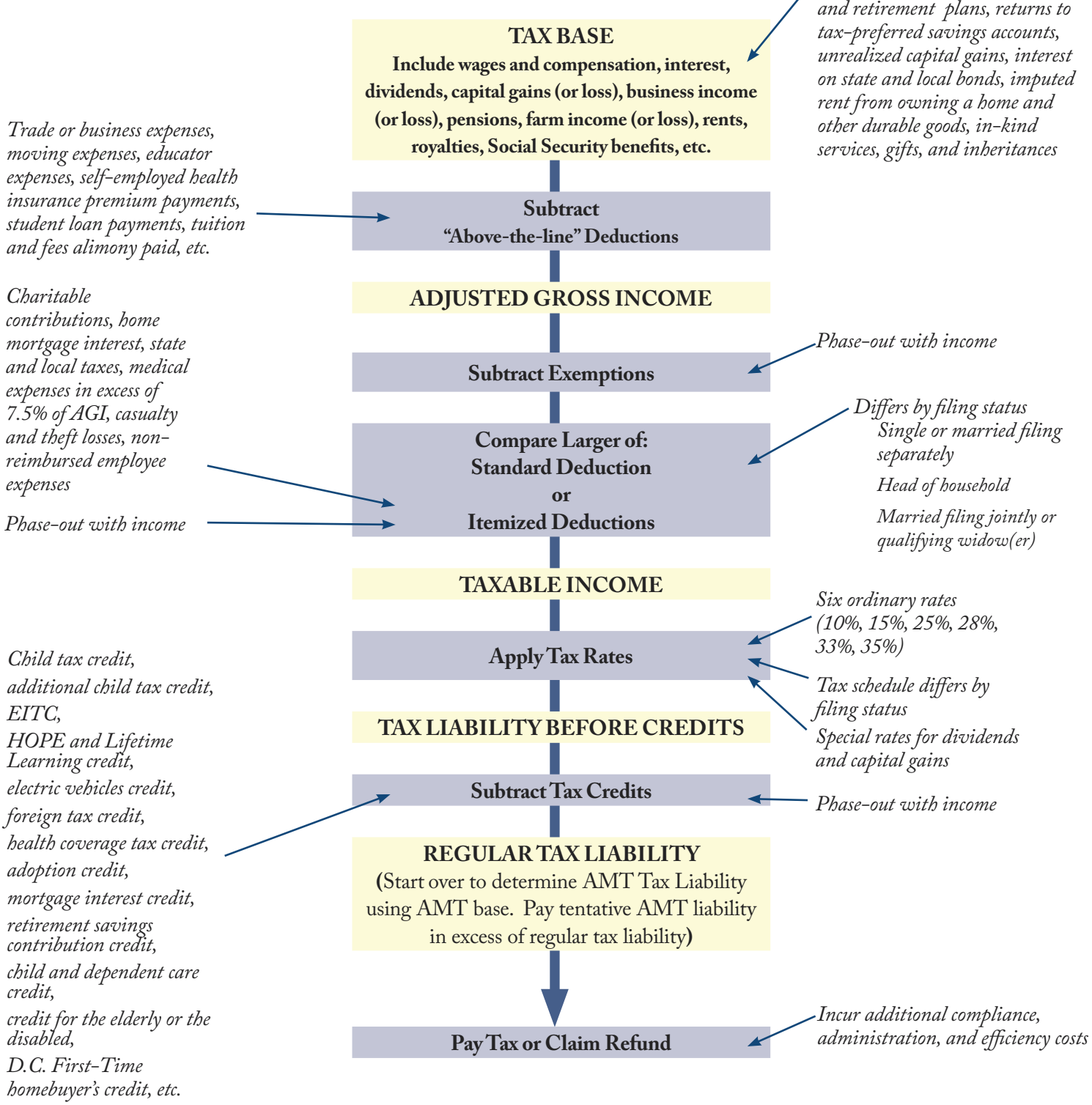


Source: Department of the Treasury, Office of Tax Analysis.

Calculating Tax Liability in Our Current System

As the history of our tax code suggests, calculating tax liability in our current system is not as simple as the four-box diagram shown in Figure 3.1. Figure 3.3 is a more accurate representation of the many steps involved in calculating taxes owed under the current personal income tax system. Taxpayers start by adding up their taxable income from different sources: wages and salaries, taxable dividends, taxable interest, rents, royalties, capital gains, business income (or losses), taxable pensions and annuities, taxable Social Security benefits, etc. This income, called ***gross income***, is the starting point for the tax calculation. Arriving at each of these components often involves its own set of calculations. Under current law, taxpayers are allowed to deduct certain expenses, such as the costs of moving for a new job or their contributions to individual retirement accounts, from gross income. After taking into account these adjustments, sometimes called "above-the-line" deductions, the taxpayer takes the resulting amount, called ***adjusted gross income*** **(AGI)**, and applies further adjustments to calculate taxable income.

Figure 3.3. Individual Tax Computation Under the Current System



How is taxable income determined? ***Taxable income***, in mathematical terms, equals AGI minus applicable exemptions and deductions. Exemptions and deductions remove a further amount of income from the tax base. In certain cases, these tax provisions, or ***tax preferences***, are in place to encourage certain kinds of economic activity, such as the purchase of homes. In other cases, these preferences are in place to generate a certain kind of social good, such as charitable giving. In still other cases, these preferences are in place to provide assistance to low or moderate-income Americans, especially those with children, by lowering their taxes. Finally, some tax preferences, like the personal exemption discussed in the next paragraph, are designed to reflect a taxpayer's ability to pay taxes. Tax preferences have varying effects and success in achieving their goals.

What is an exemption? Most taxpayers in our system are eligible to exclude a certain amount of income from taxes. This ***exemption*** depends on family size. For example, a single taxpayer claims one exemption and married taxpayers with two children (or other dependents) claim four exemptions. Not every taxpayer is allowed to claim an exemption. Personal exemptions are phased out for higher income taxpayers with AGI in excess of certain amounts. The personal exemption is an example of a tax preference designed to adjust tax liabilities for family size that, for revenue reasons, is not available to higher-income taxpayers.

What are deductions? ***Deductions***, like exemptions, are subtracted from AGI to determine taxable income. Taxpayers are allowed to choose whether to subtract a ***standard deduction*** amount determined by filing status – such as single or married – or to subtract the total of their ***itemized deductions***. It is up to taxpayers to calculate their itemized deductions and claim them if the total is greater than their standard deduction.

Only specific expenditures may be claimed as itemized deductions. Many of the most prominent tax preferences, including deductions for charitable contributions, home mortgage interest, and state and local taxes, come in the form of itemized deductions.

The benefits of these deductions are not spread evenly among taxpayers for several reasons. First, most taxpayers do not itemize their deductions, and those who do tend to have higher incomes than those who do not. The Internal Revenue Service reports that only 34 percent of taxpayers claimed itemized deductions in 2003. Among the taxpayers who did so, over 60 percent had AGI of more than $50,000. By comparison, only 12 percent of taxpayers claiming the standard deduction had AGI of more than $50,000 in 2003.

Second, the value of a deduction (or exclusion) is worth more to a taxpayer in a higher tax bracket than to a taxpayer in a lower tax bracket. The reason is simple: A $1,000 deduction reduces taxes owed to the government by $350 for someone in the top 35 percent tax rate bracket; but it reduces taxes by only $150 for a taxpayer in the 15 percent tax bracket.

Although deductions are worth more to taxpayers in higher tax brackets, the tax code has been written to phase out most deductions when a taxpayer reaches a certain income level. These trigger points are typically at different levels of income and vary based on filing status. Phase-outs add a significant amount of complexity to the process of filling out tax returns and lead to the very complicated and unpredictable set of marginal tax rates depicted in Chapter One, Figure 1.2.

Setting the Tax Brackets

Some low-income taxpayers have zero taxable income after subtracting exemptions and deductions from their adjusted gross income. Nevertheless, these taxpayers must complete the tax form to determine if they are eligible for benefits from several refundable tax credits (as explained later in this chapter). For taxpayers with positive taxable income (that is, positive income after subtracting exemptions and deductions), tax is imposed by applying a tax rate schedule with six tax rate brackets that range from 10 percent to 35 percent. The applicable rate depends on the taxpayer's family filing status. Table 3.1 summarizes the 2005 tax rates for single and married taxpayers.

Table 3.1. Tax Rates for Single and Married Taxpayers Filing Jointly in 2005

Tax Rate	Single	Married Filing Jointly
10%	Up to $7,300	Up to $14,600
15%	$7,300 - $29,700	$14,600 - $59,400
25%	$29,700 - $71,950	$59,400 - $119,950
28%	$71,950 - $150,150	$119,950 - $182,800
33%	$150,150- $326,450	$182,800 - $326,450
35%	$326,450 or more	$326,450 or more

Applying the relevant tax rates to taxable income produces the taxpayer's liability. However, certain portions of a taxpayer's income, such as dividends and capital gains, are taxed at special rates that may be lower than the rate that would be paid on an additional dollar of ordinary income – requiring yet another set of calculations.

What is a tax credit? Like deductions, exemptions, and exclusions, ***tax credits*** provide taxpayers with a tax benefit. However, tax credits are applied after the taxpayer's tax liability is calculated; they are subtracted, just like a coupon at the supermarket.

Depending on how a tax preference is designed – as a deduction, exemption, or credit – it can have different impacts on taxpayers at different income levels. For example, we have already seen how tax deductions and exemptions are more valuable to higher-income taxpayers. Since tax credits provide a dollar-for-dollar decrease in tax liability for all taxpayers who pay tax, they provide an equal benefit to taxpayers at all income levels. Tax credits can also be made refundable. A refundable tax credit is like a gift certificate that can be exchanged for cash. Even if a taxpayer has too little income to actually owe income taxes, he or she may be able to claim a refund equal to the amount of the tax credit that exceeds tax liability. The earned income tax credit (EITC) and the child tax credit are two examples of refundable credits.

In recent years, lawmakers have enacted rules that phase out some tax credits for higher-income taxpayers. This limits the cost of tax credits, but also raises the marginal tax rate, or the tax paid on a taxpayer's last dollar of income, above the rate normally paid by the taxpayer. Consider, for example, a taxpayer in the 28 percent bracket who claims credits that begin to phase out at a rate of $5 for every extra $100 earned. By this measure, each additional $100 earned by the taxpayer increases tax liability by $28, but *decreases* the value of tax credits by $5. The tax on the additional $100 of earnings is not $28, but $33, and the taxpayer's marginal tax rate (the rate applied to the last dollar earned by the taxpayer) is not 28 percent ($28/$100), but 33 percent ($33/$100).

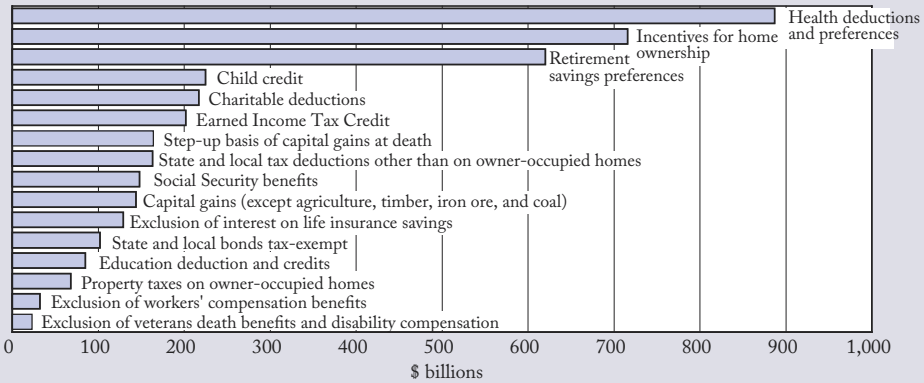
Phase-outs are so pervasive in our system that one recent study found that more than one out of every five taxpayers faced actual marginal tax rates (called "effective marginal tax rates") higher than their statutory rates in 2003. This was even more common among higher-income households: More than half of taxpayers with AGI of $100,000 or above faced effective marginal tax rates greater than the statutory rate.

Box 3.2. The Cost of Tax Preferences

Because of the rising use of special tax provisions, policymakers maintain a "tax expenditure budget" to track tax preferences, whether in the form of credits, deductions, exclusions, or exemptions. The tax expenditure budget lists the subsidy cost of tax preferences – what the government would collect in revenue if any given tax preference did not exist. There does not appear to be any institutional process to evaluate on a regular basis the effectiveness of these tax preferences.

The most recent budget lists 146 tax expenditures, most of which relate to the individual income tax system. The largest tax expenditures, grouped by major category, are the exclusion from income for employer-provided health insurance, incentives for home ownership, tax-preferred retirement savings, the deduction for charitable contributions, the child tax credit, the EITC, the step-up in basis of capital gains upon death, and state and local tax deductions.

Largest Individual Tax Expenditures (FY 2006-2010)



Note: Incentives for home ownership category does not include the exclusion of net imputed rental income on owner-occupied homes of $185.2 billion.
Source: Department of the Treasury, Office of Tax Analysis.

Double-checking: Does the Alternative Minimum Tax apply? After all these calculations, a taxpayer arrives at the moment of truth: the final tax bill. However, many taxpayers still need to consider whether they owe more taxes under the AMT. As explained in Chapter One, the AMT uses a different definition of the tax base, a higher level for exemptions, and fewer tax preferences than the regular income tax. And because the threshold for paying the AMT has never been indexed to inflation, more and more Americans are forced to consider whether they face a higher tax bill under this secondary tax system.

Paying the Tax

Because of exclusions, exemptions, deductions, and credits, a large percentage of income is never taxed, and most low-income families pay little, if any, income taxes. In some cases, refundable credits provide these families with an additional amount of money that helps offset other federal taxes paid, such as payroll taxes. As detailed in Table 3.2, a typical family of four will pay no income tax in 2005 on the first $41,000 of income it earns. The amount of income at which a family starts to pay tax is sometimes called the ***tax threshold*** and has important implications for how the burden of the tax is distributed and how people participate in the tax system and support the federal government.

Table 3.2. Components of Income Tax Thresholds for 2005

	Single, no children	Single, two children	Married, two children
Standard deduction	$5,000	$7,300	$10,000
Personal exemptions	$3,200	$9,600	$12,800
Income not subject to tax before credits	$8,200	$16,900	$22,800
Tax threshold: Income not subject to tax after earned income and child tax credits	$9,737	$34,620	$41,000

Source: Department of the Treasury, Office of Tax Analysis.

In 2002, over 30 percent of taxpayers who filed a tax return – 39 million of 130 million returns filed – either owed no tax or received a refundable credit. An additional 15 million taxpayers earned less income than the total of the standard deduction and personal exemption and, therefore, were not required to file a return. In all, approximately 40 percent of families paid no income tax directly.

It is worth noting that taxpayers do not stay permanently in the status of having a negative, zero, or positive tax liability. As their family and income circumstances change, even from year to year, taxpayers can move in and out of these negative, zero, or positive tax situations. A Department of the Treasury study that followed taxpayers over multiple years suggests that about two-thirds of taxpayers in the bottom (zero rate) bracket in the first year had moved to a higher bracket after 10 years, the vast majority moving to either the 10 or 15 percent tax brackets. This fluidity is important because simply taking people "off the rolls" may not take them out of the system for any significant length of time.

Who really pays the tax? When the calculation is complete and the tax owed (or the refund due) is finally determined, the taxpayer signs the tax form and sends it to the Internal Revenue Service (either electronically or through the mail). In the case of the income tax, the amount of tax owed is paid directly to the federal government. Not all taxes imposed on individuals are remitted directly from individuals to the government, however.

One of the most important concepts in understanding how taxes work is that who remits the tax has no relevance on who bears the ultimate burden of the tax or how the tax affects the economy. For example, the legal burden of the payroll tax (Social Security, Medicare, and unemployment insurance) is shared between employers and employees. Economists have found, however, that the burden of the employer's portion of the payroll tax is largely passed on to employees in the form of lower wages. The ***economic incidence*** is on workers even though the ***legal incidence*** of the payroll tax is shared. Box 3.3 explains how market forces, and not who is legally responsible for remitting the tax, determine who bears the economic burden of any tax.

Box 3.3. Determining Who Bears the Burden of a Tax

Imagine that the government imposed a special tax on ice cream sold from ice cream trucks. If the ice cream truck drivers are able to pass on the tax to their customers in the form of higher prices, the economic incidence of the tax would be on their customers. In this case, the price of ice cream sold from trucks would increase by exactly the amount of the tax. If customers resisted the price increase by buying their ice cream in stores to avoid the tax, and ultimately the only way the truck driver could sell ice cream was by matching the retail price at the store, then the truck driver would bear the economic burden of the tax. In this case, the legal incidence and economic incidence of the tax would be identical.

Understanding the difference between the economic and legal incidence of taxes is important in analyzing both taxes and subsidies. Take the example of tax credits for low-income housing that could be claimed by low-income taxpayers. If the price of low-income housing increases by the amount of the credit, the credit would provide no benefit whatsoever to the low-income household, but enormous value to builders of low-income housing. In this case, market forces would have passed the full benefit of the credit to builders.

Paying a "Fair Share"

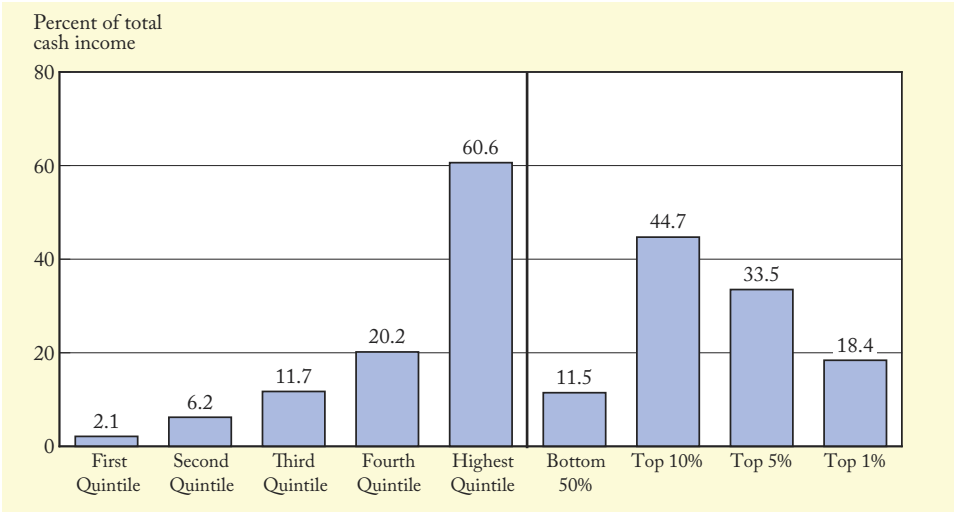
How a tax system is designed determines how the tax burden is distributed. In a progressive tax system, the household's tax burden, measured as tax liability divided by household income, increases as household income rises. Graduated tax rates, exemptions, the standard deduction, and refundable credits all contribute to the progressivity of our tax system.

Another measure of how the burden of our tax system is distributed involves calculating how much of total tax revenue is collected from different income groups. This type of analysis is produced routinely by government organizations, nonprofit organizations, academics, and other groups.

There are many assumptions involved in tax burden analysis and, not surprisingly, different organizations use different methodologies. All analyses start by ranking taxpayers according to a measure of economic well-being intended to approximate "ability to pay." The Treasury Department uses a measure called "cash income," based on the income of each household. Cash income consists of wages and salaries, business or farm net income, taxable and tax-exempt interest, dividends, rental income, realized capital gains, cash transfers from the government, and retirement benefits. Employer contributions for payroll taxes and the federal corporate income tax are also added to cash income calculations.

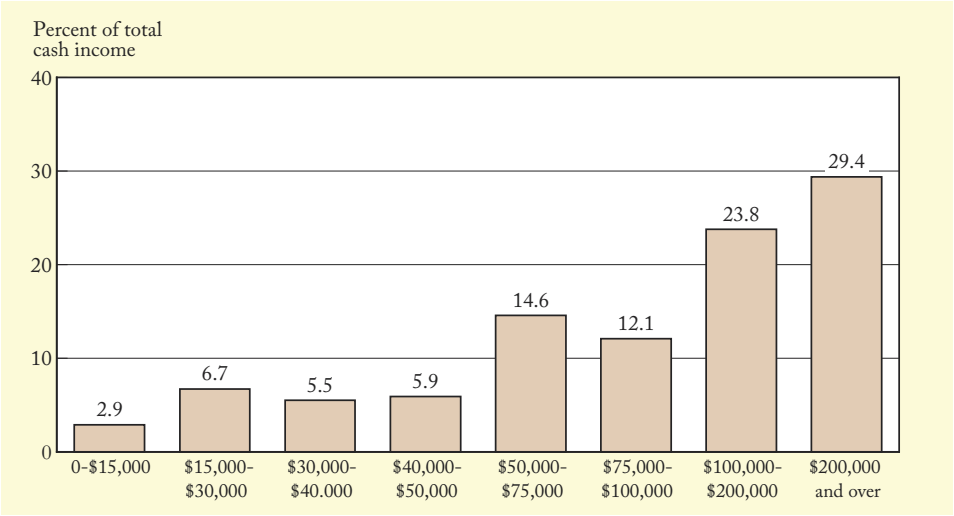
The Treasury Department constructs distribution tables by dividing the entire population of households into income quintiles or cash income levels. Taxes paid are then calculated for each group. The distribution of cash income across quintiles (and the top 10 percent, 5 percent, and 1 percent of taxpayers, as well as the bottom 50 percent of taxpayers) and across cash income levels is shown in Figures 3.4 and 3.5. Figure 3.4 shows that the top 20 percent of households earn about 60 percent of all income and the bottom 20 percent of all households earn about 2 percent of all income.

Figure 3.4. Distribution of Cash Income Under Current Law by Income Percentile



Note: Estimates of 2006 cash income levels. Quintiles begin at cash income of; Second $12,910; Third $27,461; Fourth $48,345; Highest $84,124; Top 10% $123,706; Top 5% $169,521; Top 1% $407,709; Bottom 50% below $36,738.
Source: Department of the Treasury, Office of Tax Analysis.

Figure 3.5. Distribution of Cash Income Under Current Law by Income Level



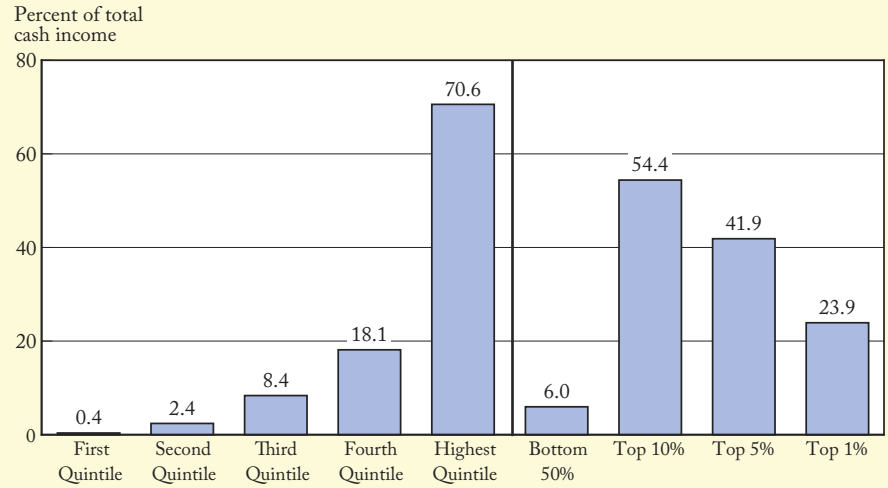
Note: Estimates of 2006 cash income levels.
Source: Department of the Treasury, Office of Tax Analysis.

The Treasury Department's quintile analysis showing the distribution of all current federal taxes (individual and corporate income taxes, payroll taxes, excise taxes, customs duties, and estate and gift taxes) across cash income quintiles is shown in Figure 3.6. Not surprisingly, given the progressive nature of our tax system, most federal taxes are paid by upper-income taxpayers. Taxpayers in the top 20 percent of the distribution pay 70.6 percent of all federal taxes, while taxpayers in the bottom 20 percent pay 0.4 percent. More than half of federal taxes are paid by taxpayers in the top 10 percent of the distribution. Figure 3.7 provides detail on the distribution of all federal taxes across cash income groups.

The Panel has considered reforms to two important components of the federal tax system: the individual income tax and the corporate income tax. The distribution of these taxes alone is shown in Figures 3.8 and 3.9. Taxpayers in the lowest two quintiles actually receive more in refunds from the federal government than they pay in income taxes and, as a result, have negative tax income burdens. Those taxpayers in the third and fourth quintile pay a relatively small share of the income taxes, 3.8 percent and 13.4 percent, respectively, while those in the top quintile pay over 84 percent of federal income taxes.

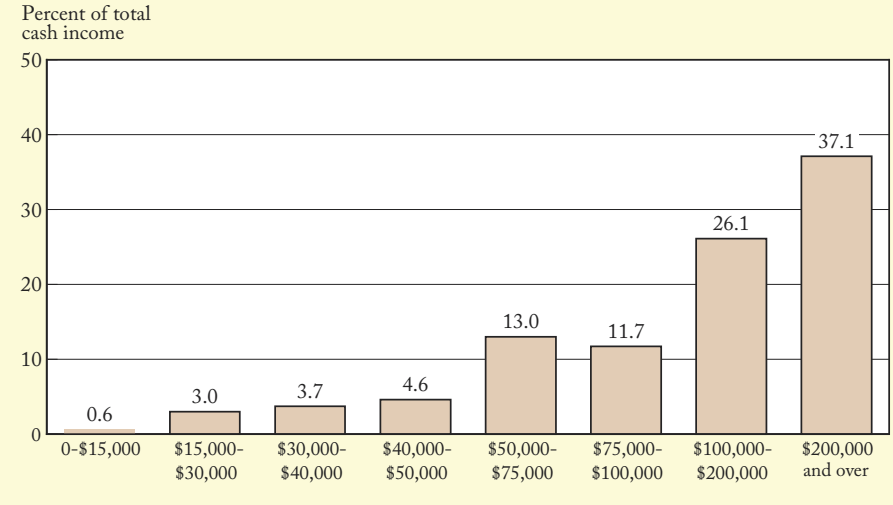
As mentioned previously, a number of assumptions are required to produce these estimates. For example, one must make an assumption about how the employer portion of the payroll tax is distributed and how corporate taxes are distributed. The note under Figure 3.6 describes the incidence assumptions used by the Treasury Department. The following discussion focuses on the assumption for the incidence of the corporate income tax since it may have an important effect on the analysis of the Panel's reform plans.

Figure 3.6. Distribution of Total Federal Tax Burden Under Current Law by Income Percentile



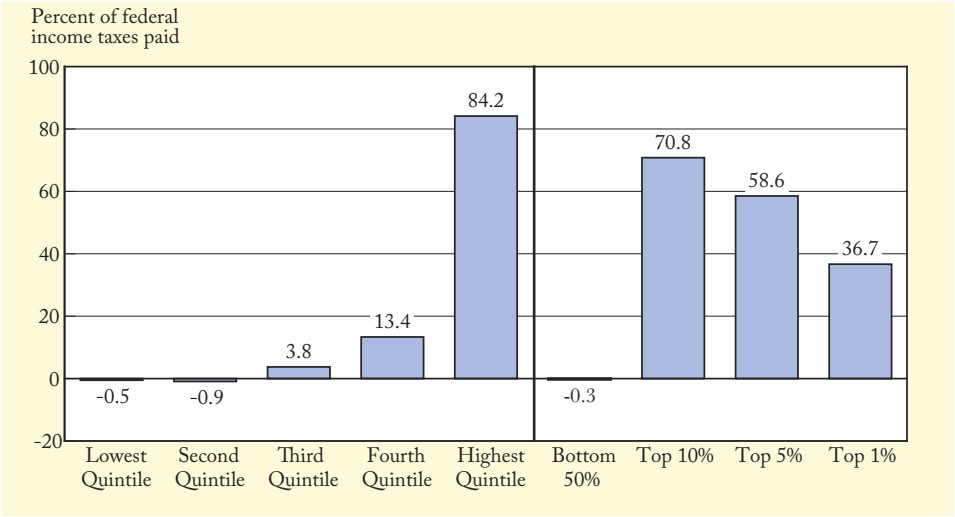
Note: The Treasury Department methodology assumes the individual income tax is borne by payers, the corporate income tax is borne by capital income generally, payroll taxes (employer and employee shares) are borne by labor, excise taxes on purchases by individuals are borne in proportion to relative consumption of the taxed good and proportionately by labor and capital income, and excise taxes on purchases by businesses and customs duties are borne proportionately by labor and capital income. The estate and gift tax is assumed to be borne by decedents. Estimates of 2006 law at 2006 cash income levels. Quintiles begin at cash income of; Second $12,910; Third $27,461; Fourth $48,345; Highest $84,124; Top 10% $123,706; Top 5% $169,521; Top 1% $407,709; Bottom 50% below $36,738.
Source: Department of the Treasury, Office of Tax Analysis.

Figure 3.7. Distribution of Total Federal Tax Burden Under Current Law by Income Level



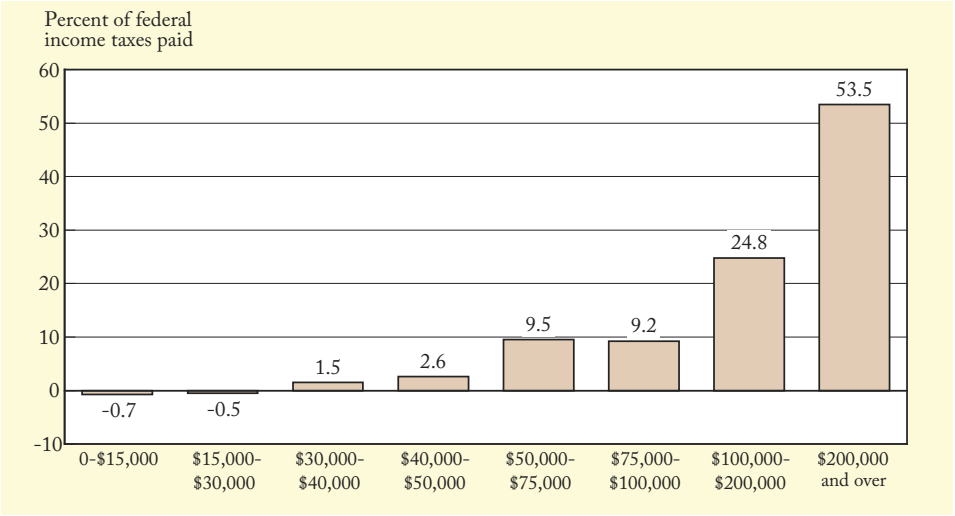
Note: Estimates of 2006 law at 2006 cash income levels.
Source: Department of the Treasury, Office of Tax Analysis.

Figure 3.8. Distribution of Federal Income Tax Burden Under Current Law by Income Percentile



Note: Estimates of 2006 law at 2006 cash income levels. Quintiles begin at cash income of; Second $12,910; Third $27,461; Fourth $48,345; Highest $84,124; Top 10% $123,706; Top 5% $169,521; Top 1% $407,709; Bottom 50% below $36,738.
Source: Department of the Treasury, Office of Tax Analysis.

Figure 3.9. Distribution of Federal Income Tax Burden Under Current Law by Income Level



Note: Estimates of 2006 law at 2006 cash income levels.
Source: Department of the Treasury, Office of Tax Analysis.

Only people can bear the burden of taxation. While corporations do remit tax payments to the federal government, the economic burden of the corporate income tax can fall only on people – specifically, shareholders, employees, or customers. The question for those who are trying to analyze the distribution of the corporate income tax is how this burden is divided. Economists at both the Treasury Department and the Congressional Budget Office assume that the burden of the corporate income tax is borne entirely by owners of capital. This means that all individuals who earn capital income (dividends, interest, rents, and capital gains) from both corporate and noncorporate sources are assumed to pay part of the corporate income tax. While this assumption may be reasonable in the short run, the implication is that most of the corporate income tax burden will be borne by high-income households because they are the ones who earn most capital income.

Over time, however, some of the burden of corporate taxes is likely to be shifted to workers and consumers. Because capital owners can choose to invest in the United States or in other nations, when the U.S. raises tax burdens on capital, some investment is likely to flow elsewhere. As the stock of capital in the United States contracts, the return on that capital rises. The smaller stock of capital leads to reduced productivity, however, and lower real wages and correspondingly higher prices. A 1998 survey asked public finance economists from the leading economics departments in the United States what percent of the burden of the corporate tax falls on capital and what percent falls on labor. Although responses varied considerably, the median response was that only 40 percent of the corporate tax is borne by capital owners and the remaining 60 percent is borne by labor.

Three Burdens of the Tax System

The vast majority of taxpayers either hire a paid tax preparer (about 60 percent in 2003) or buy software (more than 25 percent in 2003) to help them complete their tax return on their computer. These costs are examples of one of three types of burdens beyond the cost of the tax itself that a tax system imposes on taxpayers, the government, and the economy as a whole. Taxes create administrative costs for the government, compliance costs for taxpayers, and efficiency costs for the national economy.

What are administrative costs? ***Administrative costs*** are perhaps the easiest costs to understand because they represent the direct costs incurred by the government to manage and administer the income tax system. These costs include the budget of the Internal Revenue Service and other parts of the Treasury Department that help maintain the income tax system, as well as relevant expenses incurred by other government agencies. These costs total more than $10 billion per year.

Box 3.4. The Tax Gap

Included in the taxes Americans pay is the hidden cost of noncompliance. On average, the "tax gap" – a term used to describe the difference between the total tax that should have been paid and what taxpayers actually paid on time – costs honest and careful taxpayers an extra $2,000 each year. In its most recent study, the IRS estimates that the gross tax gap for individual and self-employment taxes was between $248 and $290 billion in 2001. The IRS expects to eventually recoup less than $55 billion of this amount through late payments and enforcement.

The overall noncompliance rate for the individual income tax is between 17.5 and 20.1 percent. Compliance rates are highest where there is third-party information reporting or withholding. For example, less than 1.5 percent of wages reported by employers to the IRS are misreported on individual tax returns. By contrast, individual compliance is lowest in the "cash economy," where sources of income often are not reported to the IRS. For example, two-thirds of the individual tax gap is attributable to self-employed taxpayers where there is minimal information reporting. The net effect is a subsidy to some individuals and businesses at the expense of others. The subsidy, therefore, distorts the choice about whether to invest or work in the cash or noncash sector.

The IRS has not measured noncompliance among partnerships and corporations for many years, but estimates based on research from older studies suggest that the tax gap for corporations could be as large as $32 billion, with an overall noncompliance rate of approximately 18 percent.

An important aspect of designing a tax system is how it is administered, because this affects the overall level of compliance. Noncompliance is an issue of fundamental fairness because it forces taxpayers who play by the rules to foot the bill for others who fail to pay. It also erodes confidence in the tax system and undermines voluntary compliance. The tax gap is caused by a variety of factors, such as inadvertent mistakes, technical tax shelters, and outright evasion. Although some cheating is inevitable, the complexity of our tax system is a large part of the problem. A less complicated tax code with more information reporting would reduce the tax gap by making it easier for taxpayers to understand and comply with their tax obligations and would improve the administration of the tax system.

What are compliance costs? ***Compliance costs*** represent the time and resources expended by taxpayers to interact with the income tax system. These costs include the value of individuals' time spent learning about the tax law, maintaining records for tax purposes, completing and filing tax forms, and responding to any correspondence from the IRS or to an IRS audit. Compliance costs also include amounts paid to others to conduct any of these tasks on behalf of an individual or a business.

Individuals are estimated to spend a total of 3.5 billion hours each year complying with the income tax system. On average, individuals spend 26 hours annually on their taxes, and $166 per return on out-of-pocket costs for the services of tax professionals, filing fees, and software purchases. Total yearly compliance costs are difficult to estimate, in part because estimating the value of the time people spend on their tax returns is difficult. Nevertheless, the Treasury Department estimates that total costs for complying with the individual income tax amount to

almost $100 billion per year. In addition, businesses are estimated to spend over three billion hours complying with the tax system, at a total yearly cost of $40 billion. This total cost of approximately $140 billion means that one dollar is spent on compliance costs for every nine dollars collected in federal income taxes. Other estimates of total compliance costs are somewhere between $100 billion to $200 billion.

What are efficiency costs? Finally, the income tax imposes ***efficiency costs*** on the economy. These costs arise when high tax rates discourage work, savings, and investment; distort economic decisions of individuals and businesses; and divert resources from productive uses in our economy. Our tax code contains all kinds of incentives for taxpayers to favor activities or goods that are taxed less than others. Provisions for the taxation of wages, of gains on the sale of securities and homes, or of other economic activities influence how much people work and save. As one small business owner explained to the Panel, the tax code affects almost every business decision he makes: where to invest, when to invest, how much to invest, what kinds of machines and equipment to use in production, how to finance investment, etc.

When taxpayers change their behavior to minimize their tax liability, they often make inefficient choices that they would not make in the absence of tax considerations. These tax-motivated behaviors divert resources from their most productive use and reduce the productive capacity of our economy. 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.

These effects are profound. Recall the ice cream truck tax example in Box 3.3. If a higher ice cream tax results in higher ice cream prices at ice cream trucks, some consumers will pay that higher cost, but others will not. They will switch to other ways to get their frozen treats – like getting in their car and driving to an ice cream shop that does not have to charge the tax. That decision, and the loss of time spent driving to an ice cream store instead of having it served up in one's front yard, may seem trivial. But if multiplied millions of times throughout the economy, the effects on economic efficiency are enormous. Economists call this the "***excess burden***" of taxation. Its very name indicates that the true cost of a tax exceeds the tax bill people pay or the revenue that is collected.

Federal Reserve Board Chairman Alan Greenspan explained to the Panel that the excess burden, or cost, of the tax code grows more than proportionately as tax rates increase. In fact, economic theory suggests that if you double the tax rate, you quadruple the excess burden. This means that high tax rates have disproportionately high economic costs associated with them.

A recent study estimated that the excess burden associated with increasing the individual income tax by $1.00 is between $.30 and $.50 cents, so the total cost of collecting $1.00 in additional tax revenue is between $1.30 and $1.50, before taking into account compliance or administrative costs. All else being equal, a tax with a lower excess burden is preferable to one with a higher excess burden. The size of the economic pie will be larger, for example, if it costs only $1.05 to raise a dollar of

revenue instead of $1.30. To put this into perspective, some studies have suggested that a tax system that removes the penalty against savings by switching the current structure to a progressive consumption tax could potentially increase the size of the economic pie by between 3 and 7 percent.

It would be difficult, however, to imagine a tax system that has no excess burden. Excess burden arises from people adopting less efficient behavior. A tax that does not induce people to alter their behavior would be one that does not depend on behavior at all. For example, a tax imposed on anyone with green eyes would be impossible to avoid for someone with green eyes. A real-life example of this was the poll tax, or flat charge on all adults living in a jurisdiction, which was highly efficient in collecting revenue, but perceived as extremely unfair because it applied equally to all people, regardless of wealth. As a result, these types of taxes have been rejected as revenue raising devices.

For this reason, it is clear that that raising revenue through taxation requires some distortions in the economy. One goal of good tax policy is to minimize these distortions within a "fair" tax structure. The trade-off between fairness and efficiency in raising revenue is one of the central challenges of designing a tax system. Economic analysis can describe the efficiency cost of different taxes, but fairness is much more difficult to define and different policymakers may have different views of what constitutes tax fairness.

Is There Another Way?

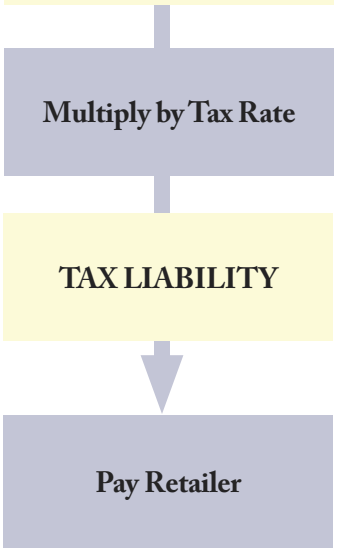
As discussed earlier, the design of a tax system begins with the choice of a tax base. Our current tax system includes a variety of provisions that exempt capital income from taxation and, as a result, move our tax system from a pure income tax base towards more of a hybrid approach. This section briefly explores tax systems that adopt a consumption tax base.

There are several different tax systems built around the taxation of spending or consumption: a retail sales tax, a value-added tax (VAT), a Flat Tax, and a "consumed income" tax. A retail sales tax would tax final sales of goods and services to consumers, with no tax imposed on sales to businesses. Retailers collect this tax and remit tax proceeds to the government. The VAT is a modification of a sales tax in which tax is collected from businesses at each stage of the production process. A Flat Tax is a two-part VAT in which tax is imposed at both the business and individual levels. Wages are deductible at the business level and taxed at the individual level. The consumed income tax is imposed at the household level only, by taxing only the income left after subtracting savings. A discussion of each of these consumption taxes follows.

The four taxes can differ in many respects. They may have different impacts on the share of the tax burden borne by different groups, on the economy, and on compliance and administrative costs. The timing of tax collection differs across the types of taxes. The Flat Tax and consumed income tax operate on a "pre-pay" basis, so that the tax is collected when wages are earned but no further tax is due at the time of consumption. The VAT and retail sales tax, in contrast, operate on a "post-pay" basis so that tax is

paid when money is spent. Although there are some differences, all four consumption taxes share a common feature: As explained in more detail in Chapter Seven, all consumption taxes exempt from taxation what economists refer to as "normal returns" from saving and investment. As a result, consumption taxes do not discourage saving and investment, nor do they distort saving and investment decisions.

Figure 3.10. How a Retail Sales Tax Works



The Retail Sales Tax

A retail sales tax is imposed when households purchase goods or services from businesses. This form of consumption tax is familiar to most Americans since many state and local governments raise revenue through retail sales taxes. In a well-functioning retail sales tax system, purchases by businesses are not taxed because these purchases are "inputs": goods or services used to produce other goods or services for sale to households. In terms of our simple box diagram, the tax base consists of taxable goods and services, the tax rate is the applicable sales tax rate, and the tax collector is the retailer. Although the retailer pays the tax directly to the government, the burden is borne by individuals. And, just as with our current income tax system, there are administrative and compliance costs, as well as distributional consequences to consider when evaluating the desirability of this tax. These issues are discussed further in Chapters Eight and Nine.

The Value-Added Tax

A commonly used variation of a retail sales tax is the value-added tax (VAT). More than 120 countries use VATs to raise a portion of total national government tax revenues. The United States is the only major industrialized country that does not impose a VAT.

The VAT can be thought of as a retail sales tax that is collected in small increments throughout the production process. The tax is calculated at each stage of production: Each business's tax base is calculated from its sales minus its purchases from other businesses. Wages are not deducted. It is easiest to understand the VAT, and its relationship to a retail sales tax, through an example.

A boot maker makes and sells custom-made cowboy boots. He buys leather and other supplies enough for one pair from a leather shop at a cost of $200 before taxes. The boot maker then sells each pair of boots he makes for $500 before taxes.

If a 10 percent retail sales tax were in place, the boot maker would add on the tax to the cost of the $500 pair of boots, and the consumer would pay $550 per pair. In the meantime, the leather shop would not have imposed a retail sales tax on its sale to the boot maker because such a business-to-business transaction would not be treated as a retail sale.

Under a VAT, the tax calculation works differently. Because the VAT is charged on all sales of goods and services, and not just sales to consumers, the leather shop would collect a VAT of 10 percent, or $20 on the $200 of supplies purchased by the boot maker. The boot maker would pay the leather shop $220, and the leather shop would

send the $20 to the government. When the boot maker sells the boots, he computes the VAT as $50, and charges the shoe buyer $550 for the boots. However, instead of sending $50 to the government, the boot maker would subtract the $20 of VAT already paid to the leather shop and remit $30 to the government. The government would receive $50 total: $20 from the leather shop and $30 from the boot maker. The government receives the same revenue under a VAT and a retail sales tax, and from the boot buyer's perspective the taxes look identical.

There is also an alternative method of calculating the VAT. Under the "subtraction method," the boot maker and the leather shop would pay the 10 percent VAT on the difference between their pretax sales and purchases. The boot maker would pay $30 (10 percent of the difference between the $500 of sales and $200 of purchases), and the leather shop owner would pay $20 (10 percent of the difference between sales and purchases). In practice, the subtraction method may be less reliable because it is harder to verify the amount of tax paid on purchases.

Administrative and compliance costs, as well as the progressivity of VATs are discussed in Chapter Seven.

The Flat Tax

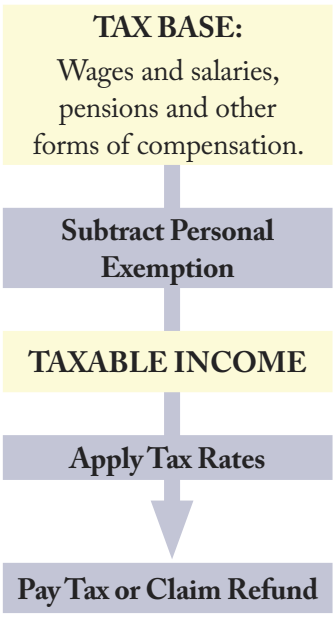
The Flat Tax collects part of the consumption tax directly from workers. As is the case with a VAT, businesses take the total value of their sales and then subtract the total value of purchases from other businesses. However, under a Flat Tax, businesses also subtract the wages and other compensation paid to workers. Thus, the tax base is total revenues from sales minus purchases from businesses and compensation to employees. Employees pay a separate tax on their wages (and other forms of compensation) at the household level.

Consider the boot maker in the VAT example above. Assume that the boot maker pays a worker $200 per pair of boots. Recall that under the VAT, the boot maker's tax liability was $30, since the difference between sales and purchases from other businesses equals $300 and the VAT rate was 10 percent. Under the Flat Tax, the boot maker's tax liability would be only $10, since both purchases from businesses ($200) and compensation to employees ($200) are subtracted from pretax sales ($500). The worker would pay tax at the individual level on his compensation. If there were no personal exemptions, the worker would have a Flat Tax liability of $20.

As the example demonstrates, unlike the VAT, the Flat Tax uses a structure that is similar to the one we have today and, therefore, is familiar to Americans. Workers fill out an annual return as an accounting matter, and the same payroll withholding of our current system is used to collect government revenues throughout the year. Businesses also file annual returns.

As one of the main proponents of the Flat Tax has commented, the Flat Tax "name is brilliant marketing, but it fails to convey the central feature of the idea relative to a VAT – the Flat Tax is progressive." The Flat Tax is progressive because the individual tax applies only above an exemption amount. Low-income workers, therefore, do

Figure 3.11. Individual Tax Computation Under A Flat Tax



not pay tax on their compensation to the extent it falls below the exemption amount. The Flat Tax is most commonly proposed using a single tax rate that applies to both businesses and workers above the exemption level. However, the Flat Tax can be made even more progressive by using multiple graduated rates at the individual level. Economists refer to one proposal that incorporates a progressive rate structure as an X-tax system. The basic X-tax system, developed by the Treasury Department in the late 1970s, works exactly like a Flat Tax at the business level. The only difference occurs at the individual level where there is a progressive tax bracket structure with a top rate equal to the business tax rate.

The Consumed Income Tax

The consumed income tax is collected directly from households. But the tax is collected only from a base of the household's spending. To calculate consumption, a household would add up wages and other forms of labor compensation, investment proceeds that are spent, and net borrowing. To calculate savings, which would not be taxed, a household would add up the net increase in bank accounts, the purchase of financial assets such as stocks and bonds, the purchase of business assets, and the purchase of owner-occupied housing. Generally, a consumed income tax base would exempt a certain level of consumption and use a graduated tax rate schedule to promote progressivity. There is no need for a corporate tax under a consumed income tax – retained corporate earnings would be a form of saving, and dividends would be taxable to shareholders unless saved.

Conclusion

This chapter described the major elements of any given tax system, as found in both our current tax code and some well-known alternatives. Understanding these elements is a critical step in reforming the current tax system. It may be possible to reform some current tax provisions in a way that enhances the objectives of simplicity, efficiency, and fairness. In other cases, changes to a particular provision may promote only one or two of these objectives. The goal of the Panel's work is to identify proposals that taken together will advance all three objectives.

It is simply not enough to use this knowledge to create a tax system that remedies the shortcomings of our current system. Any reform proposal must take into account the expected revenue collected by our current tax system, as well as the way the code has shaped our economy. Chapter Four explores the constraints the Panel faced, both in terms of the President's Executive Order and the realities of our $12 trillion economy.

Chapter Four

Our Starting Point

Courtesy of Marina Sagona

With a firm understanding of the problems in our current tax code, the Panel evaluated numerous proposals to reform the individual and corporate income tax system. The Executive Order directed the Panel to recommend options that would make the tax code simpler, fairer, and more conducive to economic growth, while recognizing the importance of home ownership and charity in American society. Fulfilling all of these objections is challenging. For example, reforms that make the tax system more conducive to economic growth may shift the tax burden toward lower-income households, which some might view as unfair. Improving the fairness of the tax code may require complicated rules and increased data collection, which might work against the goal of simplicity.

In addition to ensuring that the Panel's reform options satisfied these criteria, there were several other constraints that affected the Panel's work. This chapter discusses those constraints, as well as the approaches the Panel took to manage them.

Revenue Neutrality

The most important constraint on the Panel's recommendations is the Executive Order's direction that all of the Panel's reform options be "revenue neutral." In simple terms, this means that the Panel's options should be designed to collect roughly the same amount of money that the federal government projects it will collect under the current tax system. Although this may seem straightforward, it is not. Numerous projections and assumptions about future policy and behavior must be made – and they all have very important ramifications.

Photo by Ken Cedeno

The first building block is setting a baseline; which is the projection of future federal tax revenues. Different branches of government make different assumptions about future policies and economic data and, therefore, have different baseline estimates. The Panel used the Administration's baseline, which projects that $17.4 trillion in federal individual and corporate income tax revenue will be collected over the next ten years. The Panel used this baseline because the Panel anticipated that the Secretary of the Treasury and the Administration would use its own baseline in evaluating the Panel's reform options. It is worth noting that the Congressional Budget Office baseline, which assumes current law, predicts a relatively similar level of revenues (within approximately one percent) during the ten-year budget window.

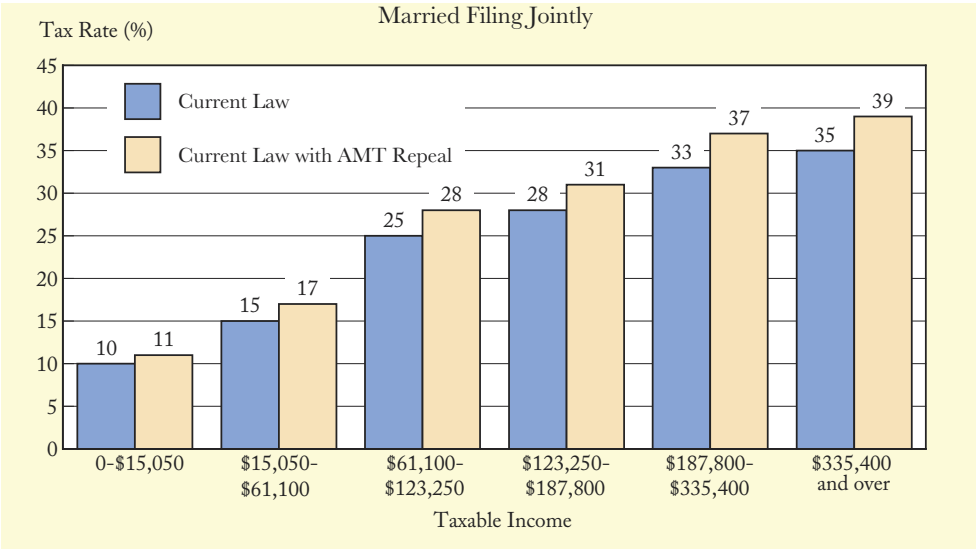
The decision to use the Administration's baseline has a number of important implications. First, the baseline assumes that the 2001 and 2003 tax cuts will be made permanent. Second, it assumes that a current law provision limiting the reach of the Alternative Minimum Tax (AMT) will expire as scheduled after the 2005 tax year. As described in Chapter One, the AMT is a parallel tax system that is steadily affecting more and more taxpayers. The combination of these two assumptions results in a revenue baseline equal to roughly 18 percent of GDP, which is consistent with the historical average for this ratio over the last half century. The Administration has acknowledged the problems caused by the growth of the AMT, and has made it clear that a long-term solution to the AMT problem is an important aspect of the overall tax reform effort.

The Burden of the Alternative Minimum Tax

The AMT is estimated to generate over $1.2 trillion in tax revenue over the next ten years. Including anticipated revenues from the AMT in the baseline of future tax receipts makes the Panel's work particularly challenging. Repealing the AMT in a revenue-neutral way requires the Panel to replace the $1.2 trillion of revenue from the AMT with other changes to the tax code. Recouping AMT revenues inevitably involves other offsetting changes, such as higher tax rates, eliminating tax preferences, or some combination of both. It is important, therefore, that American taxpayers understand that a tax reform proposal that does not repeal the AMT effectively results in a hidden, but real, future tax hike. The AMT currently affects nearly four million American families and is projected to affect more than 50 million taxpayers by 2015.

The Treasury Department estimates that collecting the $1.2 trillion of AMT revenue by simply raising current tax rates would require an 11 percent across-the-board rate increase. This should result in taxpayers in the 15 percent tax bracket paying tax at a rate of about 17 percent, and those in the 35 percent tax bracket paying tax at a rate of about 39 percent. Figure 4.1 shows the rate schedule that would be needed to raise the same revenue as the income tax and the AMT, but with only the income tax.

Figure 4.1. Effect of AMT Repeal on the Tax Rate Schedule



Note: Taxable income brackets are estimates for 2006.
Source: Department of the Treasury, Office of Tax Analysis.

As readers consider the specific rates that are outlined in the Panel's reform options, they should compare those rates to the rates in the above table, which are higher than those in current law. Those higher rates, or some other configuration of higher rates, are the real baseline for the Panel's work, because they are the rates that taxpayers will effectively face if the AMT is left in place. If only changes in the top four brackets were used to raise the same revenue under the income tax alone, each rate would have to be increased by 18 percent. Under this scenario, replicating federal revenues while repealing the AMT would require that the top tax rate be increased from 35 percent to 41 percent.

At the same time, many Panel members recognize that lawmakers are unlikely to allow the full effects of the AMT to hit American families. Congress has extended an AMT "patch" for the past few years, effectively limiting the reach of the AMT. Many observers, therefore, believe that a more realistic starting point for the Panel would assume the continued extension and indexing of the AMT patch. Indeed, there are several proposals currently before Congress that would repeal the AMT without requiring any offset of tax revenues. If these are adopted, the reach of the AMT may be limited, but the federal government would collect far less revenue to pay for necessary government programs in the coming decades.

The Treasury Department estimates that extending and indexing the AMT patch would cost $866 billion during the next ten years. If the Panel did not need to account for that revenue in its recommendations, individual tax rates could be reduced even further. Later in the report, the Panel will present the lower rates for each recommendation.

Limitations of Revenue Estimates

The next question is how to determine the specific dollar cost or savings of a particular proposal. The Treasury Department's Office of Tax Analysis uses what is commonly referred to as "conventional" or "microdynamic analysis" to score tax proposals. In making their revenue estimates, the Treasury Department's economic models account for the fact that taxpayers respond to changes in tax law, for example, by changing the timing of decisions or changing the mix of assets they purchase. However, these estimates do not account for how those behavioral changes will affect the size of the overall economy. Instead, the Treasury Department holds constant the Administration's projections for the future size of the economy. That means, for instance, that even if a reform option caused the total size of the economy to increase due to more favorable investment incentives, conventional estimates would not incorporate the corresponding increase in revenues.

There are many commentators who are troubled by the limitations of conventional scoring, and thus advocate a different method, often referred to as "dynamic" or "macroeconomic" analysis, particularly for proposals that envision broad or fundamental changes in the tax system. This approach provides estimates of the effect of tax reform on the overall economy.

While dynamic analysis conveys useful information, it is important to remember that the estimation of dynamic effects is also subject to much uncertainty. Dynamic scoring relies on numerous assumptions and the estimates may be quite sensitive to changes in these assumptions. A dynamic scoring model needs to predict, among other things, the effects of tax changes on interest rates, equity prices, labor supply responses, saving, investment, and national income. Building such a model requires economists to make a large number of assumptions concerning how individuals and businesses respond to tax policy and how these responses filter into changes in the macroeconomy and in tax revenues.

Given the number of assumptions and modeling decisions necessary to produce dynamic estimates, it is no surprise that different modeling strategies yield alternative estimates. In fact, when the Congressional Budget Office and the Joint Committee on Taxation perform dynamic analysis, they both report estimates from a range of different macroeconomic models and they include sensitivity analyses to show how their predictions are affected by alternative modeling assumptions.

Some Panel members strongly felt that dynamic analysis should be utilized, but the Panel did not want its tax policy recommendations to be overshadowed by a controversy about the validity of its scoring methodology. Other Panel members believed that there are shortcomings to more dynamic estimating techniques that hamper their usefulness. Therefore, the Panel has relied on conventional estimates as supplied by the Treasury Department to meet the mandate of revenue neutrality. At the same time, the Panel requested that the Treasury Department provide a dynamic analysis of the reform options. This analysis, which is based on three different models (described in the Appendix), suggests that the options could have positive effects on the economy.

The "Budget Window"

Another dimension of revenue neutrality concerns the relevant time horizon for revenue estimates. The Panel used a ten-year period, which is the current standard in the federal budget process. The use of any budget window raises a number of issues. Under standard conventions, the revenue effect of a proposal is simply the sum of nominal predicted revenues over the budget window – no attempt is made to discount future revenues for the time value of money. Box 4.1 discusses the effect of nominal versus present value estimates on revenue neutrality.

Box 4.1. The Effect of Nominal versus Present Value Estimates

The Treasury Department's ten-year revenue target is based on the nominal sum of annual revenues. In other words, Treasury first estimates the amount of revenue for each year, and then adds those numbers together to arrive at a total amount of revenue for the period. There is no discount for the time value of money. This approach differs from standard business practice – which does use present value discounting. The reason for discounting future revenues is simple: A dollar received at a future date is worth less than a dollar today because a dollar today can be invested to earn interest and deliver more than a dollar in the future.

The use of the convention of summing annual revenues without discounting future cash flows has implications for the Panel's proposals. Here is why: Under the Treasury baseline, the annual revenue generated by the AMT rises during the ten-year budget window. The Panel's proposals, on the other hand, generally have a much more stable flow of revenue. If one were to picture the revenue flow over the budget window it would be an upward sloping line; the Panel's proposals would flatten out that line. For both the baseline and the Panel's proposals, there will be the same total nominal flow of revenues over the relevant period; however, a tax reform proposal that generates a more stable flow of revenues over the budget window, rather than a more rapidly rising flow, will raise more revenue than the baseline if the future revenue flows are discounted. Thus, revenue-neutral tax reforms that repeal the AMT would require lower tax rates if the baseline were calculated using present discounted values instead of nominal values.

Using a ten-year period to gauge revenue neutrality requires assumptions about economic conditions that are subject to considerable uncertainty and likely to change substantially over the course of a decade. It is difficult to predict growth in the economy a year from now, let alone the strength of the economy over a longer time horizon.

At the same time, picking any particular budget horizon may provide an incomplete perspective on the revenue consequences of some tax reforms. This problem can be illustrated with two specific reform provisions included in the Panel's recommendations. One proposal is to expand the use of a particular type of tax-preferred savings and retirement account – commonly referred to as a Roth-style account. Taxpayers make after-tax contributions to these accounts, and then can

withdraw the earnings, subject to certain limitations, without paying any additional tax on the income earned on the deposits. Another proposal would allow businesses to immediately write off, or "expense," capital expenditures rather than taking depreciation deductions for the value of their investments over a defined period of time.

The Treasury Department estimates that introducing or expanding Roth-style accounts results in a slight reduction in tax revenues during the ten-year budget window. This estimate may, however, understate the overall revenue cost of the accounts for a number of reasons. First, the proposal would allow taxpayers to transfer money from traditional IRAs into these new savings vehicles. The revenue estimate assumes that many taxpayers will transfer their savings, producing revenue gains during early years as they pay taxes on money withdrawn from traditional IRAs in return for the benefit of tax-free withdrawals later. Because the taxes on the money in these accounts would have been collected eventually under the current system, but often more than ten years into the future, this transfer of assets has a favorable effect on tax revenues within the next ten years, but it does so at the expense of revenues in future years.

Second, a substantial share of the revenue loss from the reduced taxation of future capital income for each dollar contributed to these accounts occurs outside the ten-year window. When a taxpayer holds assets that would otherwise have been held in a taxable account in a Roth-style account, the Treasury loses revenue from taxes on interest, dividends, and capital gains. This revenue cost accrues for as long as assets are held in these accounts, which may be several decades if the accounts are used for retirement saving. As is summarized in Box 4.2, a rough analysis suggests that for retirement accounts, the revenue cost during the ten-year budget window is roughly one-third of the total revenue cost of this program; two-thirds of the revenue loss is not reflected in the revenue tables provided in this report. For other savings accounts in which the assets are likely to be held for a shorter period of time, the ten-year budget cost is likely to account for a higher fraction of the overall cost. Policymakers should consider the magnitude of these long-term costs.

Box 4.2 also shows that for other provisions, such as expensing of capital expenditures, the revenue estimate for the ten-year budget window may overstate the revenue loss. This is because expensing moves all of the tax deductions associated with a long-lived asset into the ten-year budget window, while traditional depreciation allowances for long-lived assets reduce revenues for a longer time period, in many cases as long as three decades. If one compares the costs of expensing a plant versus taking a hypothetical 30-year straight-line depreciation deduction, using a ten-year budget window may overstate the present value of the tax cost by nearly 25 percent.

Box 4.2. Examples of Long-Term Revenue Costs

The long-term revenue cost of a retirement account contribution depends on several key parameters. The first is the investment horizon of the taxpayer. Assume, conservatively, that each dollar contributed to a retirement account remains in the account for 30 years. For regular savings accounts, the holding period is likely to be shorter.

A second key parameter is the amount of the retirement savings account's investment that would otherwise have been held in a taxable account. This illustration assumes that half of the retirement savings account's balance represents such a transfer.

A third parameter is the investment mix of the retirement savings account's assets. This illustration assumes that 60 percent of the saving in the absence of the retirement savings accounts would have been invested in equities, with 40 percent invested in fixed income assets.

The last key parameter is the tax treatment of saving outside the retirement savings account. Assume that the average tax burden on equity investments is 10 percent, recognizing the 15 percent marginal tax rate on dividends and realized capital gains, as well as the opportunity to defer realization of capital gains, and set the marginal tax rate on interest income at 25 percent.

If equities yield a total return of 8 percent, while bonds yield 5 percent, the taxes that would have been paid on a $1,000 contribution to a retirement savings account in the first year of this contribution equal $4.90. In the absence of the retirement savings account, the assets that would have been saved would have grown through time as the after-tax income was reinvested in stocks and bonds. If the investor's asset mix remained 60 percent stocks and 40 percent bonds at all times, then the after-tax return on the whole portfolio would be 5.82 percent. Thus the nominal tax receipts if the saving assets were held outside a regular savings or retirement savings account would rise by 5.82 percent per year.

To find the present discounted value of this revenue flow over the entire 30-year period when assets are held in a retirement savings account, one discounts the foregone tax revenue stream, which grows at 5.82 percent each year, by the government discount rate. If we use a discount rate of 5 percent, thereby assuming that the government can discount the uncertain stream of future tax receipts using a risk-free interest rate, the present value of the foregone revenue over the 30-year life of the retirement savings account's investment is $164.92. This is 33.7 times the first-year revenue cost of $4.90. The present discounted value of the revenue cost over the first ten years is $50.76, or roughly one-third of the lifetime present value cost. For saving accounts where assets are likely to remain in the accounts for a shorter time period, the ten-year budget cost would account for a larger fraction of the lifetime cost.

While retirement savings accounts have larger long-term than ten-year revenue costs, other tax provisions may have smaller revenue costs from a long-term perspective than from a ten year vantage point. Proposals to expense investment in plant and equipment, for example, have a ten year revenue cost that is larger than their permanent cost. Consider switching from straight-line deprecation over a 30-year lifetime to immediate expensing. The present discounted value of the depreciation allowances over a 30-year horizon, assuming again a 5 percent annual discount rate, is 53.8 percent of the plant's purchase cost. The present value component over the first ten years is 43 percent of the purchase cost. This implies that the revenue cost of expensing over the first ten years, which equals 57 percent of the asset's purchase price (100 minus 43), overstates the long-horizon present discounted value, 46.2 percent of the asset's purchase price, by nearly 25 percent.

Revenue Estimates Are Not Precise

The sources of uncertainty in revenue estimates as discussed earlier, and many others that arise from the difficulty of accurately forecasting the behavioral responses of millions of Americans to tax changes, make projections of the revenue yield of tax

reform plans inherently uncertain. The Panel recognizes that revenue estimates are imprecise. Accordingly, upon the advice of the Treasury Department, the Panel has decided to define "revenue neutrality" as being within one-half of one percent of the projected revenue baseline for the next ten years. Some Panel members, however, believe that two percent or more would be reasonable.

Tax Reform, Progressivity, and the Distribution of the Tax Burden

The Executive Order directed the Panel to recommend options for reform that were "appropriately progressive." As discussed in Chapter Three, the current income tax system is progressive, as it provides exemptions and deductions that shield some income from tax, allows refundable credits, and applies a graduated set of tax rates. All members of the Panel endorsed the goal of a progressive tax structure. Some Panel members felt that the current system has gone too far in removing lower-income taxpayers from the tax rolls and that higher-income taxpayers pay too large a share of federal income taxes. Other Panel members were comfortable with the current distribution or believed that the income tax should be more progressive, with higher-income taxpayers bearing more of the overall income tax burden, because of a concern about substantial inequality of wealth in the country that has grown in the last decades. In the end, the Panel concluded that the appropriate burden of taxation was an issue that elected officials should resolve – and so the Panel decided to design reform options that would remain relatively close to the current distribution of tax burdens.

The Panel relied on "distribution tables" to measure the allocation of tax burdens across households. Such tables are a necessary tool for evaluating tax proposals, but like revenue estimating, creating distribution tables is an imprecise art. Distribution tables are based on an assortment of projections and assumptions about the way various taxes affect the economy and, in particular, how they affect the pretax incomes of various taxpayers.

As explained in Chapter Three, just because someone writes a check to the government, it does not necessarily follow that he or she shoulders the burden of that tax. The Treasury Department prepares distribution tables that generally assume that the corporate income tax is paid by all owners of capital. However, many public finance economists believe that at least some portion of the corporate income tax is shifted from owners of capital (or investors) to labor (or workers) and reflected in lower real wages and living standards. This assumption can make a significant difference in any distributional analysis of corporate income tax reform. Furthermore, the distribution table for 2006 will look different from that for 2015, and a table that assumes no relief from the AMT will differ from a table that assumes either repeal or a patch of the AMT.

This report shows distribution tables for the first year of a proposal, the last year of the budget window, and the ten-year budget window. The Panel also presents tables that distribute half of the corporate tax to owners of capital and half to labor.

Box 4.3. Thinking about Long-Term Distribution

Most of the distribution tables shown in this report allocate the tax burden across households, and group households by their current-year income. This approach offers important information on the distribution of tax burdens, but for some households, current income is an unreliable measure of long-term economic well-being. College students, for example, may report low current income, but their long-term earning prospects would place them much higher in the distribution of lifetime earnings. Elderly people with substantial wealth but limited income from their assets may also appear in a low-income category, even though they have been economically prosperous throughout their careers. A taxpayer who separates from a firm and receives a large one-time severance payment, in contrast, may have a current-year income substantially greater than his long-term average or than his future prospects.

Estimates from the Treasury Department, reported in the 2003 Economic Report of the President, suggest that taxpayers exhibit a considerable amount of fluidity across tax rate brackets. Treasury Department researchers calculated the statutory tax rate bracket taxpayers would have faced in 1987 and in 1996 had the Economic Growth and Tax Relief Reconciliation Act of 2001 been in place in those years. The table below reproduces the results from this study. The shaded cells report the percentage of taxpayers in each tax bracket in 1987 (year one) that remained in the same bracket in 1996 (year ten).

Taxpayers by Rate Bracket Using a Panel of Taxpayers

Year one tax bracket (percent)	Year 10 tax bracket (percent)							Returns in year ten (thousands)
	0	10	15	25	28	33	35	
	Taxpayers by rate bracket (percent distribution)							
0	33.8	24.7	32.1	7.7	0.8	0.5	0.3	10,360
10	20.1	29.3	40.8	8.8	0.6	0.3	0.1	15,370
15	8.6	13.3	53.4	22.9	1.2	0.4	0.2	50,059
25	3.9	5.1	29.9	51.4	6.7	2.2	0.8	31,427
28	3.3	2.8	11.6	35.9	24.0	14.7	7.5	2,682
33	4.7	2.6	9.1	21.0	18.9	23.9	19.8	1,096
35	5.1	1.9	5.7	10.4	8.8	19.0	49.1	633

Note. Tabulations from 1987-1996 panel of taxpayers. Tabulations include only non-dependent taxpayers present in all years of the panel data set. Each cell entry indicates the percent of taxpayers in a rate bracket in the last year of the panel (i.e., column entry) relative to the number of all taxpayers in that rate bracket in the first year of the panel (i.e., row sum).

Source. Council of Economic Advisers, based on tabulations provided by the Treasury Department

The table demonstrates that there is a substantial amount of movement across rate brackets. More than half of taxpayers were in a different tax bracket at the end of the period than they were in at the beginning of the period (the proportion of taxpayers not on the diagonal). The table also shows that the chance that a taxpayer moves from the highest income tax brackets to the lowest, or vice versa, is relatively low. While this evidence suggests that there is value in constructing distribution tables that categorize households based on a longer-term measure of income and economic status, the standard approach to distributional analysis still focuses on annual income, and so that is the approach followed by the Panel for most tables.

Simplicity

The Executive Order also directed the Panel to recommend options that would simplify the tax code to reduce compliance costs and administrative burdens. The objective of simplicity is related to, and at times is at odds with, the objectives of fairness and economic growth. Unfortunately, our tax code has steadily grown more complex as lawmakers in recent years have almost always sacrificed simplicity in choosing among these competing objectives.

Complexity in our current code arises from a number of sources. Some of the complexity is the result of attempts to make our tax system fairer. Many provisions adjust for taxpayers' ability to pay, but the price is greater complexity. Another significant cause of complexity is the numerous tax preferences in the form of deductions, credits, exclusions, and special rates. Each of these tax preferences requires special computations, eligibility rules, and recordkeeping. Mechanisms designed to target tax benefits to specific taxpayers or limit the amount of tax benefits available – such as phase-outs, caps, floors, and the AMT – are yet another source of complexity. Further compounding these sources of complexity in recent years has been the volatility of changes to the code and the increased reliance on temporary and expiring provisions, which are often the consequence of budget rules seeking to restrain loss of revenue through tax expenditures.

Complexity also affects different groups of taxpayers differently. The Panel analyzed the most significant sources of complexity affecting particular types of taxpayers. For example, complex eligibility rules for refundable credits affect low-income taxpayers; recordkeeping burdens and accounting rules are especially onerous for small businesses, and international rules create significant complexity for multinationals. As discussed in the following chapters, each of the Panel's options addresses these areas of complexity.

Recognizing the importance of simplicity, the Panel determined to make simplification a priority. In many cases, the Panel elected to make features of its options simpler, even though a more complicated design could have been used to better target the provision to provide benefits to specific taxpayers or to achieve other goals.

Illustrating the Constraints: A Policy Experiment

The previous discussion describes the many constraints facing the Panel. At the request of the Panel, the Treasury Department ran a number of policy experiments using income and consumption tax bases, to demonstrate the trade-offs between the choice of the tax base, tax rates, and the distribution of the tax within revenue-neutral policy reforms. The experiments are quite useful in understanding the range of choices available to the Panel in reforming the tax code. The analysis discussed below was presented at the Panel's July 20 meeting. The estimates differ slightly from those in other sections of the report because they were created using Treasury Department tax models that had not been updated for the annual mid-session review of the policy baseline.

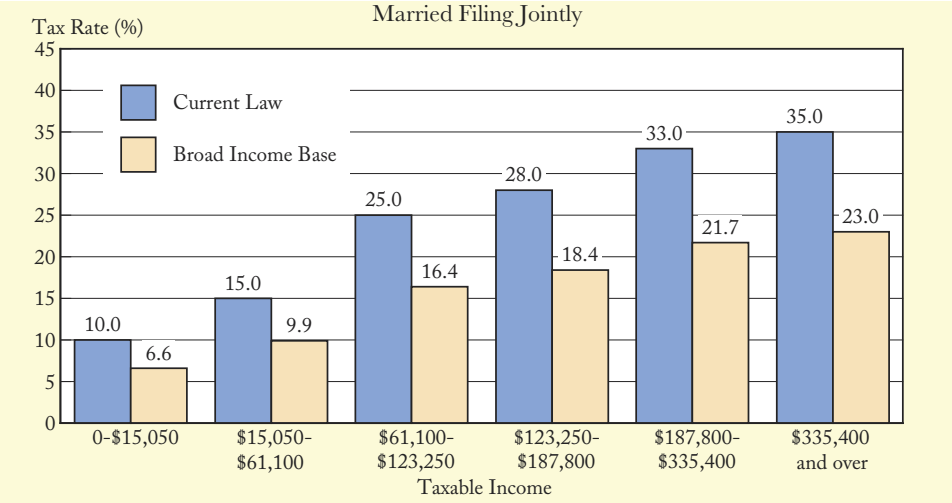
The Panel first asked the Treasury Department to determine the required rate structure to achieve revenue neutrality with a "broad" income tax base. The broad individual income tax base would retain only the standard deduction and personal exemptions. All credits, above-the-line deductions, itemized deductions, and other special preferences in our tax code would be eliminated. The broad base would also eliminate the AMT.

The individual and corporate tax systems would be integrated so that income taxed at the business level would not be taxed again at the individual level; meaning that the double tax on corporate profits would be eliminated. All capital gains would be taxed at ordinary rates, and tax-favored savings or retirement vehicles would be eliminated.

The broad corporate income tax base would eliminate corporate tax preferences. Depreciation deductions would allow taxpayers to deduct the actual decline in the value of a capital asset over the taxable period (which is known as "economic depreciation"). The top rates for the individual income tax and corporate income tax would be equal.

The Treasury Department estimated that adopting this broad base would make it possible to reduce tax rates across the board by about one-third. As Figure 4.2 shows, the lowest individual rate, currently at 10 percent, could be lowered to 6.6 percent, and the highest rate (which also applies to corporate income), 35 percent, could be lowered to 23 percent. Alternatively, the Treasury Department found that the graduated rate structure could be replaced with a single rate of 15 percent and maintain revenue neutrality.

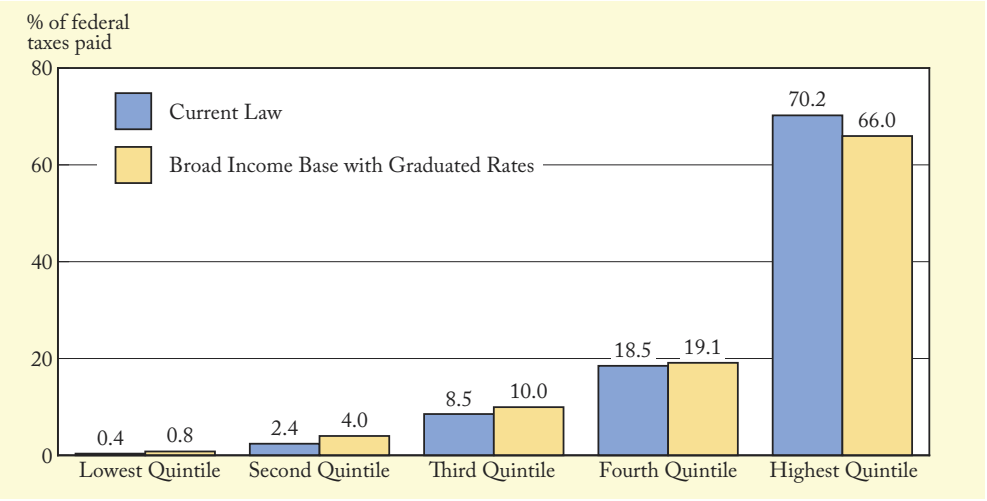
Figure 4.2. Tax Rate Schedule of Broad Income Base with Graduated Rates



Note: Taxable income brackets are estimates for 2006.
Source: Department of the Treasury, Office of Tax Analysis.

The Treasury Department also estimated the impact of the broad base on the distribution of the tax burden. As shown in Figure 4.3, taxpayers in the highest quintile would pay a smaller proportion of total federal taxes, while taxpayers in each of the other four quintiles would pay a greater proportion of the tax burden.

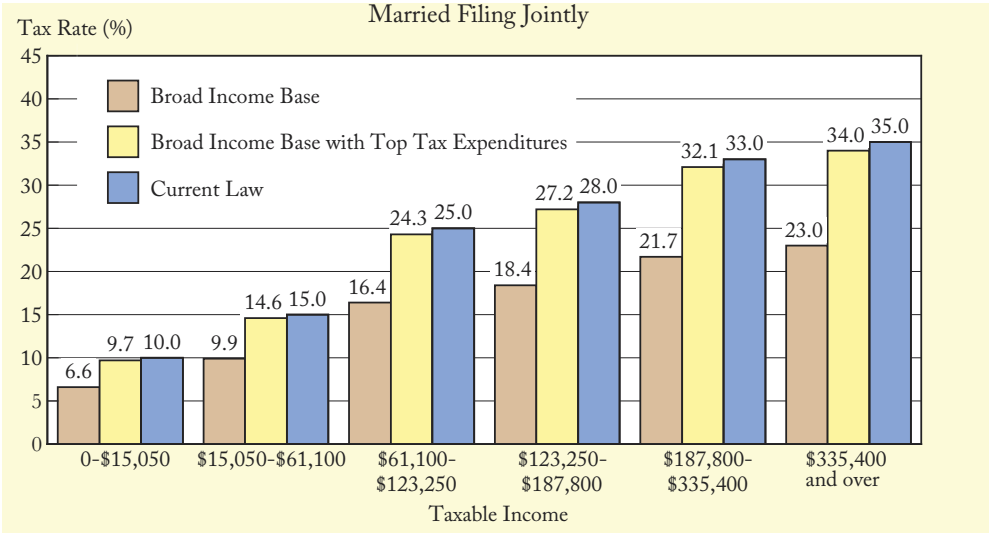
Figure 4.3. Distribution of Tax Burden for Broad Income Base with Graduated Rates by Income Percentile



Note: Estimates of 2006 law at 2004 income levels.
Source: Department of the Treasury, Office of Tax Analysis.

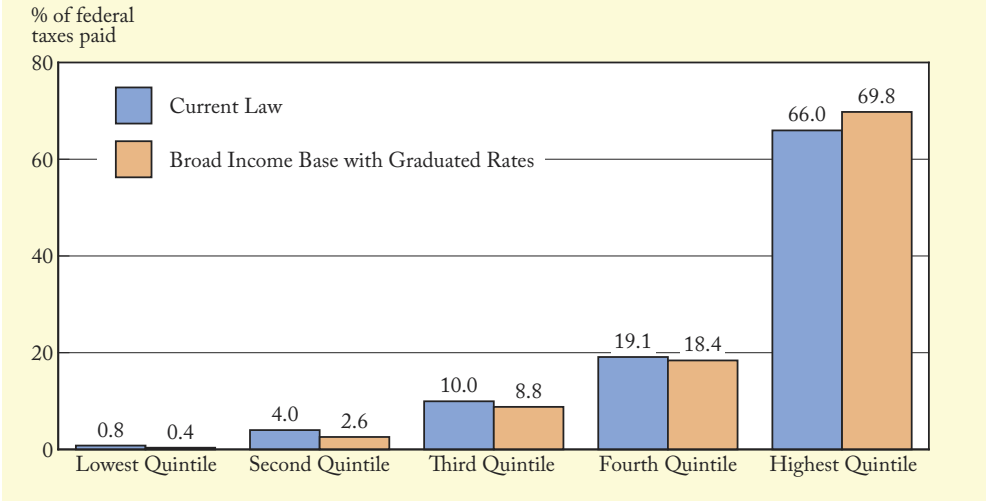
To evaluate the cost of current tax expenditures in terms of both the higher tax rates they necessitate and the distribution of the burden, the Treasury Department ran an experiment that added the top individual and corporate tax expenditures to the broad base. These tax expenditures include the tax exclusion for employer contributions for health insurance and pensions, retirement savings preferences, the mortgage interest deduction, charitable deductions, the EITC, and the child tax credit for individuals; and accelerated depreciation, oil and gas preferences, the manufacturer's deduction, progressive corporate rates, and the research and experimentation credit for corporations. Figure 4.4 shows that adding these tax expenditures to the broad tax base requires tax rates nearly as high as those under current law to collect the same amount of revenue. Figure 4.5 shows that adding the top tax expenditures to the broad base provides a distribution of tax burden that is close to current law.

Figure 4.4. Tax Rate Schedule for Broad Income Base with Top Tax Expenditures Added Back



Note: Taxable income brackets are estimates for 2006.
Source: Department of the Treasury, Office of Tax Analysis.

Figure 4.5. Distribution of Tax Burden for Broad Income Base with Graduated Rates and Top Tax Expenditures by Income Percentile



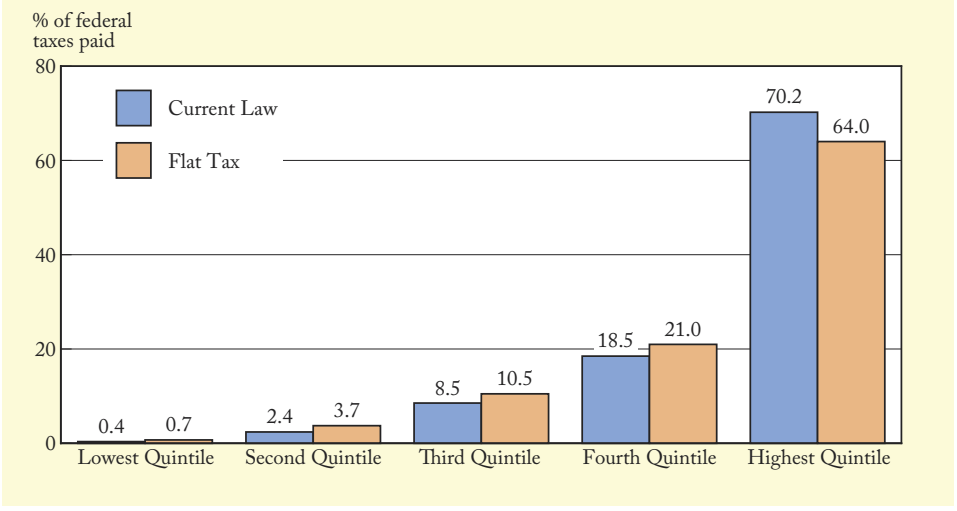
Note: Estimates of 2006 law at 2004 income levels.
Source: Department of the Treasury, Office of Tax Analysis.

Using a Consumption Tax Base

The Panel was also interested in understanding how moving to a consumption tax base would affect tax rates and the distribution of taxes. To answer these questions, the Panel asked the Treasury Department to estimate a revenue-neutral Flat Tax, a prominent consumption tax prototype. The Treasury Department's estimate allowed taxpayers a personal exemption, but eliminated all other tax preferences and the AMT. As described in Chapter Three, the business portion of the Flat Tax is based on cash flow taxation. Businesses do not receive a deduction for interest expense, and can write off all of their capital investments immediately.

The Treasury Department estimated that a Flat Tax imposed on a broad consumption tax base would require a 21 percent tax rate to preserve revenue neutrality. The estimates also showed that the distribution of the tax burden under a standard Flat Tax would be less progressive than the current tax system. Figure 4.6 shows that a standard Flat Tax would significantly increase the portion of the tax burden borne by the first through fourth cash income quintiles relative to the current distribution of the tax burden.

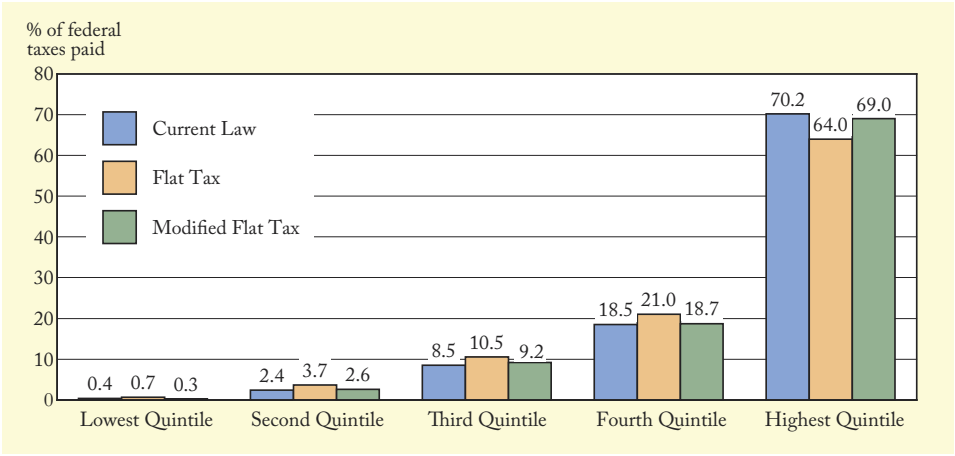
Figure 4.6. Distribution of Tax Burden for Flat Tax by Income Percentile



Note: Estimates of 2006 law at 2004 income levels. Individuals would be allowed an exemption amount that in 2006 would be $13,150 for singles, $26,300 for married taxpayers filing jointly, $17,200 for heads of households, and $6,150 for each dependent.
Source: Department of the Treasury, Office of Tax Analysis.

Consumption taxes can be made more progressive by including graduated rates at the individual level. The Panel asked Treasury to replace the single, flat rate of 21 percent described above with three tax brackets with rates of 15 percent, 25 percent, and 35 percent. The same standard deduction and personal exemption parameters would apply. To even further augment progressivity, the Panel asked the Treasury Department to also include the EITC. As shown in Figure 4.7, with the introduction of progressive rates, the distribution of the tax burden more closely resembles the distribution of the tax burden under current law. Notably, the overall tax burden on families in the first four quintiles increases to a lesser extent than under the standard Flat Tax, and the burden on families in the top quintile is reduced less significantly.

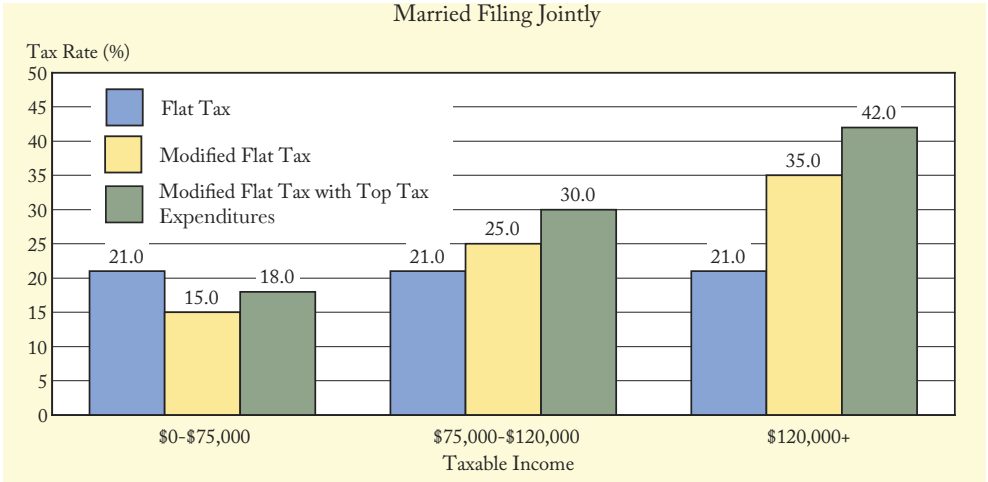
Figure 4.7. Distribution of Tax Burden: Flat Tax, Modified Flat Tax, and Current Law by Income Percentile



Note: Estimates of 2006 law at 2004 income levels.
Source: Department of the Treasury, Office of Tax Analysis.

The Panel then asked the Treasury Department to estimate the tax rates that would be required to implement this revenue-neutral modified Flat Tax with the top individual and corporate tax expenditures. In particular, the Treasury Department added back the exclusion for employer contributions for health insurance, the mortgage interest deduction, charitable deductions, and the child tax credit for individuals; and oil and gas preferences, the manufacturer's deduction, progressive corporate rates, and the research and experimentation credit for corporations. Retirement savings preferences and accelerated depreciation were not included because the tax base is consumption.

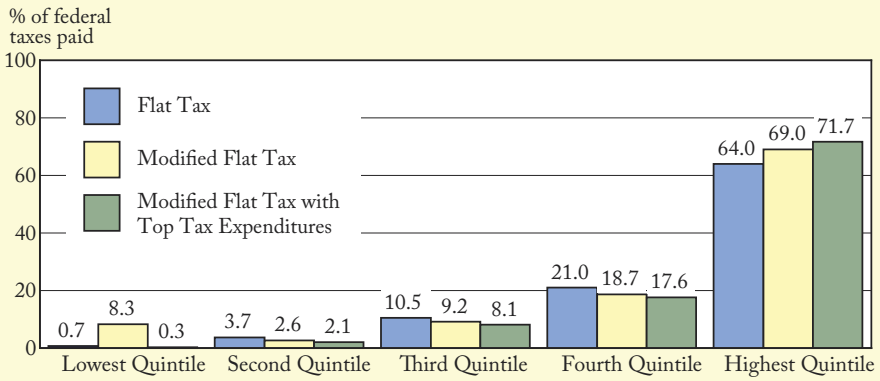
Figure 4.8. Tax Rate Schedule: Comparison of Flat Tax and Modified Flat Taxes



Note: Taxable income brackets are estimates for 2006.
Source: Department of the Treasury, Office of Tax Analysis.

Figure 4.8 shows that tax rates must be substantially higher to support a modified Flat Tax that also includes the top tax expenditures. To keep the same exemption amounts and bracket structure while adding the top tax expenditures, the top tax rate would have to rise from 35 percent to 42 percent, the middle rate would rise from 25 percent to 30 percent, and the lower bracket would rise from 15 percent to 18 percent. These large increases in tax rates highlight the importance of a broad tax base for maintaining low tax rates. Figure 4.9 compares the distribution of tax burden under the Flat Tax, the modified Flat Tax, and the modified Flat Tax with the top tax expenditures. Adding the top tax expenditures to the tax base increases the proportion of taxes paid by the highest quintile, decreases the proportion paid by the second through fourth quintiles, and has little effect on the lowest quintile.

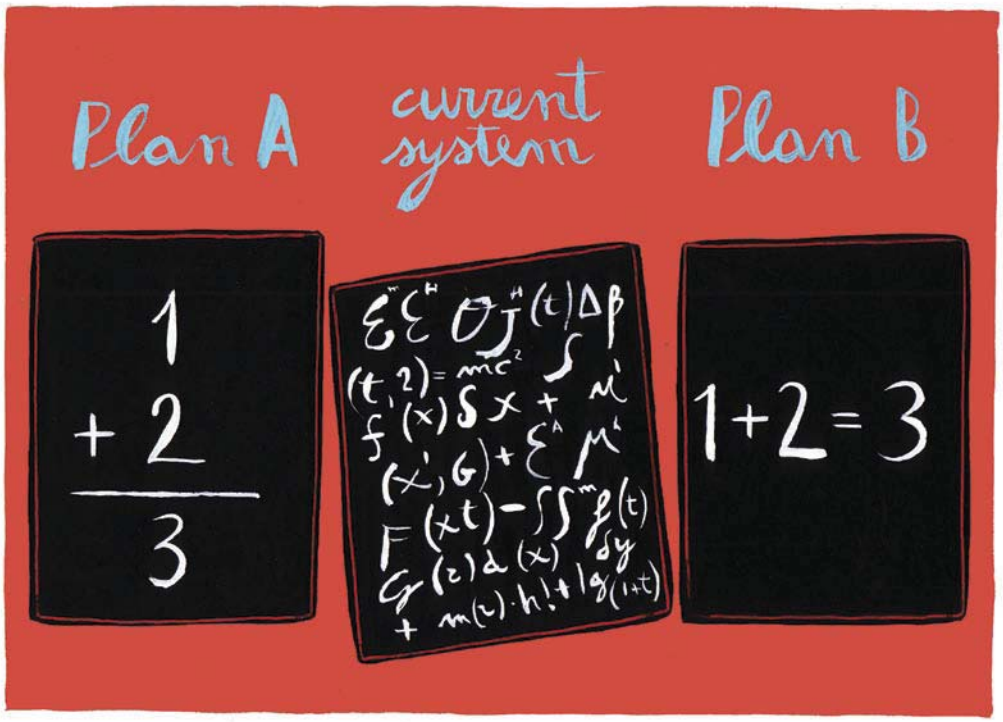
Figure 4.9. Distribution of Tax Burden by Income Percentile: Consumption Taxes with Top Tax Expenditures



Note: Estimates of 2006 law at 2004 income levels.
Source: Department of the Treasury, Office of Tax Analysis.

These policy experiments demonstrate the trade-offs that are inherent in any effort to reform the tax system. Lower rates can be achieved by broadening the tax base – but once the major tax preferences are added back to the tax code, maintaining revenue neutrality means that rates need to rise to their current levels or higher. Similarly, any major changes in the tax base or the inclusion of certain tax expenditures causes significant changes in the current-law distribution of taxes. It is important to recognize these constraints and trade-offs in evaluating the Panel's options for reform.

Chapter Five
The Panel's Recommendations



Courtesy of Marina Sagona

The Executive Order creating the Panel called for reform options that would deliver a simpler, fairer, and more pro-growth tax system. The Panel has chosen to put forward two options that achieve these goals, but accomplish them in different ways.

The Panel's options use different designs that represent a range of policy choices to simplify the tax code, remove impediments to saving and investment, and broaden the tax base. The first option, the Simplified Income Tax Plan, is a streamlined version of our current tax system that would reduce the size and costs of the tax code. The second option, the Growth and Investment Tax Plan, would take our tax system in a new direction by reducing the tax burden on saving and investment to boost economic growth without fundamentally changing how the tax burden is distributed. It would move our tax system closer to a consumption tax and impose a reduced flat rate tax on capital income received by individuals.

As the Panel pursued its work, it became clear that both reform proposals shared a common set of goals that could be achieved with identical recommendations. This resulted in a set of common elements in the two proposals that are described in the first part of this chapter.

- The Panel recommends creating only two credits related to family status, a Family Credit and a Work Credit, that would simplify tax filing by consolidating family, child, and work-related tax benefits, such as the standard deduction, personal exemption, child tax credit, head of household filing status, earned income tax credit, and refundable child tax credit.

- The Panel recommends simplifying tax benefits for charitable giving, home ownership, and health coverage and making these benefits fairer by ensuring they are available to all taxpayers.

- The Panel recommends eliminating the personal and corporate AMT.

- The Panel recommends simplifying the tax treatment of Social Security benefits by replacing the complicated three-tier calculation with a simple deduction.

- The Panel recommends reducing marriage penalties by making the tax brackets and other tax provisions for married couples equal to twice the amount for unmarried taxpayers.

Both of the Panel's two recommendations would remove impediments to saving and business investment, but would do so using different approaches. For example, the treatment of savings and business investment under the Simplified Income Tax Plan would be closer to our current tax system, while the treatment in the Growth and Investment Tax Plan would be more far-reaching. The different approaches to reform rely on similar principles, which are discussed in the second part of this chapter:

- Providing simple and straightforward ways for Americans to save free of tax.

- Simplifying the tax code for small businesses.

- Moving as far as possible to eliminate the double taxation of corporate earnings and providing a more level playing field for different types of business investment.

- Updating our international tax rules to reduce economic distortions and improve fairness by creating a more level playing field that promotes U.S. competitiveness.

Table 5.1 summarizes the Panel's reform options for households.

Table 5.1. Summary of Tax Reform Plans for Households

Provisions	Simplified Income Tax Plan	Growth and Investment Tax Plan
Households and Families		
Tax rates	Four tax brackets: 15%, 25%, 30%, 33%	Three tax brackets: 15%, 25%, 30%
Alternative Minimum Tax	Repealed	
Personal exemption	Replaced with Family Credit available to all taxpayers: $3,300 credit for married couples, $2,800 credit for unmarried taxpayers with child, $1,650 credit for unmarried taxpayers, $1,150 credit for dependent taxpayers; additional $1,500 credit for each child and $500 credit for each other dependent	
Standard deduction		
Child tax credit		
Earned income tax credit	Replaced with Work Credit (and coordinated with the Family Credit); maximum credit for working family with one child is $3,570; with two or more children is $5,800	
Marriage penalty	Reduced; tax brackets and most other tax parameters for couples are double those of individuals	
Other Major Credits and Deductions		
Home mortgage interest	Home Credit equal to 15% of mortgage interest paid; available to all taxpayers; mortgage limited to average regional price of housing (limits ranging from about $227,000 to $412,000)	
Charitable giving	Deduction available to all taxpayers (who give more than 1% of income); rules to address valuation abuses	
Health insurance	All taxpayers may purchase health insurance with pre-tax dollars, up to the amount of the average premium (estimated to be $5,000 for an individual and $11,500 for a family)	
State and local taxes	Not deductible	
Education	Taxpayers can claim Family Credit for some full-time students; simplified savings plans	
Individual Savings and Retirement		
Defined contribution plans	Consolidated into Save at Work plans that have simple rules and use current-law 401(k) contribution limits; AutoSave features point workers in a pro-saving direction (Growth and Investment Tax Plan would make Save at Work accounts "prepaid" or Roth-syle)	
Defined benefit plans	No change	
Retirement savings plans	Replaced with Save for Retirement accounts ($10,000 annual limit) available to all taxpayers	
Education savings plans	Replaced with Save for Family accounts ($10,000 annual limit); would cover education, medical, new home costs, and retirement saving needs; available to all taxpayers; refundable Saver's Credit available to low-income taxpayers	
Health savings plans		
Dividends received	Exclude 100% of dividends of U.S. companies paid out of domestic earnings	Taxed at 15% rate
Capital gains received	Exclude 75% of corporate capital gains from U.S. companies (tax rate would vary from 3.75% to 8.25%)	Taxed at 15% rate
Interest received (other than tax exempt municipal bonds)	Taxed at regular income tax rates	Taxed at 15% rate
Social Security benefits	Replaces three-tiered structure with a simple deduction. Married taxpayers with less than $44,000 in income ($22,000 if single) pay no tax on Social Security benefits; fixes marriage penalty; indexed for inflation	

Similarly, Table 5.2 summarizes the Panel's reform options for businesses.

Table 5.2. Summary of Tax Reform Plans for Businesses

Provisions	Simplified Income Tax Plan	Growth and Investment Tax Plan
Small Business		
Tax rates	Taxed at individual rates (top rate has been lowered to 33%)	Sole proprietorships taxed at individual rates (top rate lowered to 30%); Other small businesses taxed at 30%
Recordkeeping	Simplified cash-basis accounting	Business cash flow tax
Investment	Expensing (exception for land and buildings under the Simplified Income Tax Plan)	
Large Business		
Tax rates	31.5%	30%
Investment	Simplified accelerated depreciation	Expensing for all new investment
Interest paid	No change	Not deductible (except for financial institutions)
Interest received	Taxable	Not taxable (except for financial institutions)
International tax system	Territorial tax system	Destination-basis (border tax adjustments)
Corporate AMT	Repealed	

COMMON ELEMENTS

The following common elements serve as the starting point in both of the Panel's reform options. They represent simple and straightforward ideas for reforming the tax code.

A Better Way to Ensure Progressivity - New Family and Work Credits

RECOMMENDATIONS
√ Consolidate the standard deduction, personal exemptions, child tax credit, and head of household filing status into a single Family Credit.
√ Consolidate the earned income tax credit and refundable child tax credit into a single Work Credit.

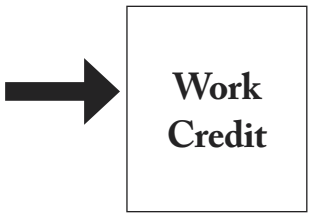
The tax code separately provides a standard deduction, personal exemptions, the child tax credit, the head of household filing status, the earned income tax credit (EITC), and a refundable child tax credit, which together are designed to serve the important goals of ensuring the tax burden is shared in a progressive manner and removing disincentives to work. As summarized in Figures 5.1 and 5.2, the first of the Panel's common solutions would simplify filing for individuals by transforming these duplicative and overlapping provisions into just two credits – a Family Credit and a Work Credit.

Figure 5.1. Family-Related Tax Benefits (amounts for 2005 tax year)

Standard Deduction	Provides a deduction for the first $10,000 of income earned by a married couple. The amount is $5,000 for unmarried taxpayers.
Personal Exemption	Provides a deduction of $3,200 for each member of a household. The personal exemption is phased out for taxpayers with higher incomes.
Head of Household Filing Status and Tax Bracket	Increases the amount of the standard deduction to $7,300 (from $5,000) and provides more generous tax bracket thresholds for unmarried taxpayers who maintain a household for a dependent.
Child Tax Credit	Provides a credit of $1,000 for each child. The credit is phased out for taxpayers with higher incomes.

→ **Family Credit**

Figure 5.2. Work-Related Tax Benefits	
EITC	Provides lower-income taxpayers a refundable credit designed to encourage work. The amount of the credit increases as additional income from work is earned before phasing out above a specified level.
Refundable Child Tax Credit	Provides lower-income taxpayers a refundable credit for each child. Like the EITC, the refundable child credit is designed to encourage work by increasing as additional income from work is earned before phasing out above a specified level.



The provisions to adjust for family size and to encourage work in the current code are redundant and unnecessarily complex. For example, four of the provisions contain different phase-outs (each at a different income level) and require lengthy worksheets and reference tables to calculate benefits. Phase-outs act as hidden tax hikes at certain income levels, as described in Chapter Three. Although some phase-outs have been justified as a way to target tax benefits to lower-income Americans, lawmakers have also adopted phase-outs to avoid raising other taxes or to reduce the budgetary cost of tax benefits they supported.

Eligibility rules that vary by provision add even more complexity and are a source of filing errors. For example, the maximum age for a qualifying child is 16 for the child tax credit, but is 23 for the EITC. Millions of taxpayers claim both of these benefits, but are required to determine their eligibility under two sets of rules. Recent efforts to simplify and bring conformity to eligibility rules across family-related provisions culminated in legislation enacted last year to create more uniform rules regarding when a child may be claimed for the dependent exemption, the child tax credit, the EITC, and the head of household filing status.

The Panel recommends further simplification that would build upon these efforts. The Panel's objective is not to fundamentally change the amount or availability of these benefits, but to ensure that these provisions serve their intended purposes as efficiently as possible and with greater simplicity and transparency. This solution provides (1) a uniform and consistent structure that will replace the existing patchwork of overlapping and duplicative provisions, (2) a process for computing the amount of tax benefits that is straightforward and simple for all households, and (3) more consistent rules that do not require taxpayers to jump through several different hoops just to claim a tax benefit.

The first of these credits, the new Family Credit, would be available to all filers. The second, the Work Credit, like the EITC it replaces, would provide a strong incentive for low-income taxpayers to work and, therefore, is designed for these taxpayers.

The New Family Credit

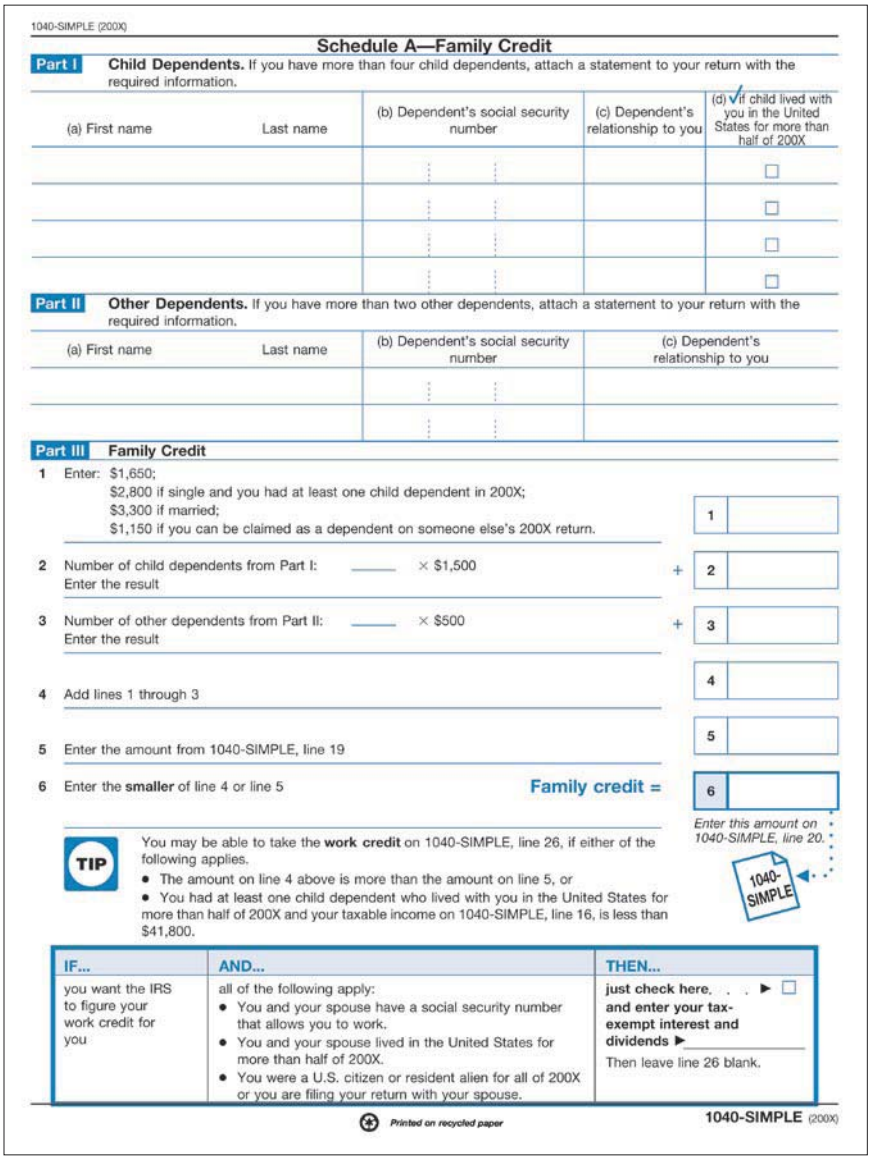
Computing the Family Credit would be easy – start with a base amount for household type and add amounts for each child and other dependent members of a household. Table 5.3 shows the base Family Credit amounts.

Table 5.3. Family Credit Base Amounts

Household Type	Base Credit
Married Couples	$3,300
Unmarried Taxpayers With Dependent Children	$2,800
Single Taxpayers	$1,650
Dependent Taxpayers	$1,150

Each family would add to the base credit amount $1,500 for each child and $500 for each dependent. The Family Credit amounts would be adjusted annually for inflation. To demonstrate the simplicity of the Family Credit, the Panel developed the simple Family Credit schedule shown in Figure 5.3.

Figure 5.3 Family Credit Schedule



1040-SIMPLE (200X)

Schedule A—Family Credit

Part I **Child Dependents.** If you have more than four child dependents, attach a statement to your return with the required information.

(a) First name	Last name	(b) Dependent's social security number	(c) Dependent's relationship to you	(d) ✓ if child lived with you in the United States for more than half of 200X
				☐
				☐
				☐
				☐

Part II **Other Dependents.** If you have more than two other dependents, attach a statement to your return with the required information.

(a) First name	Last name	(b) Dependent's social security number	(c) Dependent's relationship to you

Part III **Family Credit**

1 Enter: $1,650;
$2,800 if single and you had at least one child dependent in 200X;
$3,300 if married;
$1,150 if you can be claimed as a dependent on someone else's 200X return. — 1

2 Number of child dependents from Part I: ____ × $1,500
Enter the result + 2

3 Number of other dependents from Part II: ____ × $500
Enter the result + 3

4 Add lines 1 through 3 — 4

5 Enter the amount from 1040-SIMPLE, line 19 — 5

6 Enter the **smaller** of line 4 or line 5 — **Family credit =** 6

Enter this amount on 1040-SIMPLE, line 20.

1040-SIMPLE

TIP

You may be able to take the **work credit** on 1040-SIMPLE, line 26, if either of the following applies.

- The amount on line 4 above is more than the amount on line 5, or
- You had at least one child dependent who lived with you in the United States for more than half of 200X and your taxable income on 1040-SIMPLE, line 16, is less than $41,800.

IF...	AND...	THEN...
you want the IRS to figure your work credit for you	all of the following apply: • You and your spouse have a social security number that allows you to work. • You and your spouse lived in the United States for more than half of 200X. • You were a U.S. citizen or resident alien for all of 200X or you are filing your return with your spouse.	**just check here.** . . . ▶ ☐ **and enter your tax-exempt interest and dividends** ▶ ____ Then leave line 26 blank.

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1040-SIMPLE (200X)

The Family Credit provides a uniform tax benefit for all taxpayers. It does not phase out for taxpayers who have certain amounts or types of income, nor does it disproportionately benefit upper-income taxpayers in higher tax brackets. Unlike the current system where a taxpayer must choose between the standard deduction and itemized deductions for such expenses as home mortgage interest and charitable contributions, the amount of the Family Credit would be available regardless of whether a taxpayer claims other deductions or tax benefits.

Like the current system, the Family Credit would exempt most lower-income taxpayers from income tax. It is designed to provide a benefit that is equivalent to the provisions that it replaces, along with the current-law ten percent tax bracket.

The amount of income that would not be subject to federal income tax under the Family Credit would be similar to the amount not subject to tax under current law. Most importantly, the Family Credit structure would streamline tax filing for every American household by eliminating a number of steps from our complicated tax filing process, as summarized in Figure 5.4.

Figure 5.4. Tax Filing Using the Family Credit vs. Current Law

Family Credit

- √ Determine eligibility.
- √ Compute total allowable credit.
- √ Subtract Family Credit from tax due.

Personal Exemption

- X ~~Determine eligibility.~~
- X ~~Compute total allowable exemptions.~~
- X ~~Compute personal exemption phase-out (known as "PEP").~~
- X ~~Subtract the personal exemptions (after phase-out, if applicable) from adjusted gross income to compute income subject to tax.~~

Standard Deduction

- X ~~Determine eligibility.~~
- X ~~Determine standard deduction amount.~~
- X ~~Choose the larger of the standard deduction or itemized deductions (after computing the phase-out of itemized deductions, if applicable).~~
- X ~~Subtract the standard deduction from adjusted gross income to compute income subject to tax.~~

Head of Household Filing Status

- X ~~Determine eligibility.~~
- X ~~Determine increased standard deduction amount.~~
- X ~~Compute tax using head of household tax bracket.~~

Child Tax Credit

- X ~~Determine eligibility.~~
- X ~~Compute total allowable exemptions.~~
- X ~~Compute child tax credit phase-out.~~
- X ~~Subtract child tax credit from tax due.~~

The New Work Credit

The EITC and the refundable child tax credit have been effective tools in getting low-income workers into the workforce and out of poverty. Unfortunately, the current system for computing the EITC and the refundable child tax credit is complex. The eligibility rules and lengthy computations make it difficult for lower-income taxpayers to claim the credit without the help of a tax professional. More than 70 percent of the recipients of these benefits use a paid preparer, which reduces the amount of available benefits. Even though the use of paid preparers is widespread, the error rates for taxpayers who claim the EITC and refundable child tax credit are substantial. The IRS estimates that the EITC overclaim rate was 27 percent in 1999, the most recent year for which an estimate is available. At the same time, studies suggest that between 15 and 25 percent of eligible individuals do not claim the EITC – the underclaim rate is likely due to a variety of factors along with the complexity of the eligibility rules and the credit computation.

The Panel recommends replacing the EITC and refundable child tax credit with a Work Credit that builds on the Family Credit. The new Work Credit is designed to maintain a work incentive comparable to that of the current system by providing approximately the same maximum credit as the combined amount of the current-law EITC and the refundable child tax credit. As under the current system, the Work Credit amount would increase as the amount of earnings from work (wages and self-employment income) increases, and the rate and maximum credit amount would be higher for workers who live with qualifying children. For the first year, the Work Credit maximum amount would be $412 for workers with no children; $3,570 for workers with one child; and $5,800 for workers with two or more children. The Work Credit would be adjusted annually for inflation.

The computation of the Work Credit would be coordinated with the Family Credit computation. Taxpayers would be instructed that they might be eligible for the Work Credit if their income is below the Work Credit income thresholds or if the amount of their Family Credit exceeds their tax liability. Taxpayers would have the option of allowing the IRS to compute the Work Credit based on information provided on the tax return and Family Credit schedule, thus eliminating the need for them or their tax return preparer to compute the Work Credit. Although taxpayers might elect to have the IRS compute the current-law EITC, the process would be markedly simpler under the Panel's Work Credit. Additional details regarding the Work Credit, including a sample Work Credit worksheet and instructions, can be found in the Appendix.

Box 5.1. Why Does the Work Credit Phase Out?

Under current law, the EITC and refundable child tax credit use income limits and phase-outs to target tax benefits to encourage individuals to enter the workforce and work more. The benefit of this structure is that it rewards work among those not working or who would work less in the absence of an incentive. The downside of this approach is that it adds complexity and creates sharp increases in marginal tax rates as workers earn more income and lose the benefit of the credit.

The Panel carefully considered whether the goals of the Work Credit could be effectively achieved without phasing out the credit at higher earnings levels. The Panel designed and evaluated an alternative structure that included a Work Credit without a phase-out and an additional tax rate that, together, would provide marginal tax rates that increase steadily as taxpayers earn more, instead of the marginal tax rate spikes found in the current EITC structure. Under the alternative structure, all taxpayers would have been eligible to receive the Work Credit, but would have been required to separately compute the credit amount.

The Panel ultimately rejected this approach because it concluded that the compliance costs and additional burden imposed on all taxpayers outweighed the potential benefits of simplicity and smoother increases in marginal tax rates for eligible Work Credit recipients. Some Panel members also expressed the concern that a Work Credit structure that did not phase out would increase the number of individuals who would not pay income tax.

More Uniform Eligibility Rules

Virtually all eligibility rules would be the same for both the Family and Work Credits. Maintaining nearly identical eligibility rules has clear advantages, including the fact that it makes it much easier for individuals to determine whether they qualify for the credits. Under current law, rules frequently differ among the various tax benefits for families. For example, the maximum eligible age is 16 for the child tax credit, but is 18 for the dependent exemption and EITC, unless the child is a full-time student, in which case the maximum age is 23. The Panel recommends setting the maximum eligible child age for both the Family Credit and the Work Credit at age 18 (age 20 if a full-time student), and removing any age eligibility standard if the child is permanently disabled. For other family members, including students over age 20 but under age 24, a family would be entitled to claim the benefit for a nonchild dependent using rules that are similar to those for the current-law dependent exemption.

In just a few cases, the Panel recommends different rules for the Family and Work credits. For example, unlike the Family Credit, which would be generally available to everyone who pays U.S. taxes, the Work Credit would be limited to U.S. citizens and residents, and would not be available to someone who is claimed as a dependent on another taxpayer's return. In addition, if a taxpayer wanted to claim the higher Work Credit for a child, the child would be required to live with the taxpayer in the United States for more than half of the year. Additional information regarding the Panel's recommended eligibility rules is provided in the Appendix.

A Cleaner Tax System that is Simpler, Fairer, and More Efficient

The Panel began its consideration of options for reform by considering a tax base that was free of exclusions, deductions, and credits. The Panel recommends the retention of some features of the existing tax system, especially those that promote widely shared and valued goals, such as home ownership, charitable giving, and access to health care. However, when the Panel retained a tax preference, it did not simply replicate the current design of these features. Instead, the Panel first determined whether each preference was optimally designed or could be improved. Specifically, the Panel would maintain tax benefits that provide incentives to change behavior in ways that benefit the economy and society, rather than representing a windfall to targeted groups of taxpayers for activity they would be likely to undertake even without a tax subsidy.

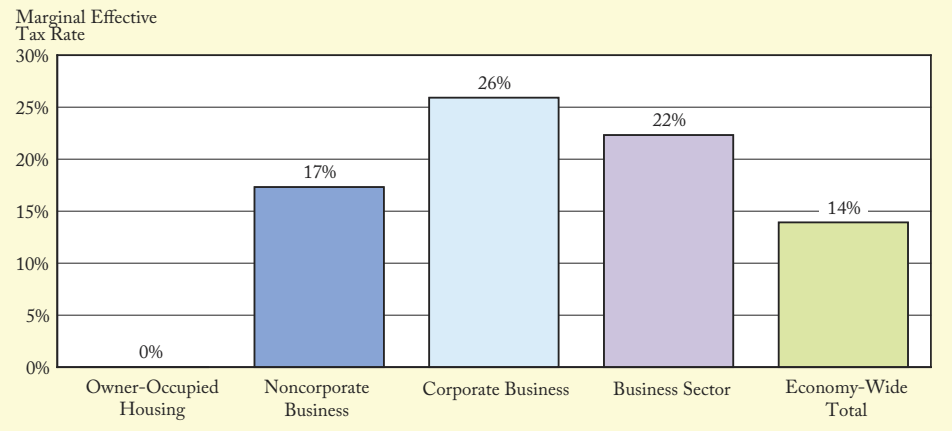
A key objective in reforming these tax incentives was making them simpler and more widely available to taxpayers. Under current law, a number of incentives are limited to the 35 percent of taxpayers who itemize deductions instead of claiming the standard deduction. The Panel's recommendations represent a fundamental shift in the way taxpayers compute their taxes – *every* taxpayer would receive a Family Credit that provides a base amount of tax benefits similar to the current law standard deduction and personal exemption. Taxpayers would then be able to claim the following newly-designed tax benefits in addition to the Family Credit.

Provisions Affecting Homeownership

Housing Tax Benefits under Current Law

The housing sector is highly favored by the tax code. Taxpayers are allowed to deduct interest paid on up to $1 million of mortgage debt secured by the taxpayer's first or second home. In addition, homeowners may deduct interest on home equity loans of up to $100,000. Other provisions allow taxpayers to deduct state and local property taxes and to exclude some or all of the capital gains on the sale of a primary residence. Together, these benefits provide a generous tax subsidy for taxpayers to invest in housing because the purchase and maintenance of a home is subsidized and a substantial amount of appreciation is not taxed. But there is a question whether the tax code encourages overinvestment in housing at the expense of other productive uses.

Figure 5.5 Comparison of Effective Tax Rates on Different Types of Investment



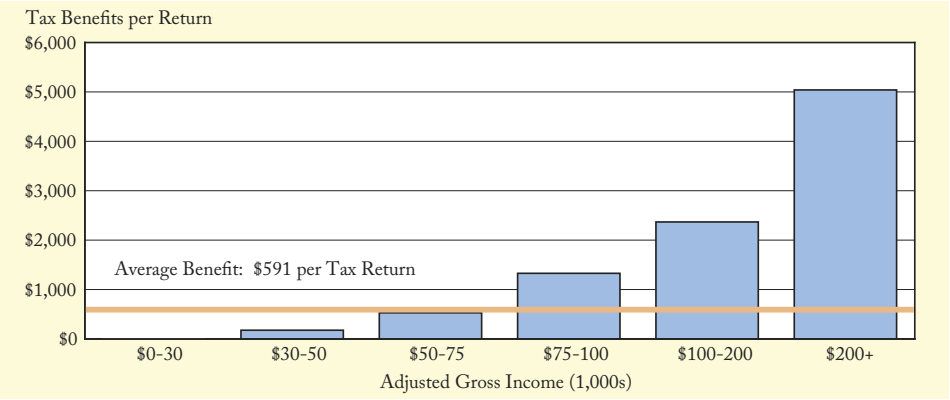
Note: These tax rates were estimated using the Administration's policy baseline, which assumes, among other things, that the 2001 and 2003 tax cuts will be made permanent and that the proposals contained in the President's Budget to create retirement savings accounts and lifetime savings accounts (each with a $5,000 limit) will be enacted.
Source: Department of the Treasury, Office of Tax Analysis.

As Figure 5.5 illustrates, the economy-wide tax rate on housing investment is close to zero, compared with a tax rate of approximately 22 percent on business investment. This may result in too little business investment, meaning businesses purchase less new equipment and fewer new technologies than they otherwise might. Too little investment means lower worker productivity, and ultimately, lower real wages and living standards. While the housing industry does produce jobs and may have other positive effects on the overall economy, it is not clear that it should enjoy such disproportionately favorable treatment under the tax code.

The tax preferences that favor housing exceed what is necessary to encourage home ownership or help more Americans buy their first home. For example, the $1 million mortgage limit may encourage taxpayers to purchase luxury residences and vacation homes. In addition, the deduction for home equity loan interest may encourage taxpayers to use their houses as a source of tax-preferred financing for consumer spending.

The benefits of current tax incentives for housing are not shared equally among all taxpayers. Under current law, the tax benefits for housing, which are larger than the entire budget of the Department of Housing and Urban Development, mostly go to the minority of taxpayers who itemize deductions. These taxpayers typically are drawn from higher-income groups. Over 70 percent of tax filers did not receive any benefit from the home mortgage interest deduction in 2002. According to the Joint Committee on Taxation, more than 55 percent of the estimated tax expenditure for home mortgage interest deductions went to the 12 percent of taxpayers who had cash income of $100,000 or more in 2004. Figure 5.6 demonstrates how households with higher income receive a disproportionate benefit from the home mortgage interest deduction.

Figure 5.6. Distribution of Tax Benefits from the Home Mortgage Interest Deduction



Source: Department of the Treasury, Office of Tax Analysis.

Although the deduction for home mortgage interest is often justified on the grounds that it is necessary for promoting home ownership, it is unclear to what extent rates of home ownership depend on the subsidy. According to the Census Bureau, there are more than 123 million homes in America, with a home ownership rate of 69 percent. There are many countries that do not allow any home mortgage interest deductions for tax purposes, including the United Kingdom, Canada, and Australia. The rate of home ownership in the United States is higher than that in some countries (approximately 66 percent in Canada), lower than that in others (approximately 70 percent in Australia), and comparable to that in still others (the United Kingdom). Thus, it appears that the level of subsidies provided in the United States may not be necessary to ensure high rates of home ownership.

Despite the concerns described above, housing is an important value in our society, and for this reason, the Panel recommends that tax benefits for home mortgage interest be retained, but shared more evenly.

RECOMMENDATIONS
√ Replace the deduction for mortgage interest with a Home Credit available to all taxpayers equal to 15 percent of interest paid on a principal residence.
√ Establish the amount of mortgage interest eligible for the Home Credit based on average regional housing costs.
√ Lengthen the time a taxpayer must own and use a principal residence before gains from the sale of the home can be exempt from tax.

The Panel recommends that the deduction for mortgage interest be replaced with a Home Credit available to all homeowners. The Home Credit would be equal to 15 percent of mortgage interest paid by a taxpayer on a loan secured by the taxpayer's principal residence and used to acquire, construct, or substantially improve that residence. The Panel recommends that the deduction for interest on mortgages on second homes and interest on home-equity loans be eliminated.

To encourage home ownership without subsidizing overinvestment in housing, the Panel recommends limiting the amount of the Home Credit. To adjust for variations in housing markets, the Panel recommends the Home Credit limit be based on the average cost of housing within the taxpayer's area.

The Panel considered various ways to accomplish this, and determined the limit should be based on average area home purchase prices as determined using data from the Federal Housing Administration (FHA). The IRS currently uses a similar methodology to provide average purchase price guidelines for other tax provisions. The FHA insures loans of up to 95 percent of the median home sale price in a given metropolitan area, subject to certain minimum and maximum levels. To estimate average home purchase prices, the Panel considered a mortgage interest cap that was 125 percent of the median sale price for each county (this amount is approximately 31.5 percent higher than the FHA amount after grossing up the FHA median values from 95 to 100 percent). This would result in current limits between approximately $227,147 and $411,704. Estimates suggest that between 85 and 90 percent of mortgages originated in 2004 would have been unaffected by the proposed Home Credit mortgage limit (using the regional limits that would have been applicable for 2004).

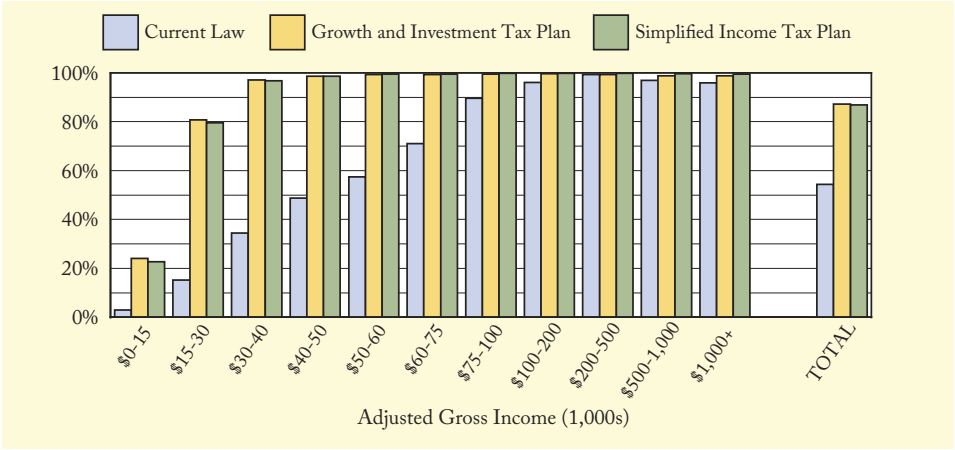
The Home Credit would encourage home ownership, not big homes. More Americans would be able to take advantage of tax benefits for owning a home, while the current subsidy for luxury and vacation homes would be curtailed. In addition, the Home Credit would reduce the incentive to take on more debt by eliminating the deduction for interest on home equity loans.

As under current law, mortgage lenders would be required to report the amount of interest eligible for the Home Credit to borrowers on annual information returns. The Home Credit would simplify tax filing because taxpayers would not need to

determine whether they are better off claiming the standard deduction or itemizing and claiming the home mortgage interest deduction.

More importantly, under the proposal, millions of Americans would be able to claim a tax benefit for home mortgage interest for the first time, which would make owning a home more affordable. Currently, only 54 percent of taxpayers who pay interest on their mortgages receive a tax benefit. As detailed in Figure 5.7, approximately 88 percent of taxpayers who pay mortgage interest would receive a benefit for home ownership under the Panel's recommendations. Lower-income taxpayers, in particular, would do better under the Panel's recommendations than under the current system. For example, the percentage of taxpayers with adjusted gross income between $40,000 and $50,000 who have mortgages and receive a tax benefit for mortgage interest paid would increase from less than 50 percent to more than 99 percent. Depending on the year, between 77 and 94 percent of taxpayers with adjusted gross income over $100,000 who would receive a lesser subsidy under the Home Credit would have paid higher taxes under the AMT, which would be eliminated under the Panel's options.

Figure 5.7. Percent of Taxpayers Who Pay Interest and Receive Mortgage Interest Tax Benefits



Source: Department of the Treasury, Office of Tax Analysis.

The Panel recognizes that limiting the amount of the current tax subsidy for mortgage interest could adversely affect individuals who purchased or refinanced homes assuming they would be able to deduct interest on up to $1.1 million of mortgage debt. To be fair to those who relied on current tax law in making important financial decisions, the options provide for a gradual phase-in of the cap over a five-year period for preexisting home mortgages. Additional information regarding the Home Credit, including the proposed transition relief can be found in the Appendix.

Under current law, up to $500,000 of capital gains on a home that a taxpayer has owned and used as his principal residence for two out of the last five years may be excluded. Although the Panel believes the exemption for gains from the sale of a principal residence should be retained for most homeowners, it also believes that the

length of ownership and use required to obtain this benefit is too short. The Panel recommends that the length of time an individual must own and use a home as a principal residence to qualify for the tax exemption be increased from two out of five years to three out of five years.

Improving Tax Benefits for Charitable Giving

To strengthen incentives for charitable giving and to improve tax administration, the Panel recommends a number of changes to simplify the deduction for charitable contributions and make charitable incentives available to more taxpayers, while reducing opportunities for abuse of the deduction.

Providing Better Incentives to Give to Charity

The current-law deduction for charitable contributions provides an incentive for taxpayers who itemize to give to charity, providing an important source of funding for charitable organizations that serve the public good. Because the deduction for charitable contributions is limited to taxpayers who itemize deductions, its benefits are not shared equally by all taxpayers. According to the Joint Committee on Taxation, more than three-fourths of the estimated tax expenditure for the charitable contribution deduction went to the 12 percent of taxpayers who had cash income of $100,000 or more in 2004.

Americans by their nature are generous and have always supported charitable causes – not only as a regular routine of giving back to the community, but also in response to times of great need or natural disasters. This support is likely to continue, even if changes in law affect the tax benefits of giving. Research has shown, however, that taxpayers are sensitive to the tax rules on charitable giving. Because of the importance of these incentives and the fact that they are not currently enjoyed by most lower- and middle-income households, the Panel recommends retaining a tax benefit for charitable deductions, but making it available to all taxpayers who give to charity, not just to taxpayers who itemize. The Panel also recommends that the tax benefit be structured as a deduction to provide incremental incentives to higher-income donors, an important source of charitable donations.

RECOMMENDATION
√ Create a deduction for charitable contributions that exceed one percent of income. The deduction would be available to all taxpayers.

The Panel recommends that all taxpayers be entitled to deduct charitable contributions exceeding 1 percent of income. This level is based on the observation that most taxpayers already contribute more than 1 percent of their income to charity.

In 2003, approximately 74 percent of individual taxpayers who claimed a deduction for charitable giving contributed more than 1 percent of current-law adjusted gross income. Using a fixed percentage of income as the threshold for the deduction would ensure a uniform incentive to contribute, regardless of income.

The Panel's recommendation also would reduce the recordkeeping burden and the potential for cheating on small deductions, which are not cost-effective for the IRS to verify. Taxpayers who give less than 1 percent of their income would not need to keep any records.

RECOMMENDATION
√ Allow tax-free distributions from IRAs to be made directly to qualified charitable organizations.

The Panel also recommends allowing taxpayers over age 65 to make tax-free gifts from their traditional IRAs directly to qualified charities. Under current law, a taxpayer who donates assets from an IRA to a charity must include the amounts in income and separately claim a charitable deduction. This treatment may discourage some taxpayers from contributing their IRA assets to charity because they may not be able to claim a charitable deduction for the entire amount. This is especially true if the taxpayer does not itemize deductions or is subject to limitations that cap the amount of the deduction to a percentage of income.

Improving Recordkeeping for Charitable Gifts

RECOMMENDATION
√ Require information reporting for large charitable contributions.

The IRS currently has no way to verify a claimed charitable deduction, short of performing an audit. To improve the accuracy of charitable contributions claimed as deductions, the Panel recommends that charities be required to report large gifts directly to the IRS and to the taxpayer, thereby assisting taxpayers in claiming correct amounts and allowing the IRS to verify deductions.

To minimize the burden on charities who accept small donations, the Panel recommends the reporting threshold be set at $600 or higher. Additional information about the Panel's recommendation for information reporting for charitable deductions can be found in the Appendix.

Reducing Controversy and Uncertainty in Valuing Gifts of Property

Under current law, taxpayers are entitled to deduct the full fair market value of gifts of some types of property. Determining the value of donated goods can be difficult because it is so fact-intensive. Valuation is especially difficult for unique property that does not have an established market value. In addition, the IRS does not have a cost-effective way to verify the value of donated property. This provides an opportunity for some taxpayers to overstate the value and inflate the amount of the tax deduction claimed. In recent years, a number of abuses involving contributions of used automobiles or partial interests in real estate have come to light. These transactions relied on inflated valuations. In some cases, middlemen and brokers used by charities to sell donated property received more benefit than the charities themselves.

The Panel recognizes that current-law rules for donations of noncash property provide an added incentive for taxpayers to give to charity and, therefore, recommends that current-law rules be retained. However, the Panel recommends that current rules for valuing donated property be tightened and made more explicit to prevent abuses.

RECOMMENDATION
√ Allow taxpayers to sell property and donate the proceeds to charity.

The Panel recommends that taxpayers be allowed to sell property without recognizing gain and receive a full charitable deduction if the entire sales proceeds are donated to a charity within 60 days of the sale. This rule would apply to the same extent that the property would be eligible for a charitable contribution deduction equal to fair market value under current law (other than items of personal property that are eligible because they are related to the charity's purpose or function). The donor of the proceeds would not be required to pay capital gains taxes on the appreciation of the property. The charitable contribution deduction would be available to the extent that the donor's total contributions exceed the 1 percent of income threshold. To be eligible, the sale of property would need to be an arm's-length sale to an unrelated party.

This proposal would remove an impediment under current law to selling appreciated property and donating cash proceeds, which are more useful to charities. The sale would provide an objective measure of the market value of the property and reduce the charity's cost and the burden of selling the property. If donors are better able to get top dollar for their donations, charities will enjoy larger gifts.

RECOMMENDATION
√ Improve rules for valuing gifts of property to charities.

In cases where property is donated to charities, the Panel believes that it is necessary to implement better standards for appraisals. The Panel recommends (1) new rules requiring clearer standards for appraisals; (2) information reporting by appraisers to the IRS, the donor, and the charity of the appraised value of property; and (3) new penalties for appraisers who misstate the value of property. Additional information regarding the Panel's recommendations for appraisal standards can be found in the Appendix.

The Panel is also concerned that the current rules for contributions of used clothing and household items create the potential for overvaluation and cheating on small deductions. The current system of self-reporting has led to the use of "do it yourself" receipts and third-party valuation guidelines that sometimes provide overly generous values. The Panel suggests that consideration be given to curbing the use of "do it yourself" receipts and inflated valuations by allowing deductions only when the taxpayer receives a price list and an itemized receipt from the charity.

Better Oversight of Exempt Organizations

RECOMMENDATION
√ Effective action should be taken to ensure better oversight and governance of exempt organizations.

The Panel believes that it would be appropriate and desirable for lawmakers to review the types of organizations that qualify for tax-exempt status. A tax exemption, which is paid for by all Americans, should be extended only to organizations that are truly serving the public interest. The Panel recommends that Congress review the standards for qualifying and maintaining status as a charitable organization. Although the Panel does not make specific recommendations for changes to rules governing exempt organizations, the Panel recommends that effective action be taken to ensure greater oversight and better governance of exempt organizations.

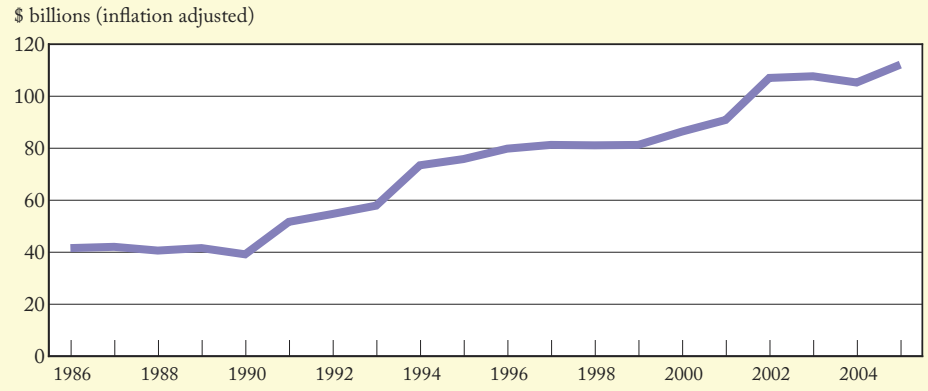
Incentives for Health Insurance Coverage

Under current law, several provisions provide benefits for health care spending. First, compensation paid to workers in the form of employer-paid health insurance premiums is excluded from taxable income and payroll taxes. Second, to the extent that an employee pays a portion of the health insurance premiums, these payments may be shielded from income and payroll taxation through so-called cafeteria plans,

which permit employees to put pretax dollars into benefits of their choosing. Third, many employers now offer flexible spending accounts that are funded with pretax dollars and can be used to pay uninsured medical costs. Fourth, medical expenditures above a certain level can be deducted from taxable income as itemized deductions. Finally, the introduction of health savings accounts, coupled with health insurance covering major medical events (such as catastrophic coverage), has given taxpayers another way to use pretax dollars on health care expenses.

Taken together, tax preferences for health care represent the largest tax expenditure and have an outsized impact on health care spending in America. The United States has the highest per capita health care spending in the world – $1.5 trillion, or $5,400 per person in 2002. Tax benefits associated with health care will cost approximately $141 billion, or 12 percent of all federal income tax revenue in 2006. The largest component of this cost is the employee exclusion for employer-provided health insurance and medical care, a tax expenditure of $126 billion. As illustrated in Figure 5.8, even after adjusting for inflation, the cost of this exclusion has tripled since 1986.

Figure 5.8. Growth of Tax Expenditures for Health Care



Source: Department of the Treasury, Office of Tax Analysis.

The large cost of this tax preference is due, in part, to the fact that employment-based health insurance is the primary source of health insurance for Americans. In 2003, 64 percent of individuals under age 65 were covered by a health plan sponsored by their employer or the employer of a family member. In contrast, 17 percent of taxpayers were covered by a government health plan (e.g., Medicaid, Medicare, or military health care programs), and only 7 percent purchased health insurance directly.

Employer-provided health insurance now constitutes a substantial proportion of a worker's total compensation. Employees and employers ultimately share the burden of rising health insurance premiums; these rising costs tend to come out of the pool of cash available for all worker compensation, including cash wages.

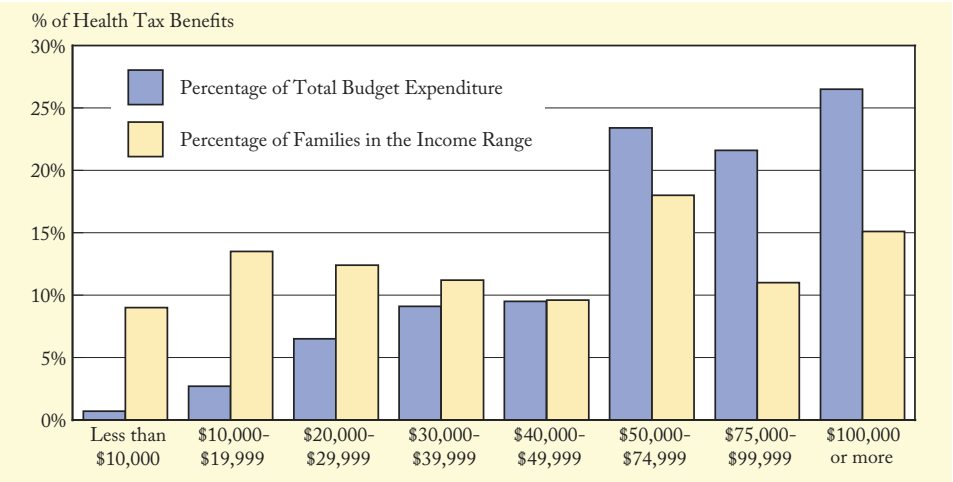
As with housing-related tax subsidies, tax benefits related to health care tend to benefit higher-income households more than lower-income households. This is true

not only because a health-care-related deduction or exclusion is worth more to a higher-income taxpayer in a progressive income tax system, but also because higher-income people are more likely to have insurance. In 2004, families earning more than $100,000 received 27 percent of the tax benefits for health spending. Figure 5.9 demonstrates how health tax expenditures disproportionately benefit higher-income taxpayers.

The current structure of the health insurance exclusion creates incentives that lead to inefficiencies in the market for health care. Because of the tax-preferred status of health insurance, people are more likely to buy health insurance that provides more coverage than they would in the absence of the incentive. Workers who purchase more health insurance may, in turn, use more health services, thereby increasing overall health spending. Estimates are imprecise, but removing subsidies for employer-provided health insurance could lower private spending on healthcare by 5 to 20 percent.

In addition, these tax subsidies for higher-income taxpayers may raise premiums for lower-income people thereby increasing the number of uninsured Americans. Ultimately, the tax treatment worsens disparities in insurance coverage, in use of care, and potentially in health outcomes.

Figure 5.9. Distribution of Health Tax Benefits by Family Income (2004)



Source: Lewin Group.

RECOMMENDATIONS

- √ Make tax benefits for health insurance fairer by allowing a deduction for the purchase of health insurance in the individual market.
- √ Limit the exclusion for employer-provided health coverage to the average cost of health coverage.

The Panel evaluated whether the exclusion for employer-provided health insurance should be retained in each of its options. Although the current exclusion for employer-provided health insurance is costly and has some negative impact on the market for health care, the Panel concluded that an immediate elimination of tax incentives for health insurance would adversely affect many Americans who currently receive health coverage through their employer. In addition, several members of the Panel felt that some incentive for health insurance should be provided through the tax code.

The Panel also recognizes that a strong system of employer-provided health insurance provides many benefits and may lead to a greater percentage of the population with health insurance. In addition, employer-sponsored group coverage reduces transaction costs and may lower premiums for some by pooling the risks of large numbers of individuals.

The Panel recommends that employers continue to be able to deduct the cost of employee compensation, whether in the form of cash compensation or health insurance premiums, and that employees be allowed to receive a base amount of health insurance free of tax. To level the playing field between workers who have access to employer-provided health insurance plans and those who do not, the Panel recommends that workers be allowed to purchase insurance either through their employer or on their own with pretax dollars up to the average cost for health insurance. Taxpayers who, for example, do not have access to employer-provided plans would be allowed a new deduction for health premiums equal to the exclusion enjoyed by workers whose employers provide health insurance.

To ensure that the tax benefits for health insurance are distributed more evenly, however, the Panel recommends that the amount of tax-free compensation an employee could receive in the form of health insurance be limited. The exclusion for employer-provided health insurance would be limited to $11,500 for families and $5,000 for single individuals, which is the national average annual amount projected to be spent on health insurance premiums in 2006. These amounts are also roughly equal to the maximum amount of tax-free health insurance coverage provided to members of Congress and other federal employees.

Figure 5.10 shows that if the exclusion for employer-provided health insurance were completely eliminated, there would be an across the board tax rate cut of approximately 14 percent. A lower cap also would allow for lower rates. For example, capping the exclusion for health insurance to $8,400 – about 75 percent of the amount proposed by the Panel – would result in a 3 percent across the board rate cut.

Figure 5.10. Impact of Eliminating the Exclusion for Health Insurance Premiums on Individual Income Tax Rates

Source: Department of the Treasury, Office of Tax Analysis.

The Panel discussed whether the limit for health insurance would be indexed based on increases in the cost of health care or increases in overall inflation. The Panel recommends that the limit for health insurance be indexed for annual increases in overall inflation like other inflation-adjusted amounts in the tax code.

The Panel's objective is to preserve the incentive for firms to maintain health insurance for their employees without encouraging them to provide excessively generous – or "Cadillac" – health insurance plans. Under the current system, an individual in the top tax bracket tends to prefer to receive additional compensation in the form of health insurance, rather than cash, even if the individual values health insurance at only two thirds of its purchase price. This is because health insurance is not taxed, while cash is. Placing a cap on the tax preferences for health insurance coverage would likely make workers more cognizant of the amount they spend on health insurance. This increased visibility might, in turn, lead some workers to reduce the amount of insurance purchased and pay more health care costs directly. For example, the insured might have higher co-pays and deductibles, or pay a greater share of the bill for lab tests and brand-name pharmaceutical drugs. This change would help stem the out-of-control costs of health care in America, which is making basic insurance harder for more Americans to afford.

Most importantly, under the Panel's proposal, some currently uninsured Americans would have a new tax deduction so they could finally afford health insurance. The Treasury Department estimates that the Panel's recommendation to cap the health insurance amount at the average premium and provide an equal deduction to all taxpayers would reduce the number of uninsured Americans by 1 to 2 million people.

Making the Tax System Easy to Understand, Effective, and Reliable

The Panel's recommended options for reform incorporate a cleaner and broader tax base that eliminates many of the tax benefits available only to a minority of taxpayers. Starting with a clean tax base also eliminates numerous phase-outs, complicated eligibility rules, worksheets, and other tax forms that accompany many of these tax benefits.

The Panel concluded that a rational tax system would favor a broad tax base, providing special treatment only where it can be persuasively demonstrated that the effect of a deduction, exclusion, or credit justifies higher taxes paid by all taxpayers. The Panel recognizes that taxpayers who receive these benefits will not want to see them eliminated. Policymakers may not share the Panel's views about whether particular preferences should be retained, and as the tax reform process continues, choices about tax preferences will be subject to much debate. However, the Panel believes that in reforming our tax system, tax preferences should be treated like any direct spending program, and should be evaluated by policymakers based on objective criteria, such as their cost, the distribution of their benefits, overall effectiveness, and the appropriateness of administering them through the tax system.

The Panel did not separately review every tax preference in the tax code. Instead, the Panel's goal was to start with the broadest possible tax base. Using a clean tax base will allow policymakers to focus on the basic design and elements of the Panel's options. Some of the tax preferences that have been eliminated – the deduction for state and local taxes, tax benefits for education expenses, and employee fringe benefits – are specifically discussed below. A number of other tax preferences enjoyed by a small minority of taxpayers were not included in the Panel's options and are not separately discussed.

The State and Local Tax Deduction

RECOMMENDATION
√ Repeal the deduction for state and local taxes.

The Panel recommends eliminating the itemized deduction for state and local taxes. This deduction provides a federal tax subsidy for public services provided by state and local governments. Taxpayers who claim the state and local tax deduction pay for these services with tax-free dollars. These services, which are determined through the political process, represent a substantial personal benefit to the state or local residents who receive them – either by delivering the service directly or by supporting a better quality of life in their community. The Panel concluded that these expenditures should be treated like any other nondeductible personal expense, such as food or clothing, and that the cost of those services should be borne by those who want them – not by every taxpayer in the country.

The state and local tax deduction forces residents of low-tax jurisdictions to subsidize government services received by taxpayers in high-tax jurisdictions. As with many other tax benefits, the state and local tax deduction requires higher tax rates for everyone, but the benefits of the deduction are not shared equally among taxpayers. The deduction is limited to itemizers, and households with higher income and tax rates receive a greater share of the benefit from the deduction. Even among itemizers, the benefits of the deduction are not shared evenly, as the AMT is increasingly erasing the benefit of the state and local tax deduction for many middle-class taxpayers. Depending on the year, between 64 and 70 percent of taxpayers with adjusted gross income over $100,000 who would no longer receive a deduction for state and local taxes also would have paid higher taxes under the AMT, which is repealed under the Panel's options.

Education Benefits

RECOMMENDATION
√ Simplify tax preferences for higher education by having the Family Credit cover some full-time students and permitting tax-free saving for education costs.

Under current law, there are a number of duplicative and overlapping tax benefits for higher education costs, including the HOPE credit, the lifetime learning credit, and the tuition deduction. Overall, the structure of the tax benefits for education expenses generally provides the largest benefit to families with students who attend schools with higher tuition. These tax benefits may allow educational institutions to increase tuition and fees because a portion of these costs is offset through the tax code.

The differing definitions, allowable amounts, eligibility rules, and phase-outs that accompany these education benefits have added tremendous complexity for middle-class families. Not surprisingly, this complexity leads to taxpayer confusion. One recent study found, based on a sample of tax returns, that more than one fourth of taxpayers eligible to claim one of these benefits failed to do so. Other taxpayers have no idea whether they are entitled to claim a tax benefit until they sit down to do their taxes and figure out which provisions might apply. It is not clear that the structure of these benefits actually encourages individuals to obtain more education than they would have in the absence of these tax benefits.

The Panel recommends that tax preferences for education be simplified by replacing the current credits and deductions with a full Family Credit allowance of $1,500 for all families with full-time students age 20 and under. The Panel also recommends that all families be allowed to save for future education expenses tax-free, as described later in the report.

Fringe Benefits

RECOMMENDATION
√ Put all taxpayers on a level playing field by eliminating tax-free fringe benefits except for certain in-kind benefits provided to all employees at the workplace.

Current law allows taxpayers to exclude the value of a number of fringe benefits received from employers. In addition to health insurance (described above), these fringe benefits include educational assistance, childcare benefits, group term life insurance, and long-term care insurance. Although these provisions are designed to satisfy a worthwhile goal of encouraging employers to provide employees with benefits, the practical effect is favored treatment for some workers at the expense of higher rates for all taxpayers, including those who do not receive these benefits at work.

The favorable tax treatment of fringe benefits results in an uneven distribution of the tax burden as workers who receive the same amount of total compensation pay different amounts of tax depending on the mix of cash wages and fringe benefits. Employees who have these employer-provided fringe benefits receive better tax treatment than employees who pay for these expenses out of their own pocket. Among workers for whom the benefit is available, more of the benefits go to high-income taxpayers, even though they are paid for with higher tax rates for everyone.

The Panel recommends that the cost of employer-provided fringe benefits, such as childcare, life insurance premiums, and education costs, not be subsidized through the tax code. The Panel's options would eliminate most current-law tax preferences for fringe benefits.

The Panel recommends that certain in-kind benefits provided to all employees at the work place, such as meals at a company cafeteria, remain untaxed to the same extent as under current law, but only if provided to all employees. Although employees who work for firms that provide this type of fringe benefit generally receive greater tax benefits than other employees, it would be administratively difficult or impracticable for employers to determine the value of the benefits provided to each employee.

Repeal the AMT

RECOMMENDATION
√ Eliminate the AMT.

The AMT is an entirely separate tax system with its own definitions, exclusions, deductions, credits, and tax rates. It is the most vivid example of the wasteful

complexity that has been built into our system to limit the availability of some tax benefits. The AMT was conceived as a way to make all Americans pay tax, regardless of their tax shelters and avoidance efforts. But over time, the AMT's simple mission has been made more complex and less effective. For example, as part of the 1986 tax reform effort, lawmakers who eliminated the state sales tax deduction nonetheless preserved an itemized deduction for state and local property and income taxes – but only for those paying under the regular tax system. For those subject to the AMT system, the income and property tax deductions were eliminated as well. At that time, this rule had little significance for most taxpayers, but it is increasingly relevant as the reach of the AMT, which is not indexed for inflation, has grown.

Eliminating the AMT would free millions of middle-class taxpayers – 21.6 million in 2006 and 52 million in 2015 – from filing the forms, preparing the worksheets, and making the seemingly endless calculations required to determine their AMT liability. In 2004, an individual had to fill out a 12-line worksheet to see if he needed to file Form 6251, a 55-line form with eight pages of instructions. Those eight pages of instructions also tell the individual to redo many regular tax forms and schedules, including Forms 4952 (Investment Interest Expense Deduction), 4684 (Casualties and Thefts), 4797(Sales of Business Property), and Schedule D (Capital Gains and Losses) using the AMT rules. The individual may also have to fill out and file Forms 8582 (Passive Activity Loss Limitation) and 1116 (Foreign Tax Credit) on an AMT basis. The taxpayer also has to fill out a 48-line form (Form 8801) to determine whether he is entitled to credits for prior AMT payments. Finally, the instructions warn that if the taxpayer claimed the standard deduction for regular taxes, he should recalculate his regular and AMT taxes using itemized deductions because while the standard deduction is not available under the AMT, some itemized deductions are, but only if the individual itemizes for purposes of the regular tax.

Under both of the Panel's recommendations, millions of taxpayers would no longer have to undertake this painful and complex series of calculations nor complete the complicated worksheets just to determine whether they are entitled to a tax benefit or whether it is taken away by the AMT.

Box 5.2. Why Not Eliminate the Regular Tax Instead of the AMT?

As described in Chapter One, the AMT is projected to grow rapidly over the next ten years. The Treasury Department estimates that by 2013, the AMT alone would actually raise more revenue than the regular tax. Some commentators have pointed to this trend and suggested that the tax code should be reformed by eliminating the regular tax instead of the AMT on the basis that the AMT has a broader base and flatter tax rates.

Adopting the AMT as the only tax system would dictate a number of policy changes from current law that may not be desirable. First, the AMT tax base is both broader and narrower than the regular tax base. The AMT starts with the same base as the regular tax, and broadens it by denying a number of tax benefits, such as personal exemptions and state and local tax deductions. However, for lower-income taxpayers, the AMT base is narrower because of the large AMT exemption.

Second, the AMT has only two statutory tax rates, 26 and 28 percent, but is less flat than it appears. The phase-out of the AMT exemption at higher income levels actually creates two additional marginal tax rates – and a resulting tax rate schedule of 26, 32.5, 35, and 28 percent. These rates, along with the AMT exemption, would significantly alter the current distribution of the income tax. Relative to the current system, many middle-income taxpayers would face higher marginal tax rates, while lower- and very high-income taxpayers would face lower marginal tax rates.

Third, the AMT contains a number of fundamental flaws not present under the regular income tax system and that would likely need to be fixed if the AMT were a stand-alone tax system. The AMT is not indexed for inflation, contains steep marriage penalties, and does not provide an adjustment for family size because personal exemptions are not allowed. Fixing each of these flaws would reduce the amount of revenue generated by the AMT and may require higher rates.

Instead of starting with the AMT and making changes to adjust for these differences, the Panel determined that a more straightforward approach was to reform the regular income tax by broadening the base. A broader tax base also would eliminate the need for the AMT.

A broader tax base and the clear, straightforward rules in the Panel's two recommendations would make fixtures like the AMT unnecessary. For example, even though the Panel recommends the elimination of the AMT, the Treasury Department estimates that the Panel's recommendations would cut the number of returns showing adjusted gross income in excess of $200,000 but no U.S. income tax by more than 50 percent. Tax returns showing adjusted gross incomes in excess of $700,000 but no U.S. income tax would be cut by more than 80 percent.

Simplification of the Treatment of Social Security Benefits

Under current law, Social Security beneficiaries must work through a convoluted series of computations in a full-page, 18-line worksheet to determine the amount of their benefits subject to tax. Current rules effectively phase out the preferential treatment of Social Security benefits based on a complicated, three-tier approach. Depending on the tier, taxpayers may be required to include 0, 50, or 85 percent of Social Security benefits in their taxable income. To find out which of these tiers applies, taxpayers who receive Social Security benefits must compute their income a second time by adding back a number of items that normally are not taxed.

Not only is the tiered structure complicated, two of its features represent some of the worst aspects of our current tax system – a phenomenon known as "bracket creep" and a marriage penalty. Bracket creep is a term coined by tax analysts to describe what happens when inflation triggers increases in income that lead to automatic annual tax increases. In the case of Social Security benefits, Congress chose not to index for inflation the thresholds above which taxpayers are required to include 50 percent and then 85 percent of Social Security benefits in their taxable income. This means that as the income of Social Security recipients grows with inflation each year, they are more likely to be above the thresholds and be required to pay more tax.

The current-law rules for Social Security benefits also treat married couples more harshly than singles. The 50 percent and 85 percent inclusion thresholds for married couples are only about 30 percent larger than the threshold for single taxpayers. Because the threshold level for married taxpayers is less than twice the amount for single taxpayers, the current-law tax treatment of Social Security benefits creates a marriage penalty under which the income tax liability of two individuals as a married couple may be greater than their combined liability would be if they filed separately as single individuals.

RECOMMENDATION
√ Simplify the tax treatment of Social Security benefits.

The Panel recommends simplifying the taxation of Social Security benefits by replacing the complex three-tier computation with a straightforward deduction that is easy to compute. Under the proposal, Social Security recipients would not be taxed on any of their Social Security benefits if their income is less than $44,000 for married couples and $22,000 for singles. These thresholds would eliminate marriage penalties and would be indexed annually for inflation. As under current law, taxpayers would never include more than 85 percent of their Social Security benefits in income. Taxpayers above the income threshold would receive a Social Security benefits deduction that would result in 50 percent of their income in excess of the threshold being included in income up to a maximum of 85 percent of Social Secuity benefits. The computation of taxable Social Security benefits will be dramatically simpler than it is today. A copy of the new simpler and shorter worksheet taxpayers would use to compute the taxable amount of Social Security benefits under the Panel's recommendations is shown in Figure 5.11.

Figure 5.11. New Social Security Benefits Worksheet

Social Security Benefits Worksheet — Line 13 *Keep for Your Records*

1.	Is the amount on 1040-SIMPLE, line 9, less than $22,000 ($44,000 if married)?		
	☐ **Yes.** STOP Enter the amount from 1040-SIMPLE, line 7 (85% of social security benefits), on 1040-SIMPLE, line 13.		
	☐ **No.** Enter the amount from 1040-SIMPLE, line 7 (85% of social security benefits)	**1.**	
2.	Enter the amount from 1040-SIMPLE, line 9	**2.**	
3.	Enter $22,000 ($44,000 if married)	**3.**	
4.	Subtract line 3 from line 2. If zero or less, enter -0-	**4.**	
5.	Multiply the amount on line 4 by 50% (.50)	**5.**	
6.	Subtract line 5 from line 1. Enter the result here and on 1040-SIMPLE, line 13	**6.**	

Reducing Marriage Penalties

RECOMMENDATION

√ Reduce marriage penalties by making tax benefits for married couples twice the amount for single filers.

A "marriage penalty" exists when the income tax liability of a married couple is greater than their combined tax would be if they had filed as unmarried individuals. Couples find it hard to understand why they should pay more in tax after they get married than they would have paid if they had remained single.

The Panel's recommended options would make the tax brackets and other tax parameters for married couples exactly twice the amount for singles. By providing marriage penalty relief, the Panel's options help reduce the barriers faced by potential second earners.

COMMON PRINCIPLES

In addition to incorporating the common elements described above, the Panel's options use different approaches to achieve the goal of a simpler, fairer, and more growth-oriented tax system. The differing design of each option represents different approaches to achieving the similar, or common, principles described below.

Reducing Disincentives to Save

Household saving is crucial to the health of our economy and to the financial health of American families. An income tax reduces the return to saving because it taxes the income that saving generates. An individual who earns a dollar today pays taxes on those wages. If he then consumes the after-tax proceeds, he will not pay any further taxes. In contrast, someone who earns the same amount today, pays the same

taxes on his wage income, but then decides to save the proceeds will be subject to additional tax in the future on the investment income generated from savings. A person weighing whether to spend money today or save it for the future may compare how much he can buy today against what he will be able to buy in the future with his savings. If the return on savings is subject to tax, current consumption will be less expensive than future consumption financed from savings. The tax on savings therefore operates like a penalty for those who choose to save.

In contrast, under a consumption tax regime, wages would either be taxed when earned and no further tax would be imposed on the return from savings, or an individual would not pay tax until wages and returns from savings are spent on goods or services. This distinction corresponds to the difference between what is commonly referred to as "prepayment" or "postpayment" consumption taxes. Although the impact on the decision to save or consume is the same under either approach, the timing of tax payments is different. In either case, a consumption tax would be imposed only on the amount the taxpayer consumes.

Compounding the tax penalty on savings under our current system is the complexity created by the different treatment of similar investments. For example, the tax treatment of bonds varies dramatically depending on whether the issuer of the bond is a corporation (where interest is taxable), a state and local government (where interest is tax-free), or the federal government (where some interest is taxable and some is tax-free). Likewise, investments in stock are treated differently depending on the size of the stock's issuer, whether the issuer pays dividends, and how long the stock is held. Table 5.4 illustrates how almost no two investment alternatives are treated the same under the current code.

Table 5.4. Different Tax Treatment of Investments Under Current Law

Investment Type	Tax Rate	When Taxes Are Due
Bonds		
Municipal	Tax-Free	Never
Federal	Regular Rates	Yearly
Federal Savings Bonds (not for education)	Regular Rates	Time of Sale
Corporate	Regular Rates	Yearly
Savings Account or Certificate of Deposit	Regular Rates	Yearly
Corporate Stock		
Capital Gains	Capital Gains Rate	Time of Sale
Dividends	Dividend Rate	Year Received
Small Business[1]	Regular Rates	Yearly
Housing	Tax-Free up to $500,000[2]	Time of Sale
Annuities and Whole Life Insurance	Regular Rates	Year Received

[1] Most small businesses are not corporations and their earnings are taxed on owners' returns.
[2] Capital gains above $500,000 ($250,000 for singles) are taxed at the capital gains rate.

To help reduce the penalty our current income tax places on savings, incentives have been added over the years to promote savings for retirement, education, and health care. Generally, each of these incentives follows a basic strategy to reduce the tax on savings. First, create a special savings vehicle for certain approved purposes where funds can be deposited; second, permit those dollars to grow tax-free until they are withdrawn; third, specify whether those funds are taxed when they are withdrawn. In the case of a traditional IRA account, deposits are generally deductible and withdrawals are generally taxed, while in the case of a Roth IRA or Coverdell education savings account, deposits are not deductible, and withdrawals are tax exempt if made under appropriate circumstances. In the case of a Health Savings Account, the deposits are deductible and withdrawals to pay health expenses are exempt; other withdrawals are taxable. This lack of uniformity is a major source of complexity for Americans.

Box 5.3. The Decline in U.S. Savings

At the same time that tax-free saving options have been added to the tax code, Americans have been saving less of their income for the future. Over the last three decades, the net U.S. savings rate, which equals household savings plus retained earnings plus the surplus or deficit of the government sector, has fallen from about 9 percent of Gross Domestic Income to about 2 percent of Gross Domestic Income. Americans are saving so little that by some measures net tax subsidies for savings actually exceeded the amount of savings by Americans due to loans against and withdrawals from these accounts. The reported savings rates should be viewed with some caution, however, because they do not include appreciation in the value of some assets, such as housing and stocks, which may contribute to increases in wealth without increasing the reported savings rate.

Although the magnitude of the decline in savings is debatable, there is widespread agreement that the overall level of investment and long-term savings is important to the health of the economy. Savings flows into investment, and increased levels of investment are generally associated with greater productivity and, ultimately, higher living standards. To offset low domestic savings, the United States has borrowed heavily from foreign lenders.

Taxing saving more heavily than current spending lowers the rate of return on saving, which in turn lowers the actual level of savings. One economist explained to the Panel that, a small increase in the rate of return of 10 percent – for example, from 5 percent to 5.5 percent – could increase the amount of new saving by Americans by between one and five percent. Some recent research suggests that a broad-based tax system that is neutral between savings and current spending could increase the national savings rate by 12 to 31 percent over a period of 14 years.

One professional financial advisor described to the Panel how investors become paralyzed by the range of tax-preferred savings choices. He said that ultimately these potential investors may choose to spend their money instead of saving it for the future simply because it is an easier decision. His views were confirmed by some members of the Panel, who said they often rely on professionals to help them make informed decisions – and even after seeking advice, they often remain confused.

The Panel doubts that taxpayers need or value the overwhelming number of options for tax-preferred savings. For example, the National Taxpayer Advocate explained to

the Panel how, in the area of retirement savings alone, there are at least a dozen tax-preferred options. Different tax-preferred retirement savings accounts are subject to different eligibility rules (depending on income and employment), contribution limits, permissible withdrawals, and circumstances when individuals can borrow against their accounts. There is no good explanation for why so many different types of plans are necessary.

Although choosing the right tax-preferred retirement savings vehicle is complex, the tax-preferred treatment of savings for education is even more confusing. In recent years, accounts known as Coverdell education savings accounts and Section 529 plans have been added to the tax code. Choosing between these options is not easy because, like other tax-preferred savings incentives, they have almost no common rules or features. Making matters even worse, Section 529 plans have proliferated – there are now more than 100 separately sponsored Section 529 plans from which to choose, each with its own contribution limits, investment options, costs, and penalties for noneducational use. Yet another level of complexity is created because the tax-free withdrawal feature of Section 529 plans is scheduled to expire in 2010, forcing families to pay tax on earnings even if the funds are used for educational purposes.

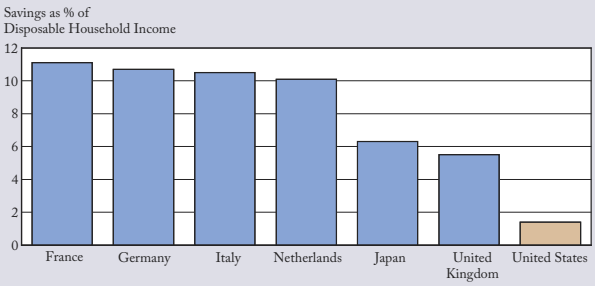
For many individuals, it is virtually impossible to decipher the rules for each plan or to determine which education savings vehicle confers the greatest benefit. In addition to complex choices between the different tax-preferred savings vehicle, the plans interact with other tax and nontax incentives for education, further clouding families' ability to determine the best way to pay for higher education. The tax code has made financial planning for higher education so complex that even professional tax planners disagree on the best course to follow. Not surprisingly, only three percent of all households actually use an education savings account. Among households that do take advantage of the accounts, the benefits go mostly to higher-income families.

In addition to retirement and education, tax-preferred savings accounts are available for health care purposes. These include Medical Savings Accounts (MSAs), Health Savings Accounts (HSAs), and Flexible Spending Arrangements (FSAs), which allow taxpayers to pay or save for health care in different ways, and each comes with a different set of rules.

Box 5.4. Comparison of U.S. Savings Rate to the Rates of Other Countries

Not only has personal savings in the United States been declining over time, it is low compared with other industrialized nations. The following figure shows that as a fraction of household income, household savings in the United States lags significantly behind many developed-countries.

Household Net Savings, 2003



Source: OECD, Economic Situation, Analysis and Projections, December 2004, Annex Table 23.

RECOMMENDATION
√ Simplify and expand opportunities for tax-free savings for retirement, health, education, and housing.

Both of the Panel's recommended options would remove existing disincentives to save. These options would provide opportunities for Americans to save in a simple and efficient manner by replacing the tax code's plethora of savings incentives with a unified system that would make tax-free savings for education, health, a new home, or retirement flexible, convenient, and straightforward. The tax code's redundant savings incentives and accounts would be combined into three simple and flexible accounts for savings. The creation of these three simple saving opportunities significantly reduces the bias against saving and investment that exists under the current system. In addition, the Panel proposes changes to the administrative rules for some employer plans that would point workers in a pro-saving direction. The plans would allow most Americans to prepare for their future financial security free of tax. Not only would these accounts provide simpler and expanded opportunities to save, the playing field for tax-preferred savings would be leveled by eliminating exclusions under current law that allow some taxpayers to save an unlimited amount tax-free through life insurance, annuities, and executive deferred compensation arrangements. The Panel's plans also would include a refundable Saver's Credit that would give low-income Americans a strong incentive to save by matching contributions to savings accounts.

The Simplified Income Tax Plan also would nearly eliminate the double tax on corporate profits by excluding dividends paid out of income earned in the U.S. In addition, 75 percent of capital gains on sales of stock in U.S. corporations would be excluded from income.

Under the Growth and Investment Tax Plan, the return to savings not held in these tax-preferred savings accounts would be subject to a flat rate tax of 15 percent. In addition, employer-sponsored accounts under the Growth and Investment Tax Plan would use a "Roth IRA," or prepayment approach, while the Simplified Income Tax Plan would use a "traditional IRA," or postpayment approach. These two approaches provide similar incentives for savers, but they have different near-term tax revenue consequences. The overall tax burden on capital income would be lower under the Growth and Investment Tax Plan than under the Simplified Income Tax Plan, although some types of capital income might have a lower tax burden under the Simplified Income Tax Plan.

These approaches would diminish the need for taxpayers to hire tax professionals to help them navigate the tax code's multitude of incentives. Americans would be able to make investment decisions based on their preferred investment strategy and no longer would be required to jump through hoops to make sure that they maximize their after-tax returns. Taxes would play a less prominent role in household savings decisions.

Small Business Rules Designed with Entrepreneurs in Mind

The tax rules for businesses, like those for households, have become a complicated mess. These rules force many businesses to engage in elaborate and burdensome recordkeeping to comply with the tax code's arcane accounting for income and deductions, especially when businesses have inventories or depreciable assets.

These rules do not apply only to large corporations. In fact, since the proportion of business profits that flows to individuals is continuing to rise, the tax rules on business are having an outsized impact on household filers. As shown in Table 5.5, in 2004, an estimated 31 million individuals – nearly one-fourth of filers – received business income from sole proprietorships, rental activities, partnerships, limited liability companies (LLCs), or S corporations and paid tax on this income on their individual returns. Over one-third of taxes on business profits are paid by owners of pass-through businesses when they file their individual tax returns.

Table 5.5. Owners of Pass-Through Businesses (2004)

Type of Business	Returns (Millions)
Sole Proprietorships	18.8
Individuals with rental activities	9.4
Partnerships and LLCs	4.2
S Corporations	3.6
Farm Proprietorships	2.1
Total	30.9*

* Total is less than components because some taxpayers own more than one type of business.
Source: Department of the Treasury, Office of Tax Analysis

For small businesses, the compliance burden is especially heavy, as compliance costs are large relative to income. Most small business owners track the profitability of their business during the year based on the balance in their checking account. The tax code's detailed business rules force many entrepreneurs to create and maintain several different sets of books and records for the sole purpose of filling out a tax return. Reforms that lower the burden of tax compliance on small businesses by reducing recordkeeping and paperwork will lead to increased entrepreneurial activity and a stronger economy.

RECOMMENDATIONS

- √ Simplify recordkeeping for small businesses by basing it on cash receipts and expenses.
- √ Expand expensing of small business assets.

The Panel recommends that most small businesses file taxes the same way they pay their bills – with their checkbook. Under the Panel's options, most small businesses would report income as cash receipts minus cash business expenses. This rule reduces compliance costs by relieving small businesses from keeping a second (or sometimes even a third) set of books for tax reasons and allowing them to use records they already keep for their businesses.

Both of the Panel's options would allow unlimited expensing for most asset purchases by businesses with less than $1 million in annual receipts. The Simplified Income Tax Plan would allow immediate expensing for all assets other than land and buildings, which would retain current-law treatment. The Growth and Investment Tax Plan would adopt a business cash flow tax that would allow businesses of all sizes to write off all purchases from other businesses immediately, including all new investment in equipment, structures, inventories, and land. This treatment represents an expansion of current-law rules, which for 2004, allowed small businesses to write off the cost of the first $102,000 of their purchases of tools and equipment. This inflation-adjusted provision is temporary and is scheduled to be cut to $25,000 in 2008 – less than one-fourth of its current size. In addition, the current-law provision does not allow expensing of intangibles, which the Panel's options would. Using the cash method of accounting for small businesses would allow them to write off the cost of their purchases of tools, equipment, and other long-lived assets immediately, which would encourage new investment and capital formation by growing businesses.

In addition, the Panel's options would not require businesses with less than $1 million in annual receipts to use an inventory accounting method. All inventory costs would be deductible when incurred.

Proposals to Boost Business Investment

Our business tax system is inefficient and hopelessly complex. It is littered with provisions for special rates, deductions, and credits that are designed to encourage particular conduct or business activity. Under the patchwork of rules that tax some business income twice, some once, and some not at all, firms have an incentive to rearrange their affairs in ways motivated by taxes, rather than by the underlying economics of business decisions. This inefficient shifting of resources away from business investment and innovation hinders economic growth.

The Panel's recommendations would improve several aspects of the current business tax code for medium-sized and large businesses. First, the Panel's options would simplify the current treatment of, and lower the tax burden on, returns on new business investment. Second, the Panel's recommendations would make our tax code more efficient by leveling the playing field between different types of business entities and investment. Both of the Panel's options also would reduce the differences in the combined individual and corporate tax on dividends and interest on corporate debt. Third, both of the options would replace our international tax regime with a system that reflects the realities of our global economy. Finally, the Panel's recommendations would eliminate the corporate AMT.

Simplifying and Encouraging Business Investment

The tax treatment of new business investment under our tax code is based on asset classifications that are outdated, do not account for new industries and technologies, and favor some assets while penalizing others. The classification of assets into recovery periods has remained largely unchanged since 1986, and most asset classifications date back at least to 1962. Entirely new industries have developed in the interim, and production processes in traditional industries have changed. These developments are not reflected in the current cost recovery system, which does not provide for updating depreciation rules to reflect new assets, new activities, and new production technologies.

A 2000 Treasury Department report on depreciation concluded that it is not known with any degree of certainty what the depreciation rates should be, even on average, for many classes of investment. For example, the Panel was told how the current depreciation schedule for computers is based on studies of the depreciation of surplus government typewriters from the late 1970s. Although computers can operate mechanically for a number of years, it should be no surprise that they lose their usefulness quickly as newer technology becomes available. The actual pattern of depreciation of computers is not accounted for under current estimates.

Accounting for the value of assets that have been depreciated under our current system creates complexity and an additional recordkeeping burden. Most businesses are required to measure the current value of an asset in at least three different ways: (1) the historic cost of the asset for financial accounting purposes, (2) the adjusted basis of the asset for tax purposes, (3) and the basis of the asset for corporate AMT using the AMT-specific depreciation method. Some states require that assets be tracked based on yet another method of depreciation.

More costly than the recordkeeping cost of our depreciation system is the impact it has on new investment. If tax depreciation is not neutral – because it does not appropriately match the economic decline in value of physical assets – capital will be allocated inefficiently. This distorts business decisions because companies will invest in tax-favored equipment over other alternatives (even if such alternatives may be better suited to the company's operations and competitive needs). The cost of an inefficient allocation of capital is fewer goods and services being produced than otherwise might be possible.

The Panel learned how the current system creates distortions that alter investment choices. Our current depreciation system creates large variations in tax rates across different types of business assets. Table 5.6, which assumes that the 2001 and 2003 tax cuts are permanent, shows how some corporate assets have marginal effective tax rates that are one-fourth of other assets.

Table 5.6. Marginal Effective Tax Rates on Capital Income of Corporations by Asset Type	
Asset Type	**Marginal Effective Tax Rate (%)**
Computers and peripheral equipment	36.9
Inventories	34.4
Manufacturing buildings	32.2
Land	31.0
Commercial buildings	30.4
Automobiles	29.7
Software	29.1
Hospitals and special care	28.4
Educational buildings	28.4
Office and accounting equipment	28.4
Electric transmission and distribution	24.9
Residential buildings	23.8
Farm tractors	22.7
Service industry machinery	22.2
Mining and oilfield machinery	21.9
Farm structures	20.8
Medical equipment and instruments	20.4
Agricultural machinery	20.2
Railroads	20.1
Metal-working machinery	19.0
Photocopy and related equipment	18.8
Light trucks (including utility vehicles)	18.2
Communications equipment	17.8
Household appliances	17.5
Construction tractors	17.4
General industrial equipment	17.3
Communication structures	17.0
Construction machinery	16.7
Ships and boats	16.5
Fabricated metal products	15.5
Aircraft	14.5
Railroad equipment	11.4
Mining structures	9.5
Petroleum and natural gas structures	9.2

Source: Congressional Budget Office

The effective tax rates listed in Table 5.6 help measure how taxes may distort investment and other economic activity. The effective tax rates cannot be found in the tax code. They represent a combination of statutory tax rates and other features of the tax system, such as the depreciation schedule for the asset. The higher the effective tax rate, the more likely it is that the tax system would discourage investment. The greater the differences in the effective tax rates across types of investments, the more likely it is that the tax system distorts investment choices.

RECOMMENDATIONS
√ Lower the tax burden on business investment.
√ Simplify recordkeeping for purchases of new assets.

To encourage new investment, the Panel recommends changes to the tax treatment of business investment in each of its options. The Simplified Income Tax Plan would improve investment incentives by lowering the tax rate on business income and overhauling the current depreciation system. This proposal would reduce the compliance headaches associated with the tax treatment of business investment for large and mid-size businesses. The new depreciation system would collapse the number of asset classes and methods, making fixed asset accounting more straightforward.

The Simplified Income Tax Plan also would reduce the top business tax rate from 35 to 31.5 percent – a 10 percent reduction in the tax burden. The lower tax rate would reduce the tax on income earned from new investment projects and would encourage businesses to invest in new assets that improve productivity.

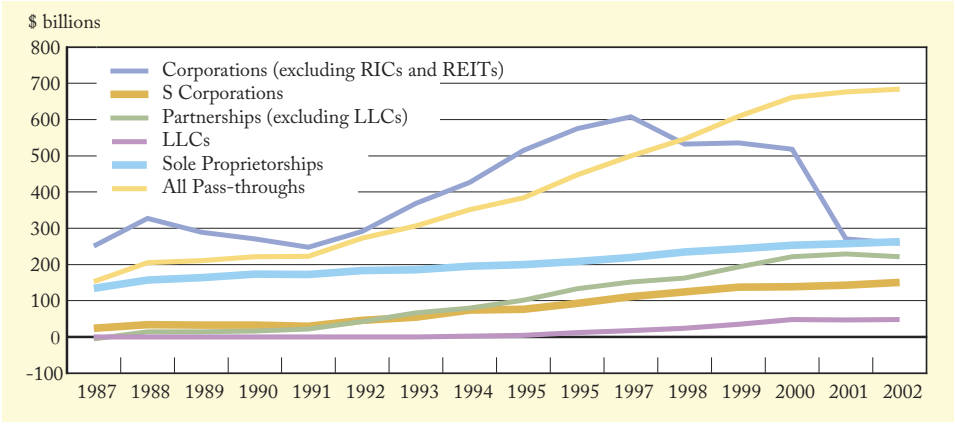
The Growth and Investment Tax Plan would take a more dramatic approach to business investment. This option would replace the system of depreciation allowances with a system that combines complete expensing of business investment and the equal treatment of debt and equity business financing. Giving businesses an immediate write-off for purchases of new assets and denying deductions for debt financing would provide the same treatment for different types of business investment. By allowing an immediate write-off for the cost of a project, the return on investment would be the same after tax as it was before tax, assuming the business is able to use the expensing deductions. This would encourage firms to make investments that would not be undertaken under today's tax code.

Reducing Distortions Created by the Corporate Income Tax

The double tax on corporate earnings – once at the corporate level and again at the individual level when distributed as a dividend or realized from a sale of stock – discourages investments in corporate equity in favor of other investments that are not taxed as heavily. This may discourage new corporate investment, encourage existing corporations to use debt financing instead of equity financing, and encourage corporate managers to retain profits or distribute profits only in a tax-advantaged manner, such as paying bonuses to owners or issuing stock options.

The tax bias against using the corporate form is clearly demonstrated by the rapid growth in business entities not subject to the corporate income tax, such as LLCs and S corporations, which provide legal benefits of limited liability, but are taxed only once on the individual owners' tax returns. For example, since 1980 the number of S corporations has grown from 528,100 to 3,612,000, while the number of C corporations has remained largely unchanged – from 2,115,000 in 1980 to 2,190,000 today. As shown in Figure 5.12, much of the tax on business profits is now being paid on the individual tax returns of shareholders in S corporations, LLCs, and other flow-through entities, as total business net income from these entities recently exceeded total business net income from C corporations.

Figure 5.12. Business Net Income by Legal Entity (1987-2002)

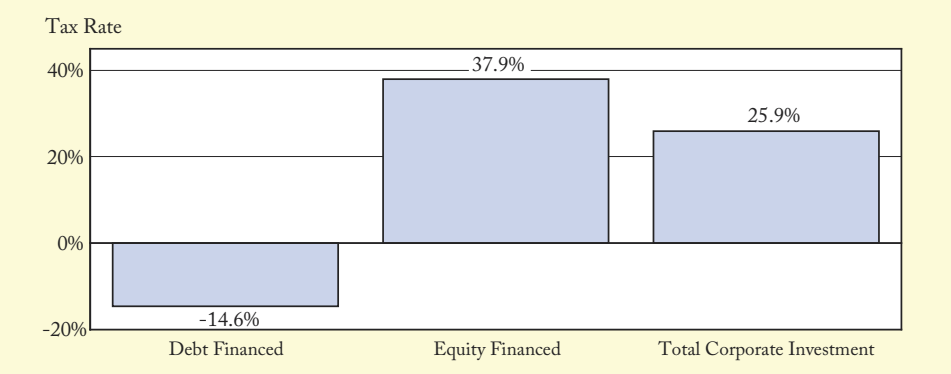


Source: Internal Revenue Service, Office of Research, Analysis, and Statistics.

Not only does the corporate income tax discourage new investment in corporate equity, it also encourages existing corporations to finance new projects with debt rather than issuing new stock. If a corporation raises funds for investment by issuing stock, the dividends paid are not deductible at the corporate level, creating a double tax on the corporation's earnings. Income from debt-financed corporate investment, on the other hand, is largely untaxed at the corporate level because corporations may deduct interest payments. Although interest income is taxed at individual tax rates of up to 35 percent, the individual tax rate is often lower than the corporate rate, and a substantial portion of interest income is received by tax-exempt or low-taxed taxpayers (e.g., pension funds, IRAs, foreigners) and so bears little or no tax.

Because corporate equity financing is treated less favorably than debt financing for tax purposes, it often costs less for corporations to borrow funds than to issue stock. As shown in Figure 5.13, the average economy-wide effective income tax rate on equity-financed investment is close to 38 percent – a nearly 35 percent corporate-level tax plus a composite 4 percent tax rate at the individual level, representing the average of dividends and capital gains taxed at the 15 percent maximum rate and those taxed at lower rates or in tax-free accounts. By contrast, the average tax rate on debt-financed investment is negative (-15 percent), as deductions for interest, together with deductions for items such as accelerated depreciation, more than offset the income generated from debt-financed investment. Debt-financed investment thus is slightly subsidized by the tax system, meaning that the reward for such investment is greater than if there were no taxes at all.

Figure 5.13. Average Effective Tax Rates on Corporate Investment by Financing Type



Note: These tax rates were estimated using the Administration's policy baseline, which assumes, among other things, that the 2001 and 2003 tax cuts would be made permanent and that the proposals contained in the President's Budget to create retirement savings accounts and lifetime savings accounts (each with a $5,000 limit) would be enacted.
Source: Department of the Treasury, Office of Tax Analysis.

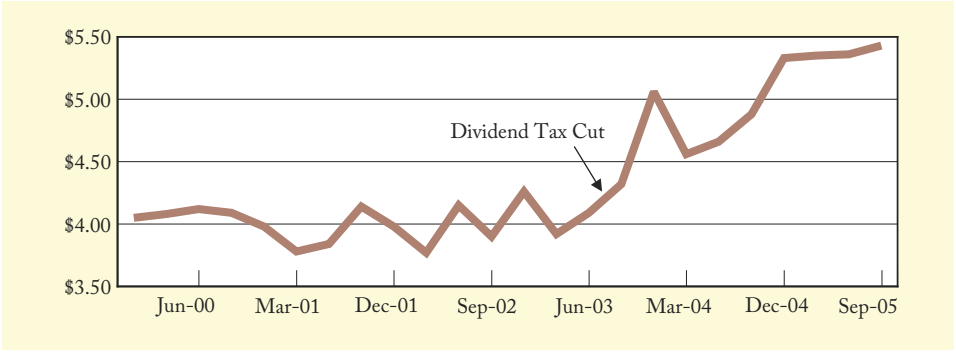
The tax bias against corporate equity encourages firms to rely on debt more than they would if the tax system imposed no such bias. The use of higher debt levels by corporations, known as "leveraging," may increase the risk of bankruptcy and financial distress during temporary industry or economy-wide downturns. This heightened bankruptcy risk can make the entire economy more volatile. In addition, the differential taxation of debt and equity may favor investment by firms or industries that have easier access to debt. The distinction between debt and equity also creates opportunities for tax planning and tax sheltering.

The corporate income tax also impacts firms' decisions about the level, timing, and form of distributions to shareholders. If firms retain earnings to avoid taxes, the resulting allocation of capital across firms and industries may be less efficient than it would be if the earnings were paid to shareholders, who could redeploy the funds towards their most productive use.

The tax system also encourages U.S. corporations to distribute earnings in tax-preferred transactions. For example, privately held corporations often pay bonuses at year end to employee-shareholders to eliminate the corporate income tax. Another increasingly popular technique is to use employee stock options to eliminate double taxation. A corporation that issues stock options essentially borrows from its employees and "repays" them with stock, generating tax deductions for compensation that can eliminate a substantial portion of a company's tax liability. In 2000, total deductions for stock options were 10 percent of total pretax income for the 100 largest U.S. companies. However, for high-technology companies in the NASDAQ 100 stock index, tax deductions for employee stock options exceeded the total pretax income of these companies.

In 2003, the top tax rate paid on dividends earned by individuals was lowered to 15 percent. This rate reduction substantially reduced corporations' incentive to retain earnings or distribute them in a tax-preferred way. Since then, more corporations have begun paying dividends, and corporations that historically paid dividends have increased their dividend payout, making more and lower-cost capital available for other businesses. Figure 5.14 summarizes the increase in the dividends paid per share for companies in the Standard & Poor's 500 (S&P 500) index since the May 2003 dividend tax cut. Since 2003, more than 30 additional S&P 500 companies began paying dividends. In fact, 2003 marked the first year that there was an overall increase in dividend initiations among S&P 500 companies since 1994. The reduced tax rate on dividends is temporary, however, and is scheduled to expire in 2008, unless it is extended.

Figure 5.14. S&P 500 Dividend Payout per Share



Source: Standard & Poor's.

Overall, the double tax of corporate earnings has a significant impact on the economy because it results in a misallocation of capital away from the corporate sector and into the noncorporate sector. Corporate investment projects require a higher pretax rate of return than noncorporate business investment projects to obtain the same after-tax rate of return. If less capital is allocated to the corporate sector, some corporations will fail to undertake investments that would be profitable if the burden on corporate and noncorporate investments were the same.

The elimination of the double taxation on corporate earnings would remove many of the distortions in our current system, including the incentive to invest in non-corporate businesses instead of corporate businesses and the incentive to use debt or retained earnings instead of equity financing of corporate investment. Removal of these distortions would likely lead to increased investment and thus further economic gains from stronger growth and job creation.

RECOMMENDATION
√ Reduce the double tax on corporate earnings and provide a more level treatment of debt and equity financing for large businesses.

Both of the Panel's options would remove the bias against investing in America's businesses by providing a more neutral tax treatment among corporate and noncorporate businesses. Both options are designed to change the rules that lead to many of the inefficient choices made by businesses. In addition, the options would help level the playing field between business projects financed by debt and those projects financed with equity.

The Simplified Income Tax Plan would provide a full exclusion for individual and corporate taxpayers of dividends paid by U.S. corporations out of domestic earnings. To help level the playing field between businesses that pay out their earnings as dividends and businesses that retain their earnings, the Simplified Income Tax Plan would exclude 75 percent of capital gains on the sale of stock of U.S. corporations.

The Growth and Investment Tax Plan would apply a uniform tax on all business cash flow because businesses would not deduct payments of interest and dividends. At the individual level, a flat rate tax of 15 percent would be imposed on all interest, dividends, and capital gains received by households, resulting in a uniform tax burden on business investment.

Reforming the Taxation of International Business Activity

Our current tax system subjects U.S. multinational corporations to tax on both their domestic- and foreign-source income. When foreign income is earned by the active business operations of a foreign subsidiary, however, U.S. tax on the parent corporation is deferred until the income is repatriated to the United States. Under our so-called "worldwide" tax system, U.S. multinationals are generally taxable on the active business earnings of their foreign subsidiaries only when those earnings are returned to the United States in the form of dividends or realized by the U.S. owner of the foreign subsidiary in the form of gains from the sale of shares. A credit for foreign income taxes paid by the foreign subsidiary can reduce U.S. tax on repatriated foreign earnings, subject to various limitations.

Although this worldwide approach to the taxation of cross-border income was once more prevalent, it is now used by less than half of the world's major developed economies. Instead, many of these countries now use predominantly "territorial" tax systems that exempt all or a portion of foreign earnings from home-country taxation.

Under a *pure* worldwide system, all foreign earnings would be subject to tax by the home country as they are earned. To prevent double taxation, a tax credit would be allowed for all income taxes paid to foreign governments. Under this pure system, the marginal after-tax return on an identical investment project at home would never be higher than in any country abroad. From the perspective of worldwide economic efficiency, this feature may be attractive because it ensures that business location decisions of multinationals are not influenced by tax considerations. Under a *pure* territorial system, on the other hand, only income earned at home would be subject to home country tax. This feature has the benefit that all those investing in a particular country face a level playing field from a tax perspective, regardless of the tax rate in the investors' home country. Unless tax rates and tax systems are identical around the world, it is impossible to simultaneously ensure that business location decisions of multinationals are not influenced by tax considerations and that all investors in a particular country are treated the same from a tax perspective.

Efficiency, competitiveness, and revenue concerns, as well as considerations such as fairness and administrability, all influence international tax policymaking and often are in conflict. Thus, countries with predominantly worldwide systems do not subject all foreign source income earned by foreign subsidiaries of multinational corporations to immediate home country taxation, largely so that home-based companies are not at a disadvantage investing in countries with lower tax rates, and they do not provide unlimited foreign tax credits, because doing so could wipe out government revenues from taxing domestic as well as foreign source income. Similarly, to prevent tax avoidance and to maintain government revenues, countries with predominantly territorial systems typically do not exempt certain foreign earnings of foreign subsidiaries, including earnings generated from holding mobile financial assets, from home-country taxation.

In both worldwide and territorial systems, the rules that determine which types of foreign income are taxed, when the income is taxed, and what credits are available to reduce that tax are complex and can be the source of a great deal of tax planning activity. Nevertheless, some systems may create fewer distortions and produce better incentives than others.

Two features of the U.S. international tax system illustrate some of the problems associated with our current rules. First, because the active business income of foreign subsidiaries of U.S. parent corporations generally is not taxable at home until it is distributed as dividends, the U.S. tax on dividend payments can be thought of as elective, much like the tax on capital gains. Due to the "time value of money" advantage of postponing tax payments, this deferral of U.S. tax allows foreign business income to be taxed at a lower effective rate than it would be if it were earned in the United States. This creates an incentive for the foreign subsidiary to retain the earnings as long as possible and distorts other business and investment decisions.

Another feature of the U.S. system that can produce undesirable incentives involves the mechanism to prevent the double taxation of corporate income. The foreign tax credit is limited to the amount of U.S. tax that would be due if the foreign income were earned in the United States. This limit is intended to prevent the company from using foreign tax credits to reduce U.S. tax on domestic income. Many complicated rules determine how companies calculate these credits. These rules further limit the use of credits in many situations, but also allow companies to arrange their affairs so that they can avoid taxes on income earned abroad if they are able to simultaneously repatriate certain income that has been subjected to high rates of foreign tax and other income that has been subject to low rates of foreign tax.

The deferral and credit features of our current tax system make the tax consequences of investment abroad dependant on the circumstances of the taxpayer. For instance, certain corporations may be able to set up their operations in a way that either avoids the repatriation of foreign profits through deferral or avoids U.S. tax on repatriated foreign profits through the credit. Both approaches may effectively allow corporations to obtain territorial tax treatment for active business income through "self-help," and some corporations may be able to receive tax treatment that is even more favorable.

Establishing repatriation of a dividend as the taxable event distorts business decisions. U.S. tax must first be paid to redeploy earnings in the United States unless tax planning has ensured that sufficient tax credits are available or other tax planning techniques have been used to avoid the U.S. tax. Further, as explained in Chapter Six, the tax planning opportunities engendered by the complicated rules surrounding deferral may allow some corporations to help themselves to results that are more favorable than territorial taxation. As a result, the active foreign income of some multinationals is taxed more heavily under the current system than it would be in a predominantly territorial system, while similar income earned by other multinationals is functionally exempt from U.S. tax through "self-help." Meanwhile, the income of a third group of multinationals may be taxed at a negative rate. The result of this complexity is that the actual rates of tax paid by U.S. companies on their worldwide income vary widely from year to year, and from company to company, based on the range of foreign operations and the sophistication of their tax planning.

The current system likely distorts economic decisions to a greater extent and is more complex than a system that simply exempted active foreign business income from U.S. tax. Despite its complexity, the current U.S. system raises relatively little revenue, at a high cost, from the foreign income of U.S. multinational corporations. Further, arranging affairs to avoid U.S. taxation of foreign earnings is costly for U.S. multinational corporations, and these costs differ across companies. The result is a system that distorts business decisions, treats different multinationals differently, and encourages wasteful tax planning.

RECOMMENDATION
√ Update our system of international taxation.

The Panel concluded that our international tax rules are in need of major reform. Income taxes and consumption taxes raise different international tax questions, and the Panel's Simplified Income Tax Plan and Growth and Investment Tax Plan include different international tax components. However, each proposal is intended to reduce economic distortions and improve the fairness of the U.S. international tax regime by creating a more level playing field that supports U.S. competitiveness.

The Simplified Income Tax Plan would exempt dividends paid from the active earnings of controlled foreign corporations and foreign branches of U.S. corporations from U.S. taxation to provide a simpler and more even treatment of cross-border investment by U.S. multinational corporations. Under the new system, territorial taxation of active foreign business income would be available to all U.S. multinational corporations, not just those that are able to "self-help" themselves to this result or its functional equivalent. The new system is designed to make U.S. businesses more competitive in their foreign operations, while reducing the extent to which tax planning allows some multinationals to achieve more favorable result than others.

The Growth and Investment Tax Plan would use domestic consumption as a tax base. This tax system is designed to improve incentives for foreign multinationals to invest in the United States, just as it would improve incentives for domestic investment by domestic investors more generally. The system also levels the playing field between domestic production and imports by assuring that all goods and services consumed in the United States face the same consumption tax burden. Using domestic consumption as a tax base strengthens tax administration by helping to prevent tax avoidance schemes involving foreign parties.

Elimination of an Inefficient Tax – The Corporate AMT

RECOMMENDATION
√ Eliminate the Corporate AMT.

As with taxes for individuals, many corporations are subject to a second, parallel tax – the corporate AMT. Like the individual AMT, the corporate AMT has been used to pare back the cost of certain tax benefits. Under the corporate AMT, corporations are required to keep two different sets of books and records, and calculate their tax liability under two very different sets of rules – the regular income tax rules with rates of up to 35 percent, and the corporate AMT rules at rates of up to 20 percent – and then pay the larger of the two amounts. The existence of these two radically different tax codes with dozens of complex differences between them makes rational tax

planning, administration, and compliance geometrically more difficult. In addition to its complexity, the corporate AMT may exacerbate business cycles during economic downturns by making corporations that are realizing losses under the regular income tax pay additional taxes under the AMT.

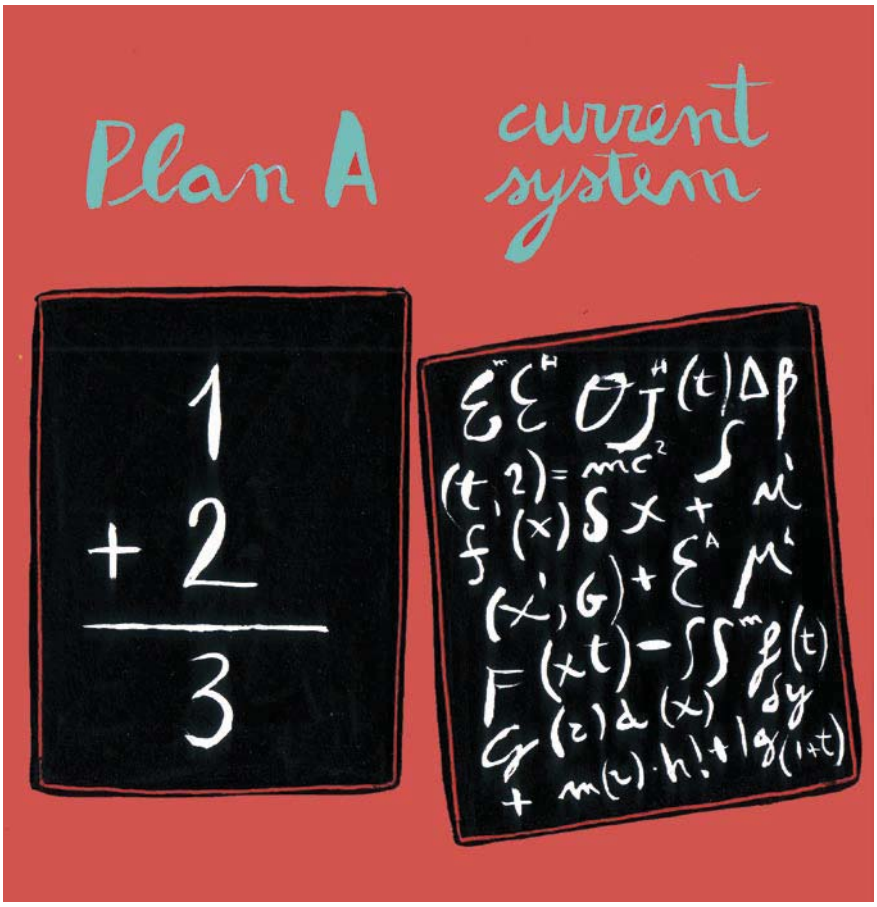
The Panel recommends the repeal of the corporate AMT, an inefficient tax that imposes enormous compliance costs on corporations relative to the amount of tax revenue it actually generates. Both of the Panel's options for reform would provide a clean tax base that is free of special breaks targeted to specific industries or business activities. Accordingly, none of the Panel's options include a second, parallel tax system like the AMT to pare back tax benefits for certain taxpayers.

Conclusion

The common elements and common principles provide a solid foundation for the Panel's reform options. The reform options described in Chapters Six and Seven represent comprehensive packages that build on these common features to provide a range of approaches to making our current tax code simpler, fairer, and more efficient.

Chapter Six

The Simplified Income Tax Plan



Courtesy of Marina Sagona

The President directed the Panel to submit at least one option using the current income tax system as a starting point for reform. The Panel developed the Simplified Income Tax Plan to meet this objective. This chapter describes the Simplified Income Tax Plan and the impact it would have on taxpayers and the economy. It begins with an explanation of the provisions of the plan, and how they would simplify the tax system for individuals and businesses. Next, it summarizes the effect of the plan on issues of tax fairness, such as tax burden and distribution. Finally, this chapter closes with a discussion of the expected impact on the economy, including improved economic output and reduced compliance and administrative costs.

The Simplified Income Tax Plan would simplify the process of filing taxes and would make it easier to predict tax consequences when planning for the future. It would consolidate and streamline a number of major features of our current code – exemptions, deductions, and credits – that are subject to different definitions, limits, and eligibility rules. It would make the tax benefits for home ownership, charitable giving, and health coverage available to more taxpayers, simpler to calculate, and

more efficient. It would repeal the AMT. It would lower tax rates, ensuring that individuals would not pay more than one-third of their income in federal income tax. And it would nearly eliminate taxes paid by individuals on income from corporate investments that are taxed in the United States.

Table 6.1 Simplified Income Tax Plan for Households

Households and Families	
Tax rates	Four tax brackets: 15%, 25%, 30%, 33%
Alternative Minimum Tax	Repealed
Personal exemption	Replaced with Family Credit available to all taxpayers: $3,300 credit for married couples, $2,800 credit for unmarried taxpayers with child, $1,650 credit for unmarried taxpayers, $1,150 credit for dependent taxpayers; additional $1,500 credit for each child and $500 credit for each other dependent
Standard deduction	
Child tax credit	
Earned income tax credit	Replaced with Work Credit (and coordinated with the Family Credit); maximum credit for working family with one child is $3,570; with two or more children is $5,800
Marriage penalty	Reduced; tax brackets and most other tax parameters for couples are double those of individuals
Other Major Credits and Deductions	
Home mortgage interest	Home Credit equal to 15% of mortgage interest paid; available to all taxpayers; mortgage limited to average regional price of housing (limits ranging from about $227,000 to $412,000)
Charitable giving	Deduction available to all taxpayers (who give more than 1% of income); rules to address valuation abuses
Health insurance	All taxpayers may purchase health insurance with pre-tax dollars, up to the amount of the average premium (estimated to be $5,000 for an individual and $11,500 for a family)
State and local taxes	Not deductible
Education	Taxpayers can claim Family Credit for some full-time students; simplified savings plans
Individual Savings and Retirement	
Defined contribution plans	Consolidated into Save at Work plans that have simple rules and use current-law 401(k) contribution limits; AutoSave features point workers in a pro-saving direction
Defined benefit plans	No change
Retirement savings plans	Replaced with Save for Retirement accounts ($10,000 annual limit) available to all taxpayers
Education savings plans	Replaced with Save for Family accounts ($10,000 annual limit); would cover education, medical, new home costs, and retirement saving needs; available to all taxpayers; refundable Saver's Credit available to low-income taxpayers
Health savings plans	
Dividends received	Exclude 100% of dividends of U.S. companies paid out of domestic earnings
Capital gains received	Exclude 75% of corporate capital gains from U.S. companies (tax rate would vary from 3.75% to 8.25%)
Interest received (other than tax exempt municipal bonds)	Taxed at regular income tax rates
Social Security benefits	Replaces three-tiered structure with a simple deduction. Married taxpayers with less than $44,000 in income ($22,000 if single) pay no tax on Social Security benefits; fixes marriage penalty; indexed for inflation

The Simplified Income Tax Plan includes a comprehensive proposal to replace the maze of rules for saving for retirement, education, and health care with a simple structure that would allow most Americans to save tax-free. The savings proposal would consolidate the numerous savings-related provisions in our current code into three simple savings plans – Save at Work, Save for Retirement, and Save for Family accounts. Low-income taxpayers would receive a match for retirement savings contributions through a refundable credit. The savings package also would ensure that income earned outside these savings accounts would be taxed the same as other income by providing for more uniform tax treatment of financial income.

For businesses, the Simplified Income Tax Plan is designed to simplify tax filing and provide a more even tax treatment of business activities for businesses of all sizes. For small businesses, the Simplified Income Tax Plan would substantially simplify taxes by allowing them to use an accounting methodology that reflects the way most entrepreneurs manage and conduct their businesses. Ninety-five percent of all businesses – those with receipts under $1 million – would report their business income based on what goes into and out of their checking account: business receipts minus business cash expenses (other than purchases of land and buildings). Medium-sized businesses – those with more than $1 million but less than $10 million in receipts – would report on the same cash basis as small businesses, but would be required to depreciate rather than expense the purchase of new assets and, in some cases, maintain inventories.

Table 6.2. Simplified Income Tax Plan for Businesses

Small Business	
Tax rates	Taxed at individual rates (top rate has been lowered to 33%)
Recordkeeping	Simplified cash-basis accounting
Investment	Expensing (exception for land and buildings)
Large Business	
Tax rate	31.5%
Investment	Simplified accelerated depreciation
Interest paid	No change
Interest received	Taxable
International tax system	Territorial tax system
Corporate AMT	Repealed

Under the Simplified Income Tax Plan, large businesses would be taxed at a single rate of 31.5 percent, significantly lower than the 35 percent rate that currently applies to most corporate income. The Simplified Income Tax Plan would provide simpler rules for business investment and eliminate many of the special tax preferences in the current code. Indeed, over 40 special provisions would be eliminated. It would also eliminate the double tax on corporate profits earned in the United States. Finally, it would provide a simpler and more efficient international tax system to reduce complexity and help American businesses of all sizes compete globally.

The Simplified Income Tax Plan also would greatly reduce compliance costs and the time and money spent doing taxes. As explained in more detail later in this chapter, the tax returns that would be filed under the Simplified Income Tax Plan would be much simpler and more straightforward. Most taxpayers would file a one-page tax return that could even fit on the front and back of a postcard. Some taxpayers would have to file additional forms or schedules, but those would be much simpler than the maze of paperwork that many taxpayers face under our current system. Because taxes would be easier to compute and file, cheating and other forms of noncompliance would be more difficult.

The Simplified Income Tax Plan would be as progressive as the current income tax. Under the Simplified Income Tax Plan, most taxpayers would pay about the same in taxes as they are expected to pay under current law. Some specific taxpayers may pay a bit more or a bit less, but most taxpayers would find that their actual tax bill is about the same. The difference is that all taxpayers would face significantly less hassle and uncertainty.

Finally, several aspects of the Simplified Income Tax Plan would promote economic growth. First, the plan would provide simplified and expanded opportunities for tax-free saving. Second, the double tax on corporate profits would be nearly eliminated. Third, there would be simplified accounting and improved investment incentives for millions of small businesses. Lastly, there would be lower marginal tax rates on individuals and businesses.

How it Works: Streamlining the Tax Process for All Taxpayers

A Simpler Tax System for Families

Under our current tax code, many families struggle with complex forms as they seek to pay their taxes accurately. Under the new system, almost half of all taxpayers would be able to file their entire tax return on a single page. The Simplified Income Tax Plan would make the process far more streamlined and simpler to understand, and would allow a family to compute their taxes after following a few easy steps:

1. Compute income from wages, interest, and dividends by copying amounts from annual forms sent to the taxpayer by employers and payers, such as W-2 or 1099 forms.
2. Compute tax by looking up the tax liability that corresponds to income in a table. Almost three-quarters of all households will pay tax on their income at the lowest tax rate.
3. Compute the value of the taxpayer's Family Credit based on family type and size; subtract that value from the tax due to find out the amount owed or to be refunded.

There are exceptions to this relatively simple process; but only three would affect substantial numbers of taxpayers, and these would not require complex calculations. These provisions cover newly designed ways to provide tax benefits for home

ownership, charitable giving, and health insurance coverage. As described in Chapter Five, the Panel recommends restructuring these tax benefits to make them simpler and fairer. For the Home Credit and charitable deduction, taxpayers would be sent forms by mortgage lenders and charities, and many taxpayers would do little more than copy the amounts from the forms onto their tax returns. Tax benefits for health insurance coverage also would be available to all taxpayers through a new deduction for health insurance. The majority of workers would not have to deal with claiming the deduction on their returns because tax-free health insurance received on the job would already be excluded from taxable wages reported to them by their employers.

Two newly designed provisions would apply only to lower-income taxpayers. Lower-income workers would be eligible to receive the refundable Work Credit described in Chapter Five, and lower-income savers would be eligible to receive the new refundable Saver's Credit, which is described below. These refundable credits would be targeted to taxpayers who have little or no federal income tax liability.

In addition, the Simplified Income Tax Plan would provide a much simpler way to measure the taxable amount of Social Security benefits. Married taxpayers who have less than $44,000 in income and single taxpayers with less than $22,000 in income would not pay tax on their Social Security benefits – about 60 percent of Social Security recipients would fall below these thresholds. As described in Chapter Five, taxpayers with income above the thresholds would include between 50 and 85 percent of their benefits in their taxable income depending on their income level – but unlike the current system, that computation would be straightforward. In addition, the new rules for calculating tax on Social Security benefits would eliminate the marriage penalties and the automatic, inflation-induced tax increases that our current code imposes.

Tax would be computed using four marginal tax rates – 15, 25, 30, and 33 percent – instead of the six rates that exist under current law. As summarized in the Table 6.3, the rate brackets for married taxpayers would be twice the amounts for unmarried taxpayers, which would reduce marriage penalties.

Table 6.3. Tax Rates Under the Simplified Income Tax Plan (2006)

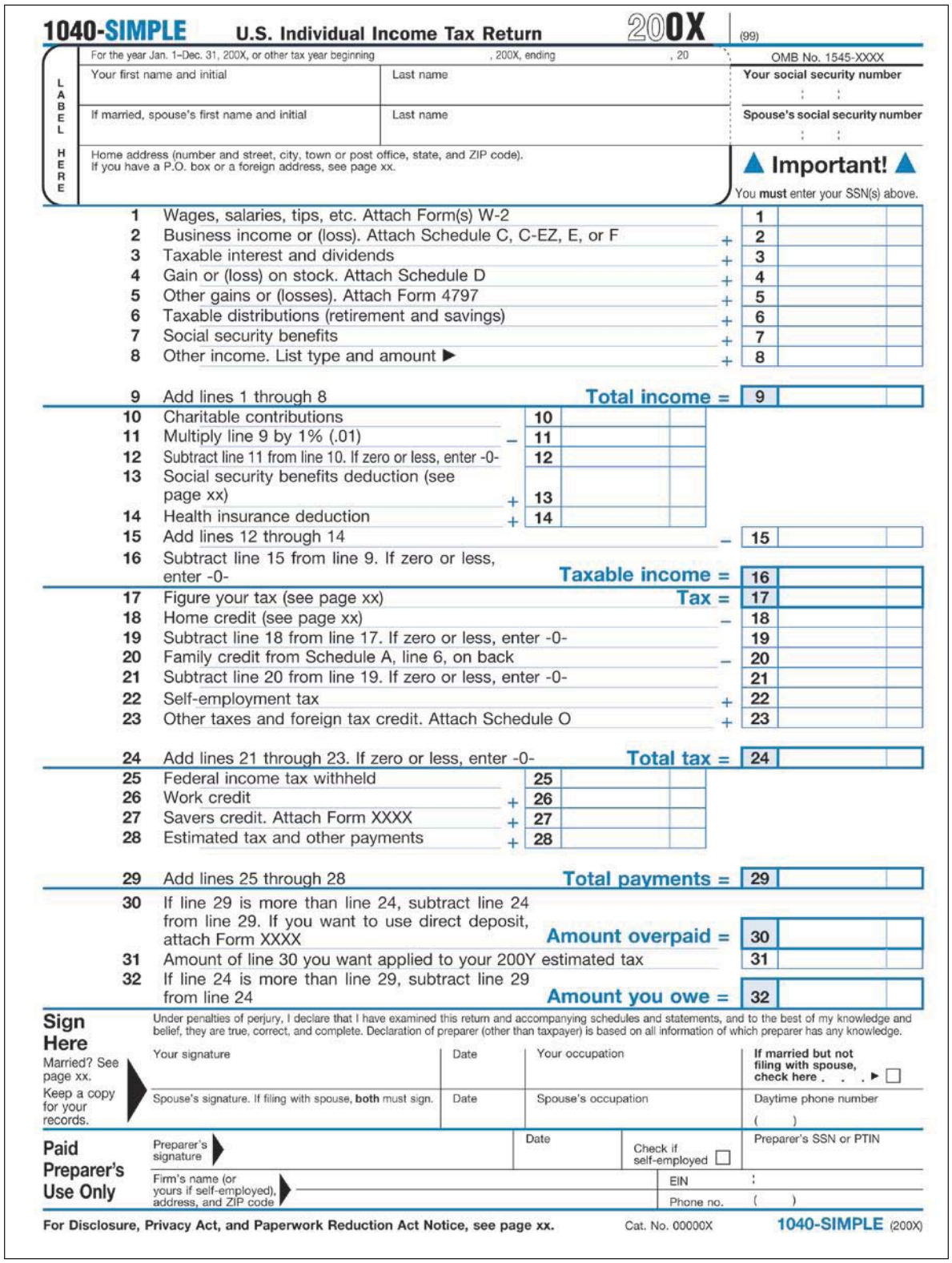
Tax Rate	Married	Unmarried
15%	Up to $78,000	Up to $39,000
25%	$78,001 - $150,000	$39,001 - $75,000
30%	$150,001 - $200,000	$75,001 - $100,000
33%	$200,001 or more	$100,001 or more

Under the Simplified Income Tax Plan, the most complicated fixtures of our current system would be eliminated. Almost every tax benefit currently available to taxpayers comes with strings attached – the benefits are reduced when taxpayers reach a specified income level. Rules that target benefits to a limited number of taxpayers through phase-outs create tremendous complexity. Almost no two benefits are phased out the same way: Phase-outs use different threshold amounts (the amount of income at which benefits begin to fade), phase-out rates (the speed at which benefits disappear), and definitions of "income." These differing rules effectively cause taxpayers to compute their income multiple ways to find out how much of the tax benefits they lose. Under the Simplified Income Tax Plan, most taxpayers would not have to worry about making numerous, complex calculations to determine whether they are eligible for a particular tax preference or applying other complicated rules designed to restrict who can claim a tax benefit. The Simplified Income Tax Plan eliminates almost all of these phase-outs.

One of the most conspicuous complexities in our current system is the AMT. As discussed previously, the AMT is a parallel tax structure that requires taxpayers to recompute their tax liability using a new definition of income, different exemption amounts, different deductions and credits, and separate tax rates. The AMT takes back tax benefits that have previously been given to taxpayers through a complicated and deceptive mechanism. The AMT also makes it difficult for taxpayers to predict their tax liability in advance. If not repealed, millions more middle-class Americans will face a tax increase each year, as well as additional complexity and compliance costs. Under the Simplified Income Tax Plan, taxpayers would only be required to make *one* straightforward set of computations to determine their share of the cost of government. The Simplified Income Tax Plan would not rely on a backstop or second set of rules like the AMT.

Simpler and more straightforward rules would result in simpler tax returns and forms. The new Form 1040-Simple that would be used under the Simplified Income Tax Plan is easy to understand and involves calculations that are intuitive. As shown in Figure 6.1, the Form 1040-Simple would be no longer than one page. It would be a tremendous simplification as compared to the current Form 1040.

Figure 6.1. Form 1040-Simple



1040-SIMPLE U.S. Individual Income Tax Return **20OX** (99)

For the year Jan. 1–Dec. 31, 200X, or other tax year beginning , 200X, ending , 20 — OMB No. 1545-XXXX

LABEL HERE

Your first name and initial / Last name	Your social security number
If married, spouse's first name and initial / Last name	Spouse's social security number
Home address (number and street, city, town or post office, state, and ZIP code). If you have a P.O. box or a foreign address, see page xx.	▲ Important! ▲ You must enter your SSN(s) above.

1	Wages, salaries, tips, etc. Attach Form(s) W-2		1	
2	Business income or (loss). Attach Schedule C, C-EZ, E, or F	+	2	
3	Taxable interest and dividends	+	3	
4	Gain or (loss) on stock. Attach Schedule D	+	4	
5	Other gains or (losses). Attach Form 4797	+	5	
6	Taxable distributions (retirement and savings)	+	6	
7	Social security benefits	+	7	
8	Other income. List type and amount ▶	+	8	
9	Add lines 1 through 8	Total income =	9	
10	Charitable contributions	10		
11	Multiply line 9 by 1% (.01)	– 11		
12	Subtract line 11 from line 10. If zero or less, enter -0-	12		
13	Social security benefits deduction (see page xx)	+ 13		
14	Health insurance deduction	+ 14		
15	Add lines 12 through 14	–	15	
16	Subtract line 15 from line 9. If zero or less, enter -0-	Taxable income =	16	
17	Figure your tax (see page xx)	Tax =	17	
18	Home credit (see page xx)	–	18	
19	Subtract line 18 from line 17. If zero or less, enter -0-		19	
20	Family credit from Schedule A, line 6, on back	–	20	
21	Subtract line 20 from line 19. If zero or less, enter -0-		21	
22	Self-employment tax	+	22	
23	Other taxes and foreign tax credit. Attach Schedule O	+	23	
24	Add lines 21 through 23. If zero or less, enter -0-	Total tax =	24	
25	Federal income tax withheld	25		
26	Work credit	+ 26		
27	Savers credit. Attach Form XXXX	+ 27		
28	Estimated tax and other payments	+ 28		
29	Add lines 25 through 28	Total payments =	29	
30	If line 29 is more than line 24, subtract line 24 from line 29. If you want to use direct deposit, attach Form XXXX	Amount overpaid =	30	
31	Amount of line 30 you want applied to your 200Y estimated tax		31	
32	If line 24 is more than line 29, subtract line 29 from line 24	Amount you owe =	32	

Sign Here

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Married? See page xx. Keep a copy for your records.

Your signature	Date	Your occupation	If married but not filing with spouse, check here . . . ▶ ☐
Spouse's signature. If filing with spouse, **both** must sign.	Date	Spouse's occupation	Daytime phone number ( )

Paid Preparer's Use Only

Preparer's signature	Date	Check if self-employed ☐	Preparer's SSN or PTIN
Firm's name (or yours if self-employed), address, and ZIP code		EIN :	
		Phone no. ( )	

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page xx. Cat. No. 00000X **1040-SIMPLE** (200X)

For the approximately 38 percent of taxpayers who have children and other dependents, the Family Credit would be claimed on new Schedule A, which would assist taxpayers in making the straightforward computation. Computation of the refundable Work Credit would follow from the simple Family Credit computation on Schedule A. Taxpayers could even indicate their desire for the IRS to calculate the Work Credit for them by checking a box on new Schedule A. In total, 75 percent of current law filers would file, at most, the Form 1040-Simple and Schedule A.

The proposed tax forms take into account both the Panel's reform proposals and a number of other refinements that would reduce compliance burdens and streamline return processing. The Panel recognizes that some of these refinements reflect a departure from the way the IRS currently constructs and processes Form 1040.

This simplification would have a real impact on millions of Americans. The Simplified Income Tax Plan would reduce the time individuals spend doing their taxes and the records they have to keep. The Simplified Income Tax Plan also would reduce taxpayers' out of pocket costs for help with tax preparation and allow more taxpayers to prepare their own tax returns if they so choose. More importantly, under the Simplified Income Tax Plan, taxpayers would have a better understanding of how their taxes are computed.

Perhaps more valuable would be the greater confidence a simplified system would engender in our tax code. Taxpayers could file their taxes knowing they had determined their tax liabilities correctly. Taxpayers would feel more confident that they had not overlooked tax benefits available to them and that others are paying their fair share. The simpler and more transparent tax system also would be less susceptible to tax avoidance.

The greater transparency under the Simplified Income Tax Plan also would allow taxpayers to make better and more efficient economic decisions. Planning for the future – how much to save, for example – would no longer be complicated by the tax code's current set of elaborate rules. In addition, there would be fewer unpleasant surprises each April because taxpayers would not be caught off guard by phase-outs and the AMT that force them to pay more taxes than anticipated.

A Comprehensive Proposal To Remove Impediments to Saving

As described in Chapter Five, the current tax system discourages saving by imposing a higher tax on those who choose to save than those who spend. The Simplified Income Tax Plan includes a comprehensive package of savings proposals designed to allow Americans to save in a simple and efficient manner. The savings proposal consists of three parts. First, it would replace the current tax code's plethora of savings incentives with a unified system of expanded savings opportunities. Second, it would provide a refundable credit as an incentive for lower-income taxpayers to save. Third, it would introduce a more consistent treatment of savings held outside of tax-preferred accounts. The Panel believes that all components of this package should be considered together, and would not necessarily recommend adoption of some components without the others.

Flexible, Convenient, and Straightforward Savings Opportunities

The first component of the Simplified Income Tax Plan's savings proposals would combine the tax code's panoply of savings incentives and accounts into three simple and flexible opportunities: (1) Save at Work plans; (2) Save for Retirement accounts; and (3) Save for Family accounts. The Save at Work plans would incorporate changes to the way plans are administered, referred to as "AutoSave," that are designed to point workers in the direction of savings. The creation of these three opportunities would allow most Americans to save for their future financial needs, such as education, health costs, a new home, or retirement, free of tax. They would also largely eliminate the need for taxpayers to hire tax professionals to help them navigate the tax code's multitude of savings incentives. Americans would be able to make investment decisions based more on their preferred investment strategy, rather than the effects that certain tax-preferred investment vehicles have on their tax liability.

Save at Work

For millions of Americans, employer-provided retirement plans have been an integral part of retirement security. Over 90 million workers utilize some type of tax-preferred retirement savings plan at work. The benefits of employer-sponsored retirement savings accounts are not evenly distributed among the population, however. Taxpayers whose employer offers a retirement plan pay less tax on their income than those whose employers do not. In addition, employees who work for employers that offer tax-free matching contributions receive more favorable treatment than those whose employers do not offer a match.

The rules covering tax-preferred retirement savings are among the most complex in the tax code and may be a barrier to additional retirement saving by workers. Current law provides a number of different plans, including 401(k), SIMPLE 401(k), Thrift, 403(b), governmental 457(b), SARSEP, and SIMPLE IRA plans, that offer different kinds and amount of benefits to employees and are subject to different rules and standards. This variation and complexity creates high administrative and compliance costs. Those costs often prove to be a deterrent to employer sponsorship of retirement plans, making such tax-preferred savings unavailable to many workers. Only about 53 percent of private employers offer a defined contribution retirement plan to their workers. Administrative costs are a particular problem for small firms – less than 25 percent sponsor any retirement plan.

Small employers, which employ about 40 percent of American workers, can choose to offer either a 401(k) or SIMPLE IRA plan to employees, but each provides different rules governing employee eligibility, contribution amounts, catch-up amounts, and employer matching limits, among other features as summarized in Table 6.4. These different rules create significant obstacles for small employers because they find it difficult to determine which plan best fits the needs of their employees at the lowest cost.

Table 6.4. Example of Variation in Small Employer Retirement Plans		
	401(k) Plan	**SIMPLE IRA Plan**
Pre-tax Contribution Amount	$14,000 in 2005	$10,000 in 2005
Catch-Up Amounts	$4,000 in 2005	$2,000 in 2005
Employer Matching	May be matching and/or nonelective	*Either* a full match on elective contributions up to 3% of pay or 2% nonelective contribution
Nonelective Contributions	Matching not limited to 3% and match may be less than full	Nonelective contributions limited to 2% of pay
Discrimination Testing	Yes	No
Vesting	Vesting schedule may be added	Full vesting of employer contribution
Top Heavy Contributions	May be required	Not required
Plan Loans	Permitted	Not permitted
Other Plans	May adopt other qualified plans	May not sponsor any other SIMPLE plan or qualified plan
Pooling of Plan Assets	May pool §401(k) contributions into a single trust invested by trustee	Individual assets within IRAs invested by employees
Eligibility	Eligibility may exclude employees with less than 1,000 hours of service	Eligibility must include employee who earns $5,000 or more during calendar year
ERISA Applicability	Protects benefits from creditors	Not applicable
Required Return	Form 5500 annual filing	No Form 5500 filing

The complexity of employer-sponsored retirement savings plans also affects employees. Account holders have to negotiate convoluted rules when changing jobs, for example. Given that job change is a feature of today's workforce, complexity in handling retirement savings disrupts workers' retirement savings patterns. It is not uncommon for a worker to have multiple 401(k) accounts spread out among past employers, each holding modest amounts. It is also not uncommon for separated workers to withdraw funds from a 401(k) plan, pay tax and an additional penalty, and spend what is left – instead of moving the funds into a new tax-preferred savings vehicle. The most recent studies suggest as of 1996, a sizable majority of workers who receive a lump-sum distribution of $5,000 or less from their former employer's retirement plan do not roll it over to another qualified plan or IRA, reducing the funds set aside to support the employee's future retirement.

The employer-provided Save at Work retirement plan would combine 401(k), SIMPLE 401(k), Thrift, 403(b), governmental 457(b), SARSEP, and SIMPLE IRA plans into a single type of plan that could be easily established by any employer. To encourage employers to make the Save at Work accounts available to their employees, a single set of administrative rules would be established. Save at Work plans would be less expensive for employers to administer, reducing compliance costs. In addition, the AutoSave features described below would change the administrative rules to encourage greater savings by workers. Save at Work plans would follow the existing contribution limits and rules for 401(k) plans, but the plan qualification rules would be greatly simplified.

Under current law, there are a number of complicated rules that ensure that highly compensated employees do not enjoy undue benefits from tax-deferred saving plans. These rules, known as "nondiscrimination requirements" generally apply a set of tests that ensure that highly compensated employees do not receive disproportionately high benefits relative to other employees. To simplify administration, Save at Work plans would apply a single test to ensure that employee contributions are not skewed towards highly compensated employees. In addition, an alternative rule would be provided to allow employers to avoid nondiscrimination testing altogether if the Save at Work plan is designed to provide consistent employer contributions to each plan participant, regardless of their compensation.

The Save at Work option also would include rules for small businesses to help reduce costs and encourage them to offer plans. Small employers with 10 or fewer employees could contribute to a Save at Work account largely controlled by the employee and similar to current-law SIMPLE IRAs. Like current-law SIMPLE IRAs, small business owners would not be required to file annual returns for these accounts and would not be subject to the same legal liability rules that apply to larger employer-sponsored plans.

Box 6.1. Eliminating Impediments to Saving Through Better Retirement Plan Design

Employer-provided retirement plans are designed to eliminate impediments to saving by reducing the tax on returns to savings. But studies have found that the return on savings is not the only factor that influences savings decisions: The structure of retirement savings plans and the way employers present them to employees affects their decisions to save.

Currently, participation in most employer-sponsored plans is dependent on the worker actively choosing to participate. Until recently, most believed that the voluntary aspects of employer-sponsored retirement savings had little to do with participation. In fact, a number of recent studies show the exact opposite result.

One study, focusing on firms that automatically enrolled their employees in the savings program unless the employee actively chose not to participate found significant increases in employee participation and contribution levels. In some cases, participation rates doubled to more than 90 percent. Employees also tended to adopt the default contribution amount and asset allocations, which invested employee contributions in balanced and diversified investment funds.

In another study, employees were given the option to commit a share of future salary increases to savings. Nearly 80 percent of employees who were offered the plan chose to participate and savings rates for participants more than tripled in just 28 months.

The study also found that default rules for disbursement when employees leave their jobs influence decisions to continue saving. If cash disbursement of retirement balances is the default option, employees tend to accept cash instead of putting the funds back into a tax-free savings account. On the other hand, employees whose default option was to automatically move the funds into an IRA or other retirement plan continued to save these funds.

AutoSave

The Save at Work plan would be accompanied by a number of features, referred to as AutoSave, that are designed to point workers in the direction of sound saving and investment decisions. Firms would be permitted, but not required, to include AutoSave as part of their retirement plan structure. The Panel's recommendation would remove restrictions that may currently discourage employers from implementing AutoSave. The AutoSave program would incorporate the following features:

- Automatic Enrollment in Save at Work – Employees would automatically become participants in their employer's Save at Work plan unless they actively choose not to participate.
- Automatic Growth in Save at Work Contributions – The employee contribution percentage would automatically increase over time – either through scheduled periodic increases or increases conditioned on pay raises over time – to boost the proportion of earnings set aside and total accumulated retirement savings.
- Automatic Investment of Save at Work Contributions – Employee contributions would be invested in balanced, diversified alternatives with low fees, such as broad index or life-cycle funds, unless the employee elects different investment alternatives.

- Automatic Rollover – Upon leaving a job, an employee's Save at Work plan balance would be retained in the existing plan or would be automatically transferred to a Save at Work account with their new employer, or to a rollover Save for Retirement account. Automatic rollover would ensure that amounts put aside for retirement continue to grow.

None of the AutoSave features would be mandatory and employees would be able to opt out of AutoSave at any time. Furthermore, employers would choose which default to use. The AutoSave features do not dictate choices, but merely point workers in a pro-saving direction when they fail to indicate their saving preferences. Provisions to ensure that employees retain control over enrollment and investment decisions would be incorporated. AutoSave plans would be required to provide participants with advance notice and an adequate opportunity to make their own, alternative choices before proceeding with the default option.

The Panel recommends that the following provisions be adopted as part of its AutoSave proposal. First, current law should be clarified to confirm that federal laws permitting automatic payroll deductions for retirement plans supersede any state laws that might prohibit this practice. Second, fiduciary liability protection against investment losses would be extended to sponsors of Save at Work plans that incorporate AutoSave features to the same extent provided by current law to all plans in which the employee exercises control over the investment of plan assets. Third, AutoSave plans would be entitled to discrimination testing that is less stringent than current law. Finally, to demonstrate leadership in this area, the Panel also recommends that the federal government adopt Auto-Save for its Thrift Savings Plan.

Save for Retirement

Save for Retirement accounts would allow taxpayers to supplement their Save at Work retirement savings by putting up to an additional $10,000 (or the total amount of earnings, if less) in tax-free accounts. The annual contribution amount would be indexed annually for inflation. No income limits would apply to Save for Retirement accounts.

The Save for Retirement accounts would replace existing IRAs, Roth IRAs, Nondeductible IRAs, deferred executive compensation plans, and tax-free "inside buildup" of the cash value of life insurance and annuities. Contributions would be made with after-tax dollars like current law Roth IRAs and earnings would grow tax-free.

Roth IRAs would be automatically converted to Save for Retirement accounts. Existing traditional IRAs (including those to which nondeductible contributions were made) could be converted into a Save for Retirement account by subjecting the value of those accounts to taxes once, similar to a current-law conversion of a traditional IRA account to a Roth IRA account. No income limits would restrict conversions. Similarly, upon separation, Save at Work plans could be rolled directly from an employer plan into a Save for Retirement account by paying income tax on the rollover amount. Existing traditional IRAs not converted into a Save for

Retirement account would continue to exist, but new contributions would have to be made to Save for Retirement accounts.

The Save for Retirement accounts are intended to supplement, not replace, retirement savings incentives provided through Save at Work accounts. The Save for Retirement accounts are proposed as part of a savings package that includes the Save at Work and AutoSave proposals, which are designed to ensure that the cost to employers of sponsoring a plan would be low and that more workers participate in employer-sponsored retirement plans.

To increase the likelihood that money set aside for retirement would not be spent early, Save for Retirement accounts would restrict distributions. Tax-free distributions from Save for Retirement accounts could be made only after age 58, or in the event of death or disability. Earlier distributions would be treated as taxable income and would be subject to an additional 10 percent tax, similar to the penalty paid on early withdrawals from Roth IRAs under current law. No minimum distribution rules would apply.

Under current law, there are exceptions for early withdrawal for education, first-time home buyer expenses, and medical expenses. These exceptions would no longer be necessary under the Simplified Income Tax Plan because Save for Family accounts, described below, would provide a separate vehicle to save for these important family needs.

Save for Family

The Simplified Income Tax Plan would provide flexible Save for Family accounts that could be used by taxpayers for retirement, health, education and training, or a down payment on a home. Save for Family accounts would allow every taxpayer to save $10,000 each year for these major expenditures, and would replace existing education and medical accounts, including Coverdell Education Savings Accounts, Section 529 Qualified Tuition Plans, Health Savings Accounts, Archer Medical Savings Accounts, and employer-provided Flexible Spending Accounts. In addition, Save for Family accounts could be used to supplement retirement savings.

All Americans, regardless of income, age, family structure, or marital status, could have a Save for Family account. Contributions would be made on an after-tax basis, and like current-law Roth IRAs, earnings would grow tax-free. Existing education and health savings plans could be converted to Save for Family accounts. Existing accounts that are not converted would continue, but all new contributions would be made to Save for Family accounts.

Tax-free withdrawals from Save for Family accounts could be made at any time to pay qualified expenditures for health or medical costs, education or training expenses, and purchases of a primary residence. As with Save for Retirement accounts, funds would be available tax-free at any time to taxpayers who are 58 or older.

To provide taxpayers even greater flexibility and to reduce record-keeping burdens, taxpayers would be able to withdraw up to $1,000 tax-free each year from Save for

Family accounts for any reason. Distributions in excess of $1,000 that are not for qualified expenditures would be treated as taxable income and would be subject to an additional 10 percent tax, similar to the penalty paid on early withdrawals from Roth IRAs under current law. No minimum required distribution rules would apply.

Figure 6.2. Summary of Simplification Created by New Save for Retirement and Save for Family Accounts

Retirement Accounts	
Description	**Contribution Limit**
IRAs[1,2]	$4,000 ($5,000 in 2008)[1]
Roth IRAs[1]	$4,000 ($5,000 in 2008)[1]
Health Incentives	
Description	**Contribution Limit**
Health Savings Accounts (HSAs)[2]	$2,600 single/$5,150 family
Archer MSAs[2] (small businesses and self-employed)	75 percent of deductible for high deductible health plan
Flexible Spending Arrangements[2]	Unlimited (but portion may be forfeited if not used within prescribed time periods)
Education Savings Incentives	
Description	**Contribution Limit**
Coverdell Savings Accounts	$2,000 (per student)
Qualified Tuition Programs (529s)	Effectively unlimited
Savings Bonds	Interest excludible up to qualified higher education expenses[1]
Other Tax Preferred Savings	
Description	**Contribution Limit**
Life Insurance	Unlimited
Executive Deferred Compensation	Unlimited

→ **Save for Retirement Accounts** ($10,000 annual contribution limit)

→ **Save for Family Accounts** ($10,000 annual contribution limit)

[1] Contribution limit may phase out based on income.
[2] Contributions made to these accounts are excluded from income.

The New Refundable Saver's Credit

The Simplified Income Tax Plan savings proposals are designed to increase the likelihood that taxpayers will save more and to help establish a habit of saving and familiarity with the financial markets. As noted in Chapter Three, the progressivity of our current income tax relieves many lower-income Americans from paying any tax. The tax-free features of the Save at Work, Save for Retirement, and Save for Family accounts therefore would provide little, if any, additional tax benefit if these taxpayers save for their future. The second component of the Simplified Income Tax Plan's savings proposal would provide a subsidy for lower-income taxpayers to save.

Under current law, taxpayers with low to moderate incomes are eligible to receive the credit for qualified savings contributions (sometimes referred to as the "saver's credit"). The saver's credit provides a credit for 10, 20, or 50 percent of contributions of up to $2,000 made to an Individual Retirement Account (IRA) or an employer-sponsored defined contribution plan. The credit is phased out as the taxpayer earns more.

This credit is scheduled to expire after 2006. In addition, it has several design flaws that make it less effective than it could be in encouraging low-income taxpayers to save. Because the credit is nonrefundable, lower-income taxpayers who do not have tax liability receive no benefit from the credit. The combination of nonrefundability and income phase-outs as taxpayers earn more means that many taxpayers are unable to receive the full amount of the credit. The maximum credit of 50 percent is available to married couples with adjusted gross income (AGI) up to $30,000, head of household filers with AGI up to $22,500, and single filers with AGI up to $15,000, but quickly phases down to 10 percent once the taxpayer earns income above these thresholds. Head of household and single taxpayers are unable to receive the maximum $1,000 credit because their tax liability over the range where the 50 percent credit is applicable is always below $1,000. The complexity of the credit, its limited benefit to the targeted taxpayer group, and a lack of awareness of the credit have all contributed to its underutilization.

Recent studies suggest that lower-income taxpayers are responsive when given clear incentives to contribute to retirement accounts. These studies suggest that the presence of a meaningful match that is presented at the time of tax preparation can have a sizeable impact on the percentage of lower-income taxpayers who save and the amounts saved.

The Simplified Income Tax Plan would replace the current law credit with a new refundable Saver's Credit that would be available to more lower-income taxpayers. The maximum annual contribution eligible for the credit would be $2,000 and the credit rate would be 25 percent, making the maximum credit amount $500. This 25 percent credit would effectively provide an implicit government match rate of 33 percent: a $2,000 contribution reduces the taxpayer's income tax liability by $500, so the taxpayer's net contribution of $1,500 results in an account balance of $2,000.

The amount of the new Saver's Credit is calculated on a per-person basis. Although eligibility for the new Saver's Credit would be gradually reduced as taxpayers earn

more than $30,000 if married and $15,000 if single, it would be fully refundable. The credit would phase-out smoothly at a rate of 5 percent: each additional $100 of earnings would reduce the credit amount by $5. The credit would be completely phased out at income levels of $40,000 for married couples and $25,000 for single taxpayers. To help encourage new savings and prevent taxpayers from merely shifting savings from one tax-preferred account to another, the credit would be required to be deposited into a Save for Retirement or a restricted Save for Family account. The restricted Save for Family account would not permit annual $1,000 unrestricted withdrawals. If the taxpayer has not qualified for a match in five years, the funds in the restricted Save for Family account could be transferred to a regular, unrestricted Save for Family account.

It is also important that the taxpayer would not, by reason of depositing savings that qualify for the Saver's Credit, lose eligibility for other means-tested programs, such as food stamps, temporary assistance for needy families, or Pell Grants. Thus, the Panel recommends that these assets be ignored for purposes of determining whether the taxpayer is eligible for a means-tested federal assistance program.

Leveling the Playing Field for Savings

An important element of the savings proposals included in the Simplified Income Tax Plan would provide a more neutral treatment for financial income earned outside of Save for Retirement, Save for Work, or Save for Family accounts. Currently, there are no annual limits on the tax benefits for certain deferred compensation arrangements and increases in the cash-value of annuities and life insurance. The Panel recommends that new rules be put in place to treat these arrangements like other investments.

Some life insurance policies and annuities allow for nearly unlimited tax-free savings. Currently, there is no taxable income until the policy is cashed in, even though the policyholder is receiving the benefit of increases or "inside build-up" in the value of the policy or annuity. In addition, withdrawals from policies are taxed favorably.

Under the Simplified Income Tax Plan, the increase in value in those policies would be treated as current income, and therefore would be subject to tax on an annual basis, just like a savings account. As with other financial investments, such as stocks or bonds, whole-life insurance policies and deferred annuities could be purchased through tax-deferred Save for Retirement and Save for Family accounts, subject to the same dollar limits. Life insurance that cannot be cashed out and annuities that provide regular, periodic payouts of substantially equal amounts until the death of the holder (known as life annuities) would not be taxed on an inside build-up, the same treatment as under current law.

The Simplified Income Tax Plan also would eliminate the ability of some taxpayers to save tax-free through the use of executive deferred compensation plans. These plans allow executives to elect to defer a portion of their compensation in order to receive an amount later that has grown tax-free. Recently enacted legislation tightened the rules applicable to deferred executive compensation, but retained a number of

exceptions that allow tax-free growth on deferred wages. The Simplified Income Tax Plan would require all amounts deferred under a nonqualified deferred compensation plan to be included in income to the extent these amounts are not subject to a substantial risk of forfeiture and were not previously included in income.

Annuities, life insurance arrangements, and deferred compensation plans that currently are in existence would continue to be taxed under current-law rules.

Currently, interest earned on tax-exempt bonds is not taxed. Providing an incentive for investment in public infrastructure is seen as sensible public policy that is widely valued. Similar to preferences for home ownership, charitable giving, and health coverage, the Panel chose to maintain current law treatment of state and local tax-exempt bonds for individual investors. The Panel recommends, however, that because of the flexibility businesses have to deduct interest, the exclusion from business income for state and local tax-exempt bond interest be eliminated. Although current law disallows interest paid by businesses to buy or carry tax-exempt bonds, the rule is difficult to administer and easy to avoid.

As under current law, individual investors would be able to deduct the amount of interest incurred to generate taxable investment income. The deduction for investment interest would be limited to the amount of taxable investment income reported by a taxpayer.

Taxing Corporate Earnings Once

The Simplified Income Tax Plan also would improve the environment for business investment by reducing the double taxation of corporate income earned in the United States. In our current system, business income is taxed twice – once when earned by the corporation and a second time when shareholders receive dividend distributions out of profits or realize capital gains from the sale of stock. The Simplified Income Tax Plan would allow shareholders to exclude from income the value of dividends received from corporations that are paid out of profits on which tax is paid in the United States.

Under the Simplified Income Tax Plan, corporations would notify shareholders of the portion of dividends that would be subject to tax – this would be based on the proportion of income not subject to U.S. taxation during the prior year. Shareholders would pay tax only on the reported proportion of dividends not based on income taxed in the United States during the prior year. For example, if in the prior year a firm reported taxable income of $800 in the United States out of total worldwide income of $1,000, shareholders would be taxed only on 20 percent ($200 divided by $1,000) of dividends received during the following year. Requiring corporations to publicly report to their shareholders and the IRS the proportion of profits that were taxed in the United States also would make the tax system more transparent by directly informing shareholders how much of their income is taxed in the United States.

The Panel considered, but rejected, extending the exclusion for corporate dividends to amounts paid by U.S. corporations out of income earned abroad. Under the territorial system recommended as part of the Simplified Income Tax Plan, earnings from active foreign operations of U.S. corporations would be excluded from U.S. tax. A dividend exclusion for foreign earnings of U.S. corporations would require raising revenue elsewhere, thereby causing U.S. taxpayers to subsidize foreign operations of U.S. corporations. In addition, dividends received by U.S. shareholders from foreign corporations would not receive an exclusion. The Panel considered extending the exclusion for dividends paid from U.S. corporations to dividends paid from foreign corporations, but concluded that it would not be possible to implement a workable plan to determine the portion of dividends paid out of profits of foreign corporations on which U.S. tax had been paid.

Of course, dividends are not the only way shareholders benefit from corporate earnings. Earnings that are not distributed to shareholders as dividends, but are retained by corporations and reinvested in new projects, increase the value of the corporation's stock. Shareholders realize this increase in value as capital gains when they sell their shares. To reduce double taxation of corporate earnings retained by U.S. corporations, the Simplified Income Tax Plan would exclude 75 percent of capital gains received by individuals on sales of U.S. corporations if the individual held the stock for more than one year. This treatment would lower the capital gains rate on sales of corporate stock to a maximum of 8.25 percent. For example, if a shareholder recognizes $100 of capital gain on the sale of stock, only 25 percent, or $25, would be subject to tax at ordinary rates. A taxpayer in the top 33 percent tax bracket would pay $8.25, or 8.25 percent, in tax, while a taxpayer in the lowest 15 percent tax bracket would pay $3.75, or 3.75 percent, in tax.

The Panel considered more complicated regimes that would more precisely track the amount and timing of dividends and capital gains that should be exempt from shareholder-level tax based on the amount of income on which U.S. tax was paid at the business level. These regimes would require shareholders to track increases in the basis of their stock on an annual basis to more accurately level the playing field between dividend distributions and retained earnings. The Panel rejected these more complicated regimes in favor of the 100 percent dividend exclusion and the 75 percent exclusion of capital gains on stock sales because these approaches provide simpler ways of reducing the double tax on earnings of U.S. corporations. The treatment represents an area where the Panel made a tradeoff in favor of simplicity over more precise calculations.

Taken together, the exclusion from income for domestic dividends and 75 percent of capital gains from U.S. corporate stock sales would substantially reduce the tax rate on investment in America's companies. It also would introduce greater efficiency in the way American investors deploy their capital and choose between corporate and non corporate investments. It would likely result in increased investment in corporate equity. Additional information regarding the treatment of corporate dividends and capital gains can be found in the Appendix.

Capital Gains

The sale of corporate stock is just one way individuals can earn capital gains. Individuals also realize capital gains when they sell other kinds of assets. Under current law, capital gains of both corporate and non-corporate investments are taxed at a maximum rate of 15 percent (the rate is 5 percent for taxpayers in lower tax brackets). By providing a special rate for all capital gains, the current tax code fails to fully eliminate the double tax on corporate retained earnings, while providing a generous tax break on other kinds of gains.

The Simplified Income Tax Plan would tax all gains, other than those on the sale of stock of U.S. corporations, at the taxpayer's regular tax rates. The Simplified Income Tax Plan would therefore raise the tax rate on some capital gains for higher-income individuals, while lowering the rate for all investors in corporate stock. This treatment would greatly simplify reporting of income from capital gains and the separate provisions described above would achieve the objective of reducing the double taxation of corporate retained earnings. Taxing capital gains at the same tax rate that applies to other income also would eliminate the need for a host of complex rules for the recapture of tax on the sales of assets by small businesses that take advantage of the new simplified and expanded expensing of investments described below.

One type of capital gain that receives special treatment under our current tax system is the gain on the sale of housing. Under current law, taxpayers may exclude a substantial amount of the gains on the sale of their primary residences from income (the exclusion amount is up to $500,000 if the taxpayer is married and up to $250,000 if single) if the home was owned and used as a principal residence for two or more of the preceding five years. Gains in excess of this amount are taxed at the capital gains rate, which is up to 15 percent under current law. Taxing capital income at the same rate as other income may mean that some taxpayers would pay a higher tax rate on capital gains from selling their homes than they do under current law. To help ensure that there is not an increase on the overall taxation of owner-occupied housing, the Panel recommends that the current law exclusion be increased to $600,000 ($300,000 for singles), an amount roughly equal to the current-law exclusion if it had been indexed for inflation since its enactment in 1997. As described in Chapter Five, the Panel recommends that the exclusion would apply only if a home was used as a principal residence for at least three of the preceding five years, instead of two of the preceding five years under current law. The $600,000 figure would be indexed annually for inflation. This proposal would ensure that capital gains on the sale of a home would be free from taxation for a great majority of American home sellers.

A Simpler Tax System for Businesses

The tax imposed on a business under current law turns on a number of factors, including the legal form of the business, the type of business activity, and the type of investment a business makes. The result is a tax system for businesses that is overly complex and inefficient. The Simplified Income Tax Plan would simplify the tax system for all businesses, remove subsidies for favored industries and activities, and

replace the current system with one that taxes business income more uniformly and lowers the overall tax burden.

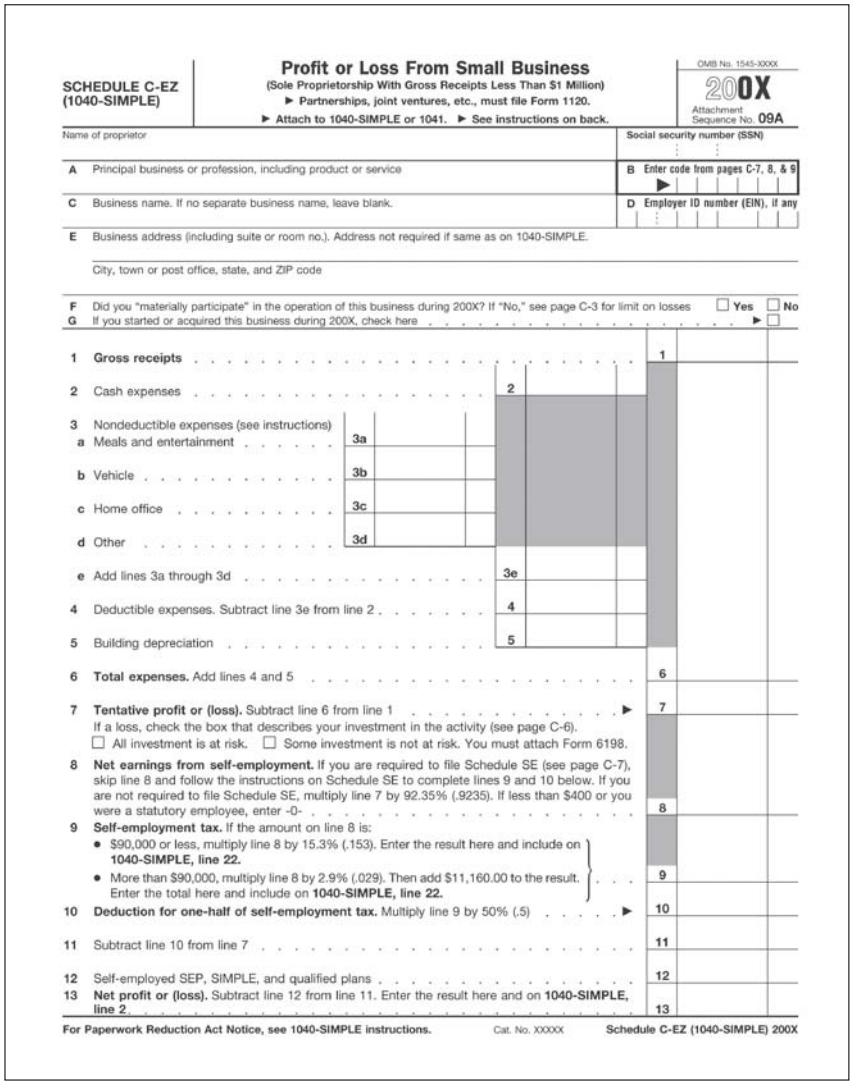
Small Business Rules Designed for Small Businesses

As described in Chapter Five, small business owners bear disproportionately higher compliance costs as a result of the complexity of our tax system. Under the Simplified Income Tax Plan, businesses with less than $1 million in receipts would no longer be required to maintain their books and records using the multitude of complex accounting rules found in our tax code. This would provide greater simplicity for more than 22 million small businesses, which account for more than 95 percent of all businesses. Under the Simplified Income Tax Plan, noncorporate small businesses would report income based on cash receipts less cash business expenses. Simplified cash accounting would be extended to almost all items of income and deductions, except for purchases of land and buildings.

This expanded cash accounting would make tax filing extremely straightforward for most small businesses. They would simply use their existing records as a basis for establishing their income and expenses. By comparison, today's rules require many small businesses to separately track and compute depreciation, amortization schedules, inventory, capitalized expenditures, and other items that require special accounting for taxes. In addition, abolishing the AMT would eliminate another set of complex tax computations. Figure 6.3 shows the new simple form that millions of sole proprietors would use to report their business income.

As described in Chapter Five, small-business owners would have greater flexibility to immediately write-off purchases of new assets, such as new tools, software, and equipment – extending and expanding current-law rules that

Figure 6.3. New Schedule C under the Simplified Income Tax Plan



SCHEDULE C-EZ (1040-SIMPLE)

Profit or Loss From Small Business
(Sole Proprietorship With Gross Receipts Less Than $1 Million)
► Partnerships, joint ventures, etc., must file Form 1120.
► Attach to 1040-SIMPLE or 1041. ► See instructions on back.

OMB No. 1545-XXXX
20**0X**
Attachment Sequence No. 09A

Name of proprietor | Social security number (SSN)

A Principal business or profession, including product or service | B Enter code from pages C-7, 8, & 9 ►

C Business name. If no separate business name, leave blank. | D Employer ID number (EIN), if any

E Business address (including suite or room no.). Address not required if same as on 1040-SIMPLE.

City, town or post office, state, and ZIP code

F Did you "materially participate" in the operation of this business during 200X? If "No," see page C-3 for limit on losses ☐ Yes ☐ No

G If you started or acquired this business during 200X, check here ►☐

1 **Gross receipts** . . . 1

2 Cash expenses . . . 2

3 Nondeductible expenses (see instructions)
a Meals and entertainment . . . 3a
b Vehicle . . . 3b
c Home office . . . 3c
d Other . . . 3d

e Add lines 3a through 3d . . . 3e

4 Deductible expenses. Subtract line 3e from line 2 . . . 4

5 Building depreciation . . . 5

6 **Total expenses.** Add lines 4 and 5 . . . 6

7 **Tentative profit or (loss).** Subtract line 6 from line 1 . . . ► 7
If a loss, check the box that describes your investment in the activity (see page C-6).
☐ All investment is at risk. ☐ Some investment is not at risk. You must attach Form 6198.

8 **Net earnings from self-employment.** If you are required to file Schedule SE (see page C-7), skip line 8 and follow the instructions on Schedule SE to complete lines 9 and 10 below. If you are not required to file Schedule SE, multiply line 7 by 92.35% (.9235). If less than $400 or you were a statutory employee, enter -0- . . . 8

9 **Self-employment tax.** If the amount on line 8 is:
- $90,000 or less, multiply line 8 by 15.3% (.153). Enter the result here and include on **1040-SIMPLE, line 22.**
- More than $90,000, multiply line 8 by 2.9% (.029). Then add $11,160.00 to the result. Enter the total here and include on **1040-SIMPLE, line 22.**

. . . 9

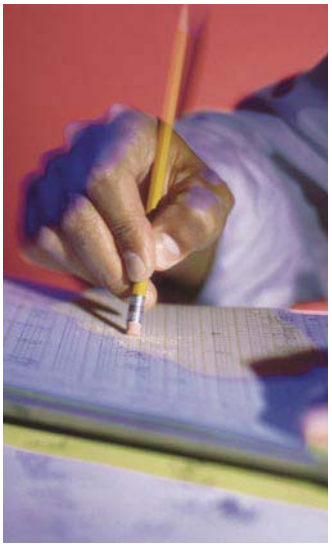
10 **Deduction for one-half of self-employment tax.** Multiply line 9 by 50% (.5) . . . ► 10

11 Subtract line 10 from line 7 . . . 11

12 Self-employed SEP, SIMPLE, and qualified plans . . . 12

13 **Net profit or (loss).** Subtract line 12 from line 11. Enter the result here and on **1040-SIMPLE, line 2.** . . . 13

For Paperwork Reduction Act Notice, see 1040-SIMPLE instructions. Cat. No. XXXXX Schedule C-EZ (1040-SIMPLE) 200X



give small business an incentive to purchase productivity-enhancing assets. Similarly, these small businesses would no longer be required to make difficult determinations about whether a particular expenditure can be immediately deducted or must be capitalized and amortized. The current-law treatment of land as a nondeductible expense and the depreciation of buildings and structures would continue to apply.

Medium-sized businesses – those with receipts of more than $1 million, but less than $10 million – would also be allowed to use simplified and expanded cash accounting. These medium-sized businesses would use the cash method for small business described above, but would be required to depreciate the cost of equipment and other capital expenditures (in addition to land and buildings). The Simplified Income Tax Plan also would make permanent administrative practice that requires only medium-sized businesses in inventory-intensive industries to use inventory methods for physical inventories.

For purposes of classifying a business as small, medium-sized, or large, gross receipts would be measured using the average over the prior three years. A business that crosses a particular gross receipts threshold would continue to be treated as a medium-sized or large business, even if its receipts later fall below the applicable gross receipts threshold.

To improve recordkeeping and compliance, the Simplified Income Tax Plan would require that small and medium-sized businesses use designated business bank accounts into which they would deposit all receipts and from which they would make business expenditures. Businesses would be prohibited from making personal expenditures out of, or from commingling personal and business funds in, these segregated business bank accounts. To aid small businesses in filing their returns and to improve compliance, banks would be required to provide small businesses with an annual summary of account inflows and outflows. This summary would be reported directly to the IRS by the financial institution maintaining the account. Similarly, the Simplified Income Tax Plan would require that issuers of debit and credit cards report to businesses and the IRS payments for credit and debit card purchases of their cardholders. Although taxpayers who fail to deposit cash receipts into segregated accounts would still present a compliance issue, simpler accounting rules and more detailed information reporting would make such willful evasion easier to detect.

The Panel also recommends that the tax treatment of small business entities be simplified. Under current law, owners of sole proprietorships, LLCs and partnerships, and S corporations report business income from these entities on their tax returns. Although these three separate regimes are designed to provide a single level of tax, there are a number of differences between them that make choosing a legal business form and tax compliance unnecessarily complex. In light of the recommendations that would provide for a single level of tax on profits of large businesses earned in the United States, the Panel recommends that the rules applicable to pass-through entities be simplified and streamlined. For example, greater uniformity among the rules for contributions, allocations of income, distributions, and liquidations would eliminate confusion and simplify choice of entity considerations. The Panel also

recommends that the current-law rule that treats an unincorporated business that is jointly owned by a married couple as a partnership be modified to permit the couple to treat the business as a sole proprietorship and report business income on Schedule C instead of a separate partnership tax return.

One Set of Rules for Large Businesses

The Simplified Income Tax Plan contains rules for larger businesses that, like the rules for small and medium-sized businesses, are designed to provide a more uniform and consistent treatment of business activity. Gone from the tax code would be most of the special preferences and rates that often apply to such large businesses. This would result in a system that taxes large business entities with more than $10 million of receipts more uniformly and at a lower 31.5 percent tax rate. Business entities with less than $10 million in receipts would be free to report income and to be taxed as a corporation if they so chose; if they did so, their owners would obtain the benefits of the 100 percent exclusion for domestic dividends and the 75 percent exclusion of capital gains on the sale of their corporate stock.

Large business entities would be taxed at the entity level like corporations. Owners of these entities would not be subject to tax when they receive distributions of income earned in the United States and would exclude 75 percent of the capital gains on the sale of an interest in these entities. For large businesses that currently are taxed as flow-through entities, such as partnerships, LLCs, and S-corporations, domestic earnings would be subject to tax at the business level. Passive investment vehicles, such as regulated investment companies (RICs) and real estate investment trusts (REITs), would continue to be treated the same as under current law. Distributions and capital gains would be subject to the rules applicable to corporations.

Currently, there are only about 150,000 active U.S. businesses that have more than $10 million in receipts. Requiring all large entities, including partnerships, to abide by the same business tax rules would provide fewer opportunities for tax shelters and less exploitation of loopholes. For example, a consistent treatment of income from large businesses would shrink opportunities to use a partnership structure to avoid taxes. Many recent tax shelters were designed to exploit the complicated partnership rules. The uniform treatment of large businesses under the Simplified Income Tax Plan also would greatly simplify the individual income tax returns of their owners, who now must cope with complex distributions of various categories of business income and expenses that are reported to them on complicated partnership and S corporation forms.

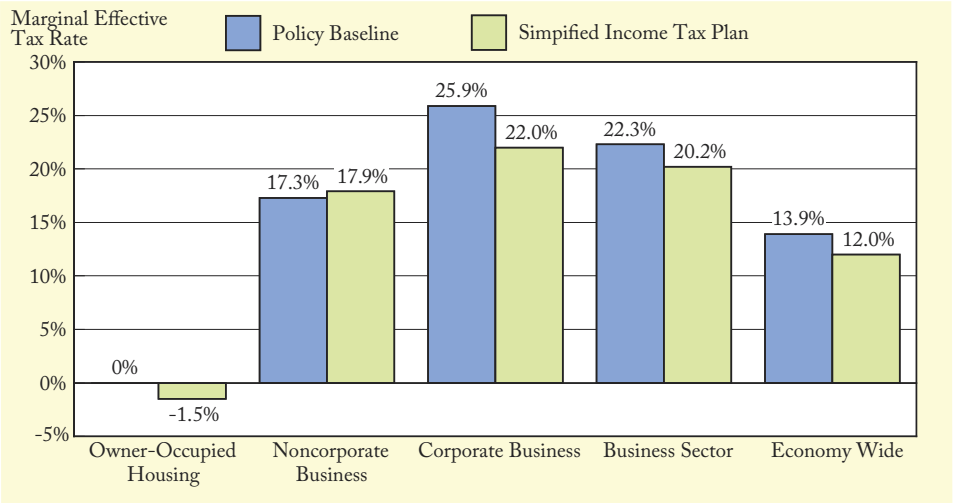
Over the years, numerous special preferences for business activities have been added to the tax code. Some of these preferences are substantial in size and affect a significant percentage of businesses, while others are much smaller and affect only a few businesses. Each item on the long list of tax preferences requires complex rules and regulations to define who is entitled to get these preferences. These rules are an enormous source of controversy and confusion for taxpayers and the IRS. In addition, these preferences have the effect of raising the rates for all businesses.

Like the individual income tax provisions, the Simplified Income Tax Plan begins with a clean tax base for large businesses by eliminating all tax preferences other than accelerated depreciation. Over 40 business tax breaks would be eliminated, including the research and experimentation credit, the rehabilitation investment credit, and the newly-enacted deduction for domestic production activities. To level the playing field between large businesses that pay tax at the entity level and small business owners who pay tax on business income on their individual returns, the deduction for state and local income taxes would be eliminated for large businesses under the Simplified Income Tax Plan.

This clean tax base would permit the business tax rate to be reduced from 35 to 31.5 percent – a 10 percent across-the-board reduction – while enormously simplifying the tax code. Eliminating special preferences that many large businesses use to reduce or avoid paying tax also would reduce the need to more closely track a business's taxable income for purposes of the 100 percent exclusion of dividends paid out of domestic earnings.

The tax treatment of investment by businesses also would be significantly improved. Currently, our tax system favors a strategy of financing corporate growth by issuing debt rather than by issuing stock. This is because distributions out of corporate profits are taxed twice, while interest on debt is deductible. The result is a corporate sector that disproportionately uses debt to finance future growth, retains earnings rather than distributing them as dividends, and favors unincorporated entities over corporations. The single-rate, business-level tax paid by all large business entities coupled with the proposal to nearly eliminate the tax on domestic earnings of large business entities at the individual level would reduce the tax burden on business investment and provide a more even treatment across types of business financing. As illustrated in Figure 6.4, there will be a lower and more even tax burden on the returns to investment.

Figure 6.4. Comparison of Effective Tax Rates on Different Types of Investment



Note: The tax rates for the policy baseline assume, among other things, that the 2001 and 2003 tax cuts will be made permanent and that the proposals contained in the President's Budget to create retirement savings accounts and lifetime savings accounts (each with a $5,000 limit) would be enacted.
Source: Department of the Treasury, Office of Tax Analysis.

The Panel also evaluated a proposal to tax large entities based on net income reported on financial statements instead of requiring a separate calculation of income for tax purposes. Although the Panel has not included that proposal as part of the Simplified Income Tax Plan, the Panel recommends that it be studied further.

A Simplified Cost Recovery System

Under current law, taxpayers are allowed to take depreciation deductions for new investments under the Modified Accelerated Cost Recovery System, or MACRS. Under MACRS, each asset is assigned a recovery period (the number of years over which depreciation allowances are spread), a recovery method (how depreciation allowances are allocated over the recovery period), and an applicable convention that establishes when property is deemed to have been placed in service during the year. Under the asset classification systems that date back to 1962 and earlier, assets are assigned to one of nine specific recovery periods. Recovery methods range from straight line, which provides even depreciation allowances over the recovery period, to double declining balance, which provides more generous deductions in the early years.

Under MACRS, most investments in equipment are assigned a recovery period that depends on the taxpayer's industry. Equipment is assigned to one of seven recovery periods, ranging from three years to 25 years, but most are assigned to the five or seven-year recovery periods. Investments in buildings are recovered on a straight-line basis over 27.5 years for residential buildings or 39 years for nonresidential buildings.

Under the Simplified Income Tax Plan, all businesses would benefit from simplified rules for recovering the cost of new assets. As described above, small businesses would be able to take an immediate deduction for the cost of new tools, equipment, and other assets. These businesses would not have to worry about complicated asset classifications, asset class lives, depreciation methods, or depreciation tables, except for purchases of buildings.

A simplified cost recovery system would be adopted to reduce the compliance hassles associated with the tax treatment of business investment. The new simplified depreciation system would replace the nine different asset class lives, three different recovery methods, and three different applicable conventions with a simple system involving only four asset categories. This system would provide roughly the same cost recovery deductions as current law, but would greatly simplify the process. It would eliminate much of the accounting and recordkeeping burden imposed by our current system. It also would eliminate many of the inter-asset distortions created by the antiquated classification of assets in our current system. For example, there would no longer be different recovery periods for similar assets just because they are used in different industries.

Under the simplified depreciation system, taxpayers would increase the balance in each property account by the amount of new purchases and be allowed a uniform allowance each year. Depreciation would be computed by multiplying the account's average balance by the depreciation rate applicable to the specific asset category. As summarized in Table 6.5, there would be only four categories of assets.

Table 6.5. Asset Categories Under the Simplified Depreciation System

	Category I	Category II	Category III	Category IV
Type of Assets	Assets used in the 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 percent	7.5 percent	4 percent	3 percent

Medium-size businesses (and small businesses that depreciate buildings and structures) would be allowed to use a much simpler accounts-based system under which the amount of new assets would simply be added to the existing balance in each asset account. Unlike current law, separate accounts for assets placed in service in each year would not be required. The new depreciation system also would provide a more simple treatment of asset dispositions by not requiring adjustment of the account upon sale, retirement or other disposition of an asset. Depreciation would be allowed for the account balance and, if all assets in a category were disposed of, the remaining adjusted basis in an account would be deducted. Any proceeds received from an asset disposition would be included fully in the taxpayer's gross income. These rules would relieve businesses from detailed tracking of individual assets for tax purposes.

Large businesses would continue to track assets as they do under current law, but would benefit from the simpler process of categorizing assets into one of four asset classes and claiming depreciation deductions based on the simplified method.

Simplifying the Taxation of International Business

The Simplified Income Tax Plan would update our international tax regime by adopting a system that is common to many industrial countries. As explained in Chapter Five, our tax system taxes all income of U.S. corporations regardless of where it is earned and provides a limited tax credit for income taxes paid to foreign governments. Many of our trading partners use "territorial" tax systems that exempt some (or all) of business earnings generated by foreign operations from home country taxation. France and the Netherlands, for example, exempt foreign dividends. Canada, on the other hand, exempts foreign dividends from countries with which it has tax treaties from home taxation. Canada effectively administers a territorial system because it has tax treaties with many countries.

To understand the tax implications of territorial and worldwide systems, consider a simple example. A French multinational company and a U.S. multinational company both have subsidiaries with active business operations in another country, Country X, that imposes a 20 percent tax on corporate income. The U.S. corporate income tax rate is 35 percent. Assume that both companies earn $100 from their operations in Country X and immediately send the profits home as a dividend.

Both the U.S and French subsidiaries pay $20 of tax to Country X on their $100 of earnings. However, the U.S. company faces a "repatriation tax" on the dividend, but the French company does not. The U.S. tax bill of $35 on the $100 of foreign earnings is reduced to $15 because the company receives a credit of $20 for the taxes already paid to Country X by its subsidiary. This means that the U.S. multinational pays a total of $35 in tax: $20 to Country X and $15 to the United States. The French multinational, on the other hand, pays only $20 in tax to Country X. The French company faces a lower tax rate on investments in Country X than the U.S. company because France has a territorial tax system.

Unfortunately, reality is not as simple as this example portrays it. As explained in Chapter Five, the U.S. multinational does not pay U.S. tax on its subsidiary's earnings in Country X until the earnings are repatriated to the United States. The repatriation tax is elective and, as a result, distorts business decisions. If the U.S. multinational redeploys earnings abroad by reinvesting the $80 in an active business, for example, it may avoid the U.S. tax on the earnings. To do so, the U.S. company may forego more attractive investments in the United States or may have to fund investments at home through costly borrowing that would be avoided if there were no repatriation tax on the foreign earnings. Tax planners can devise elaborate strategies to avoid the repatriation tax, but the strategies employed may themselves be costly and wasteful to the economy.

For some firms, arranging corporate affairs to avoid the repatriation tax involves costly and distortionary activity that would not take place except for tax considerations. As explained in Chapter Five, the combination of deferral and the foreign tax credit creates a situation in which the tax rate imposed on investment abroad differs among U.S. multinationals. For example, a multinational that can defer repatriation indefinitely (or avoid the repatriation tax at no cost) pays no repatriation tax. A multinational that is unable to structure operations to avoid the repatriation tax faces the U.S. tax rate.

Under our current tax system, it is also possible for companies to face tax rates on marginal investments abroad that are lower than host country rates. For example, consider a U.S. multinational that finances additional investment in Country X through U.S. borrowing. If the multinational is able to indefinitely defer tax on earnings in Country X (or avoid any repatriation tax through tax planning) it will face a lower than 20 percent rate on its investment. This is because the U.S. company

gets a deduction at the U.S. tax rate for interest payments with no corresponding taxation of income at the U.S. rate. Although territorial tax systems are designed to impose no home country tax on active foreign earnings, the goal of these systems is not to subsidize foreign investment. For this reason, provisions that allocate expenses associated with exempt foreign income against that income (or tax some otherwise exempt foreign income as a proxy for allocating those expenses) are necessary.

The Simplified Income Tax Plan would adopt a straightforward territorial method for taxing active foreign income. Active business income earned abroad in foreign affiliates (branches and controlled foreign subsidiaries) would be taxed on a territorial basis. Under this system, dividends paid by a foreign affiliate out of active foreign earnings would not be subject to corporate level tax in the United States. Payments from a foreign affiliate that are deductible abroad, however, such as royalties and interest would generally be taxed in the United States. Reasonable rules would be imposed to make sure that expenses incurred in the United States to generate exempt foreign income would not be deductible against taxable income in the United States. Because insuring that related entities charge each other "arm's length" prices for goods and services is even more important in a territorial system than under current law, additional resources would need to be devoted to examining these transfer prices. As is common in territorial systems around the world, income generated by foreign assets – such as financial income – that can be easily relocated to take advantage of the tax rules would continue to be taxed in the United States as it is earned. For example, if the U.S. company in our example was to invest the $100 of foreign profits in Country X in bonds instead of in an active business, the interest earned on the bonds would be subject to immediate U.S. taxation (with a credit for any taxes paid to Country X).

Such a tax system would more closely reflect the international tax rules used by many of our major trading partners. It would level the playing field among U.S. multinationals investing abroad. It would allow U.S. multinationals to compete with multinationals from countries using a territorial approach without having to bear the planning costs that are necessary under today's system. In addition, it would make it easier for American companies to repatriate income earned in foreign nations tax-free and reduce the degree to which tax considerations distort their business decisions. Finally, commentators from both industry and academia have concluded that a carefully designed territorial-type system can lead to simplification gains.

Research on the consequences of adopting a territorial system for the United States suggests that this reform could lead to both efficiency and simplification gains. Economists have found that the financial decisions of corporate managers are extremely sensitive to the tax on repatriations – lower U.S. taxes on dividend repatriations lead to higher dividend payments and vice-versa. This correlation implies that repatriation taxes reduce aggregate dividend payouts and generate an efficiency loss that would disappear if active foreign source income were exempt from U.S. tax. Corporate managers would be able to arrange corporate affairs and financial policies to meet objectives other than tax avoidance if they were freed from worrying about how to time repatriations of foreign income to reduce U.S. taxes.

At first glance, one might assume that exempting active foreign source income from U.S. taxation would lead to a substantial reallocation of U.S. investment and jobs worldwide. A careful study of how location incentives for U.S. multinational corporations may change under a territorial system similar to the one proposed for the Simplified Income Tax Plan provides different results. Researchers found no definitive evidence that location incentives would be significantly changed, which suggests that the territorial system the Panel has proposed would not drive U.S. jobs and capital abroad relative to the current system. This result is not surprising. As explained in Chapter Five, the U.S. international tax system has both worldwide and territorial features. For some firms, the U.S. international tax system produces tax results that are as good or even better than those that would apply under a territorial system. Exempting active foreign-source income repatriated as a dividend from U.S. tax provides no additional incentive to invest abroad if, in response to the current tax system, firms have already arranged their affairs to avoid the repatriation tax. Instead, exempting dividends allows firms to productively use resources that were inefficiently employed under current law. The Simplified Income Tax Plan would produce no less revenue from multinational corporations than the current system, but would be less complex and more uniform in its application.

Additional information regarding the Panel's proposals for a new system of international taxation under the Simplified Income Tax Plan can be found in the Appendix.

Strengthening Rules to Prevent International Tax Avoidance

The Simplified Income Tax Plan also would modify the definition of business subject to U.S. tax to ensure businesses that enjoy the benefit of doing business in the U.S. pay their fair share. Under current law, residency is based on the place a business entity is organized. This rule makes an artificial distinction that allows certain foreign entities to avoid U.S. taxation even though they are economically similar to entities organized in the United States. This rule may give businesses an incentive to establish legal place of residency outside the United States to avoid paying tax on some foreign income. Several large U.S. companies have used a similar technique to avoid taxes under our current system. Recently enacted legislation created rules to prevent existing corporations from moving offshore, but does not prevent newly organized entities from taking advantage of the rules.

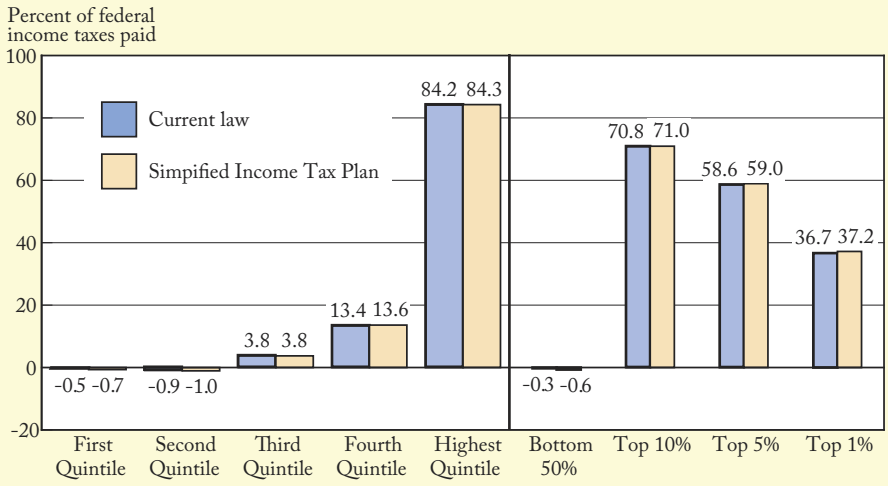
To prevent this tax-motivated ploy, the Simplified Income Tax Plan would provide a comprehensive rule that treats a business as a resident of the U.S. (and subject to U.S. tax) if the United States is the business's place of legal residency or if the United States is the business's place of "primary management and control." The new two-pronged residency test would ensure that businesses whose day-to-day operations are managed in the United States cannot avoid taxes simply by receiving mail and holding a few board meetings each year at an island resort.

A Progressive Tax System

As discussed in Chapter Four, the Panel agreed to design tax reform options that would not materially alter the current progressive distribution of the federal individual and corporate income tax burden. The following estimates provided by the Treasury Department demonstrate that the Simplified Income Tax Plan meets those guidelines. While there are some minor differences, the overall distribution closely tracks current law.

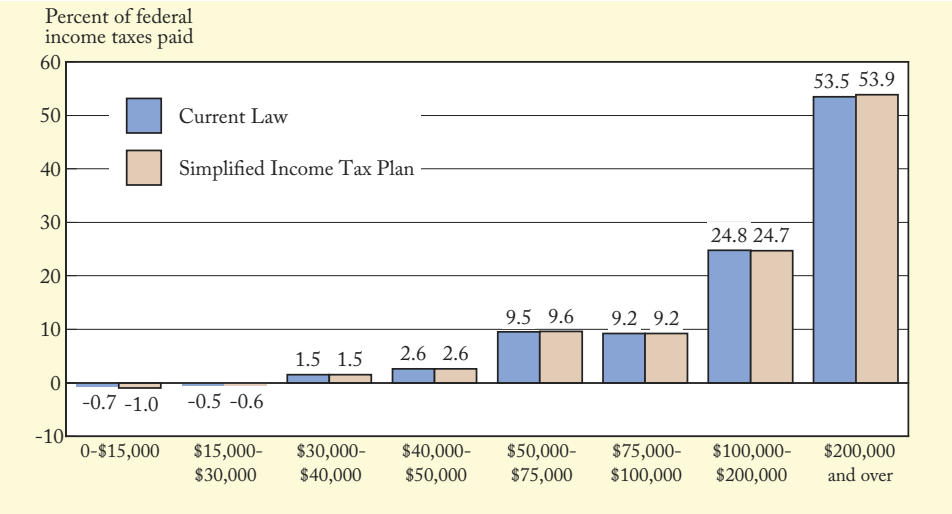
Figures 6.5 and 6.6 show the results for 2006. Figure 6.5 breaks the population into fifths – or quintiles – according to their cash income. The figure also shows the taxes paid by the fifty percent of the population with the lowest incomes, and those in the top 10, 5, and 1 percent of the income distribution. Figure 6.6 presents similar information, but instead of assigning households to percentiles of the income distribution, it shows the distribution of taxes by taxpayer income levels. The figure presents income levels ranging from zero to $15,000 of income to $200,000 and over of income.

Figure 6.5. Distribution of Federal Income Tax Burden Under Current Law and the Simplified Income Tax by Income Percentile (2006 Law)



Note: Estimates of 2006 law at 2006 cash income levels. Quintiles begin at cash income of; Second $12,910; Third $27,461; Fourth $45,345; Highest $84,124; Top 10% $123,076; Top 5% $169,521; Top 1% $407,907; Bottom 50% below $36,738.
Source: Department of the Treasury, Office of Tax Analysis.

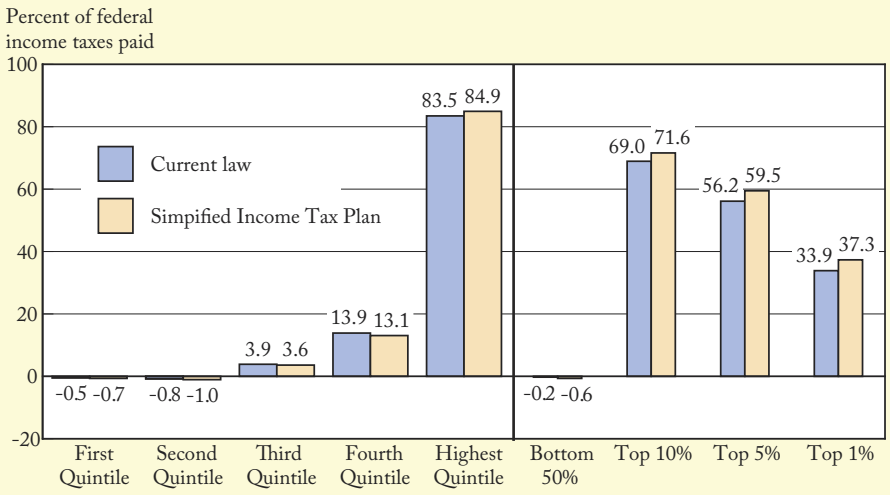
Figure 6.6. Distribution of Federal Income Tax Burden Under Current Law and the Simplified Income Tax Plan by Income Level (2006 Law)



Note: Estimates of 2006 law at 2006 cash income levels.
Source: Department of the Treasury, Office of Tax Analysis.

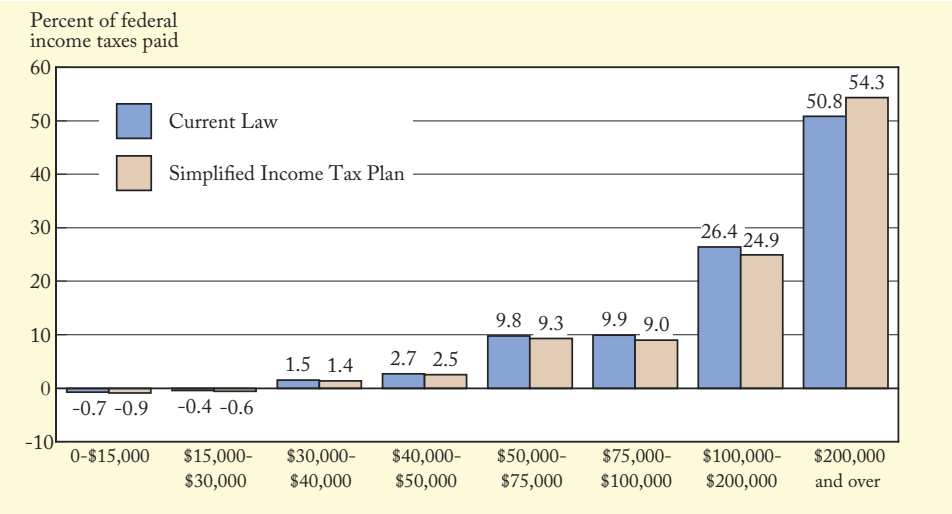
To provide additional information about the effect of the Simplified Income Tax Plan, the Panel asked the Treasury Department to provide a distribution of the Simplified Income Tax Plan for 2015, the last year of the budget window. Figures 6.7 and 6.8 compare the effect of the Simplified Income Tax Plan and current law in 2015, while holding constant the level and pre-tax distribution of income.

Figure 6.7. Distribution of Federal Income Tax Burden Under Current Law and the Simplified IncomeTax Plan by Income Percentile (2015 Law)



Note: Estimates of 2015 law at 2006 cash income levels. Quintiles begin at cash income of; Second $12,910; Third $27,461; Fourth $45,345; Highest $84,124; Top 10% $123,076; Top 5% $169,521; Top 1% $407,907; Bottom 50% below $36,738.
Source: Department of the Treasury, Office of Tax Analysis.

Figure 6.8. Distribution of Federal Income Tax Burden Under Current Law and the Simplified Income Tax by Income Level (2015 Law)

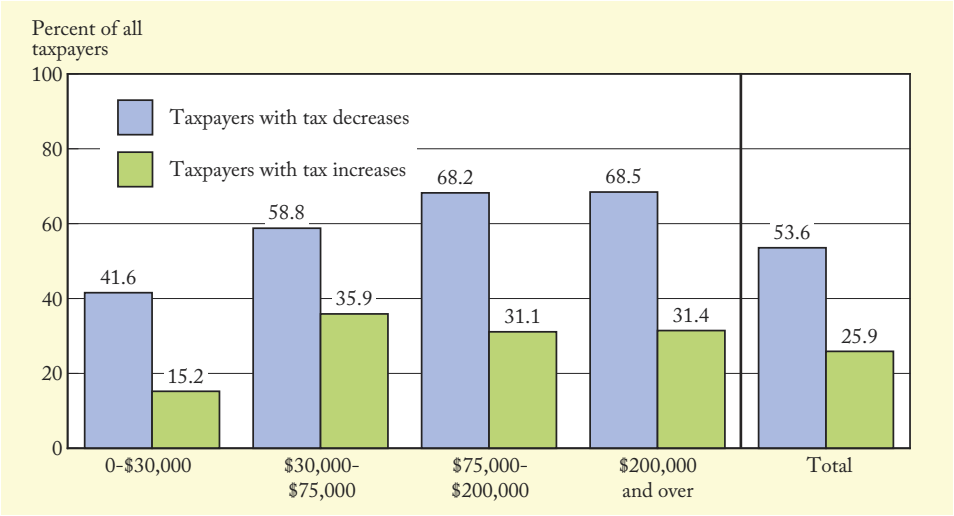


Note: Estimates of 2015 law at 2006 cash income levels.
Source: Department of the Treasury, Office of Tax Analysis.

The Treasury Department has also provided two additional sets of distribution tables that are explained and displayed in the Appendix. One table describes the tax burden under the Simplified Income Tax Plan for the entire ten-year budget period. The other shows the tax burden if the corporate income tax is distributed 50 percent to owners of capital and 50 percent to labor, rather than solely to owners of capital income.

Another way to evaluate the distributional effects of a tax reform proposal is to consider the number of taxpayers who would face higher or lower taxes under the proposal. The constraint of revenue neutrality implies that any tax relief provided to one taxpayer must be financed with higher taxes on somebody else. Looked at solely from the perspective of one's tax bill, the Simplified Income Tax Plan is certain to generate both "winners" and "losers." The Panel recognizes that this comparison is inevitable, but at the same time urges taxpayers to recognize other benefits of tax reform. Greater simplicity in the tax system would allow taxpayers to save time and preparation fees, and would inspire confidence that the tax system is straightforward and fair, and not providing hidden loopholes to others. Greater economic growth should also benefit all Americans.

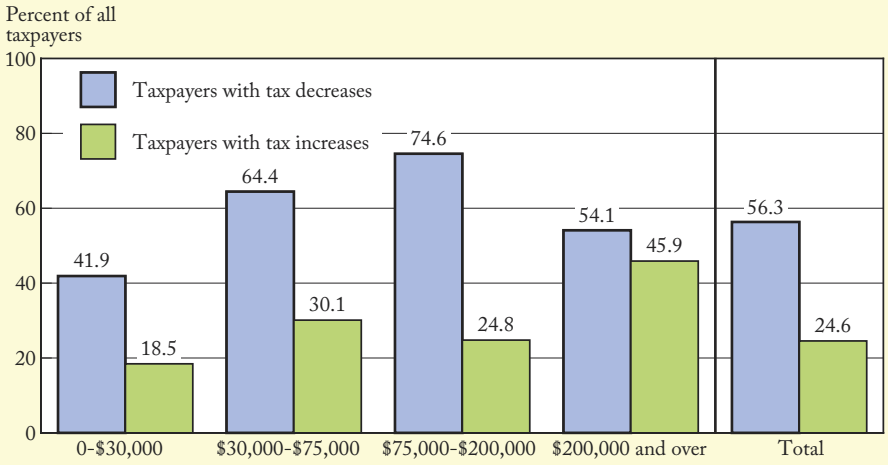
Figure 6.9. Percentage of Taxpayers with Decreases and Increases in Tax Liability Under the Simplified Income Tax Plan (2006 Income Levels)



Note: Estimates of 2006 law at 2006 cash income levels. Figure does not show the percentage of taxpayers who have neither an increase nor a decrease in tax liability.
Source: Department of the Treasury, Office of Tax Analysis.

Figures 6.9 and 6.10 demonstrate that in each income class, many more taxpayers would receive a tax cut than a tax increase. Overall, under the Simplified Income Tax Plan, there are more than twice as many taxpayers who would pay less in taxes.

Figure 6.10. Percentage of Taxpayers with Decreases and Increases in Tax Liability Under the Simplified Income Tax Plan (2015 Income Levels)



Note: Estimates of 2015 law at 2006 cash income levels. Figure does not show the percentage of taxpayers who have neither an increase nor a decrease in tax liability.
Source: Department of the Treasury, Office of Tax Analysis.

All of the above distributional information looks at the aggregate effects on groups of taxpayers. While this is informative, the Panel understands that many taxpayers would like to have a greater level of specificity and would like to know what would happen to their personal tax bill. To provide some information of that type, the Panel has developed an array of hypothetical taxpayers and calculated their taxes under the Simplified Income Tax Plan.

Before analyzing the results, it is important to describe how the Panel chose these examples. The Panel asked the IRS to construct a set of stylized taxpayers with different family structures, ages, incomes, and deductions. The IRS created these model taxpayers using data on actual taxpayers, divided into singles, married joint filers, and heads of households, and further sorted by whether or not the household head is over the age of 65. Within each of these taxpayer categories, households were ranked according to their adjusted gross income. This ranking was carried out using tax return data from 2003. Dollar figures were inflated to 2006 levels.

The Panel asked the IRS to consider the characteristics of taxpayers at the bottom 25th percentile, median, top 25th percentile, and top 5th percentile of the income distribution, with particular emphasis on the composition of income and the use of various deductions. In determining the attributes of a stylized 25th percentile taxpayer, for example, the Panel asked the IRS to use data on taxpayers with incomes between the 24th and 26th percentiles. Averages of the amount of wage and salary income, the amount of capital income flows such as interest, dividends, and capital gains, and, in the case of itemizers, the amount of various deductions were calculated for each of the stylized taxpayers. In addition, the Panel asked the Treasury Department to estimate values of itemized deductions for taxpayers who did not itemize, and included these estimates in the averages. Although these stylized taxpayers may not correspond to actual taxpayers due to the averaging procedure for income and itemized deductions, they nevertheless provide an illustrative way to compare different tax systems.

Table 6.6 presents a set of Treasury Department calculations for how the Simplified Income Tax Plan would affect hypothetical taxpayers for 2006. These examples demonstrate an essential point, which is that looking at elements of the Simplified Income Tax Plan in isolation can result in very misleading conclusions. The plan is a carefully crafted combination of numerous individual provisions intended to achieve substantial improvements in the tax system while minimizing the changes in total tax liabilities experienced by individual taxpayers. While some elements of the plan, considered in isolation, may increase the taxes paid by some taxpayers, other elements will have offsetting effects. Rather than focusing on the effects of individual provisions, the focus should be on the overall changes in tax liability that would result from the Simplified Income Tax Plan in its entirety.

Table 6.6. Examples of Taxpayers Under the Simplified Income Tax Plan in 2006 (in dollars)

	Taxpayer Characteristics and Placement in Income Distribution	Income	Salaries and Wages	Taxable Interest	Dividends	Capital Gain	Itemized Deductions				Income Tax under 2006 Law at 2006 Levels		
							State and Local Taxes	Mortgage Interest	Charitable Contributions	Misc (before 2% floor)	Current Law	Simplified Income Tax	Percentage Change in Tax Liability
Single Taxpayers Younger Than 65													
1	Bottom 25th	12,300	12,300						369		385	158	-59.0%
2	50th	24,300	24,300						729		2,003	1,922	-4.0%
3	Top 25th	41,000	40,700	200	100				1,230		4,758	4,542	-4.6%
4	Top 5%	82,800	80,500	800	700	800	4,000	6,400	2,000	2,200	13,541	14,336	5.9%
Heads of Household Younger Than 65 (bottom 25th and 50th percentile households have two child dependents; top 25th and top 5% household has one child dependent)													
5	Bottom 25th	14,000	14,000						420		-4,941	-5,488	-11.1%
6	50th	23,100	23,100						693		-4,225	-4,242	-0.4%
7	Top 25th	37,200	36,700	200	100	200			1,116		1,960	1,202	-38.7%
8	Top 5%	71,800	71,300	300	100	100	2,900	8,300	2,400	2,500	7,042	8,112	15.2%
Married Filing Jointly Younger Than 65 (all have two child dependents)													
9	Bottom 25th	39,300	38,600	300	200	200			1,179		-282	-833	-195.9%
10	50th	66,200	65,300	400	300	200	2,300	8,200	2,400	2,100	3,307	2,286	-30.9%
11	Top 25th	99,600	97,800	600	600	600	4,100	9,400	2,700	2,200	9,340	9,129	-2.3%
12	Top 5%	207,300	196,200	2,300	2,700	6,100	10,000	14,400	5,400	2,800	40,417	37,162	-8.1%
Single Taxpayers (and Surviving Spouses) Age 65 and Over*													
13	50th	24,800	0	3,200	1,600	100			555		1,919	1,983	3.3%
14	Top 25th	42,800	0	4,000	3,200	200			1,130		5,731	5,820	1.6%
Married Filing Jointly Age 65 and Over**													
15	50th	51,000	0	3,000	1,300	500			1,125		2,772	2,363	-14.7%
16	Top 25th	77,500	0	5,400	3,600	1,000			2,230		9,635	8,822	-8.4%

Note:
* The 50th percentile taxpayer has gross Social Security benefits of $6,300 and taxable pensions, annuities, and IRA distributions equal to $13,600. The top 25th percentile taxpayer has gross Social Security benefits of $12,000 and taxable pensions, annuities, and IRA distributions equal to $23,400.
** The 50th percentile taxpayer has gross Social Security benefits of $18,400 and taxable pensions, annuities, and IRA distributions equal to $27,800. The top 25th percentile taxpayer has gross Social Security benefits of $21,000 and taxable pensions, annuities, and IRA distributions equal to $46,500.
See text for further explanation of sample taxpayers.
Source: Department of the Treasury, Office of Tax Analysis.

For 2006, a prototypical married couple under age 65 at the median income level of $66,200 would expect to pay $3,307 under current law. Under the Simplified Income Tax Plan, that couple would pay $2,286 in taxes, which would be a decrease of almost 31 percent. A prototypical married couple under age 65 earning about $100,000 would expect to pay $9,340 in taxes in 2006. Under the Simplified Income Tax Plan, that couple would pay $9,129, a decrease of about 2 percent.

Similarly, for 2006, a single taxpayer under age 65 at the median income level of about $24,000 would receive a tax cut of 4 percent. The tax bill of a head of household taxpayer at the median income of about $23,000 would remain roughly the same. Single taxpayers and heads of households who are at the 95th percentile of income would face a tax increase under the Simplified Income Tax Plan.

The Panel also felt that it would be instructive to see how the plan affected taxpayers living in high tax and low tax states. Accordingly, the Panel asked the IRS to vary the amount of state and local taxes paid by each of the taxpayer groups under age 65. The Treasury Department then calculated how tax liabilities would change for those taxpayers who would have itemized and claimed state and local tax deductions under current law for "high" and "low" values of state and local tax deductions. The "high" value is the cut-off level for the top 10 percent of state and local taxes claimed in 2003 (inflated to 2006 levels) and the "low" value is the cut-off level for the bottom 25th percent. These figures are shown below for each group of taxpayers in Table 6.7.

The examples in Table 6.7 show that because of the interaction between the alternative minimum tax and other provisions, there was no difference in the treatment of the stylized married couple earning about $100,000 or in the treatment of the married couple earning about $207,000. In other words, regardless of whether those couples lived in high-tax or low-tax states, they still came out ahead in the Simplified Income Tax Plan. The stylized couple earning about $66,000 living in a low-tax state receives a tax cut of $1,081 while the same couple living in a high-tax state receives a tax cut of $781. Both of these taxpayers would pay the same tax level under the Simplified Income Tax Plan, regardless in which state they reside. For single taxpayers and head of households who itemized under current law, there would be a larger tax increase in taxes for those taxpayers who are living in high-tax states. This is due to the fact taxpayers in high-tax states currently pay less tax than taxpayers in the low-tax states. Under the Simplified Income Tax Plan, taxpayers with similar income and characteristics face the same tax bill.

Table 6.7. Examples of Taxpayers Living in "High" and "Low" Tax States Under Current Law and Simplified Income Tax Plan

Taxpayer Characteristics and Placement in Income Distribution	Income	State and Local Tax Deduction	Income Tax under 2006 Law at 2006 Levels		
			Current Law	Simplified Income Tax	Percentage Change in Tax Liability
Single Taxpayers Younger Than 65					
Top 5% in "low-tax" state	82,800	3,500	13,666	14,336	4.9%
Top 5% in "high-tax" state	82,800	6,400	12,941	14,336	10.8%
Heads of Household Younger Than 65 (bottom 25th and 50th percentile households have two child dependents; top 25th and top 5% household has one child dependent)					
Top 5% in "low-tax" state	71,800	2,400	7,167	8,112	13.2%
Top 5% in "high-tax" state	71,800	4,800	6,567	8,112	23.5%
Married Filing Jointly Younger Than 65 (all have two child dependents)					
50th in "low-tax" state	66,200	1,900	3,367	2,286	-32.1%
50th in "high-tax" state	66,200	3,900	3,067	2,286	-25.5%
Top 25th in "low-tax" state	99,600	3,600	9,340	9,129	-2.3%
Top 25th in "high-tax" state	99,600	6,900	9,340	9,129	-2.3%
Top 5% in "low-tax" state	207,300	8,300	40,417	37,162	-8.1%
Top 5% in "high-tax" state	207,300	16,300	40,417	37,162	-8.1%

Notes: Taxpayers have same characteristics as those in Table 6.6 with the exception of state and local taxes. See text for further explanation of sample taxpayers.
Source: Department of the Treasury, Office of Tax Analysis.

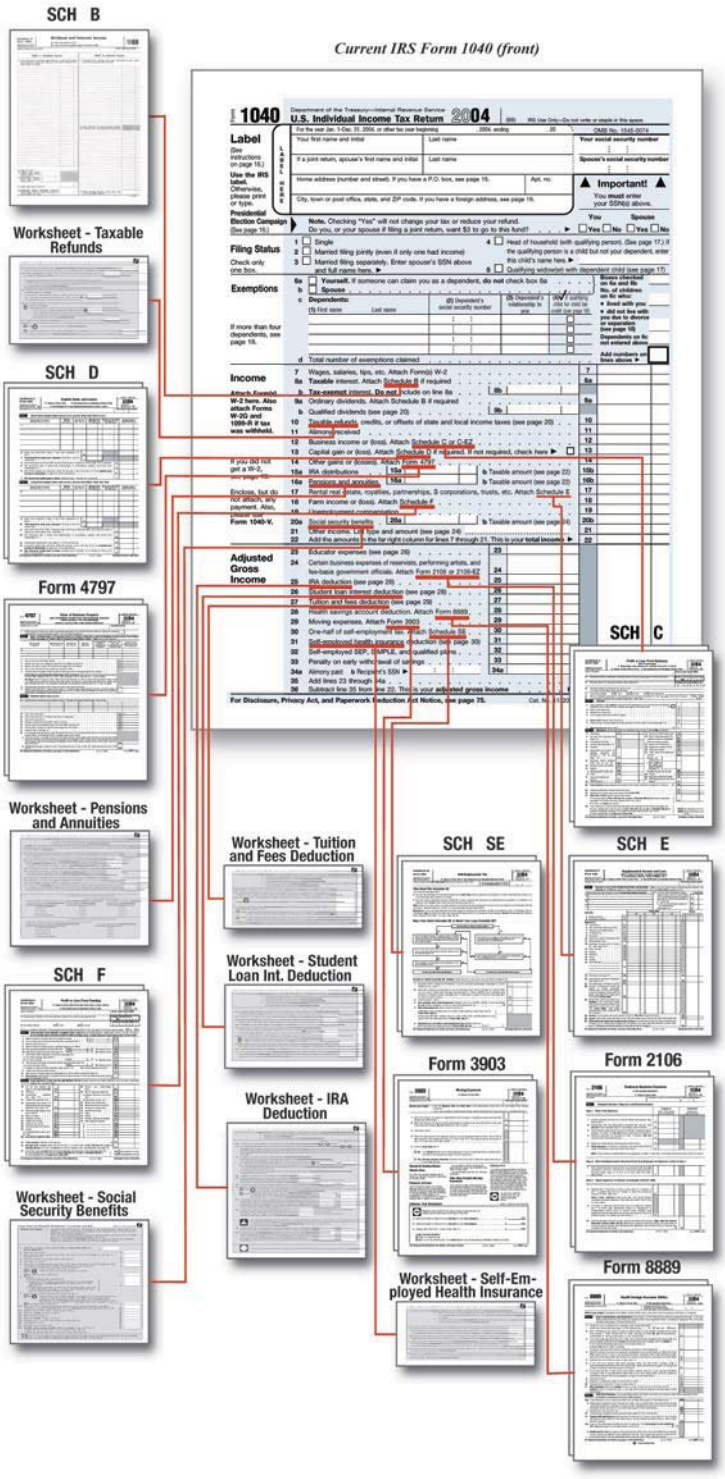
Improved Transparency and Lower Compliance Costs

An obvious benefit of this system would be a simple and straightforward process for computing taxes dramatically cutting the time spent keeping records and filling out forms.

Figures 6.11 and 6.12 demonstrate how much simpler the tax filing process would be. Figure 6.11 shows the current, two-page Form 1040 with over 50 forms, schedules, and worksheets that are frequently used to compute taxes. Figure 6.11 shows the tax return that would be used under the Simplified Income Tax Plan – not only is the form easier to use, but only a fraction of the forms would be required to compute tax owed.

Making taxes of individuals and businesses easier to compute and report would also make our tax system fairer and more transparent. The IRS would be able to process returns and enforce the tax laws more efficiently, thus freeing up resources that could be better used to reduce the gap that exists between taxes owed and taxes paid.

Figure 6.11. Current IRS Form 1040 with Related Schedules, Forms, and Worksheets



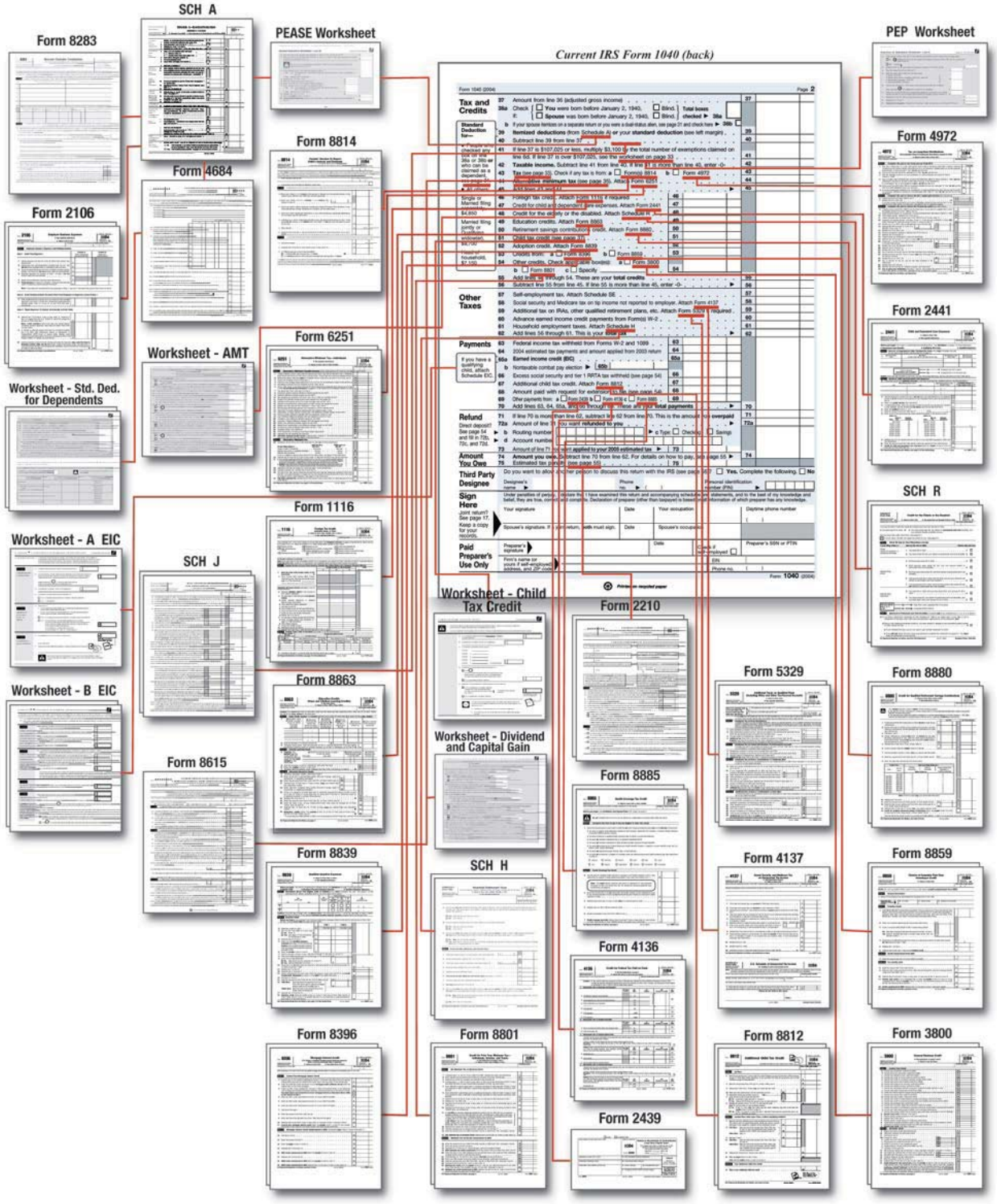
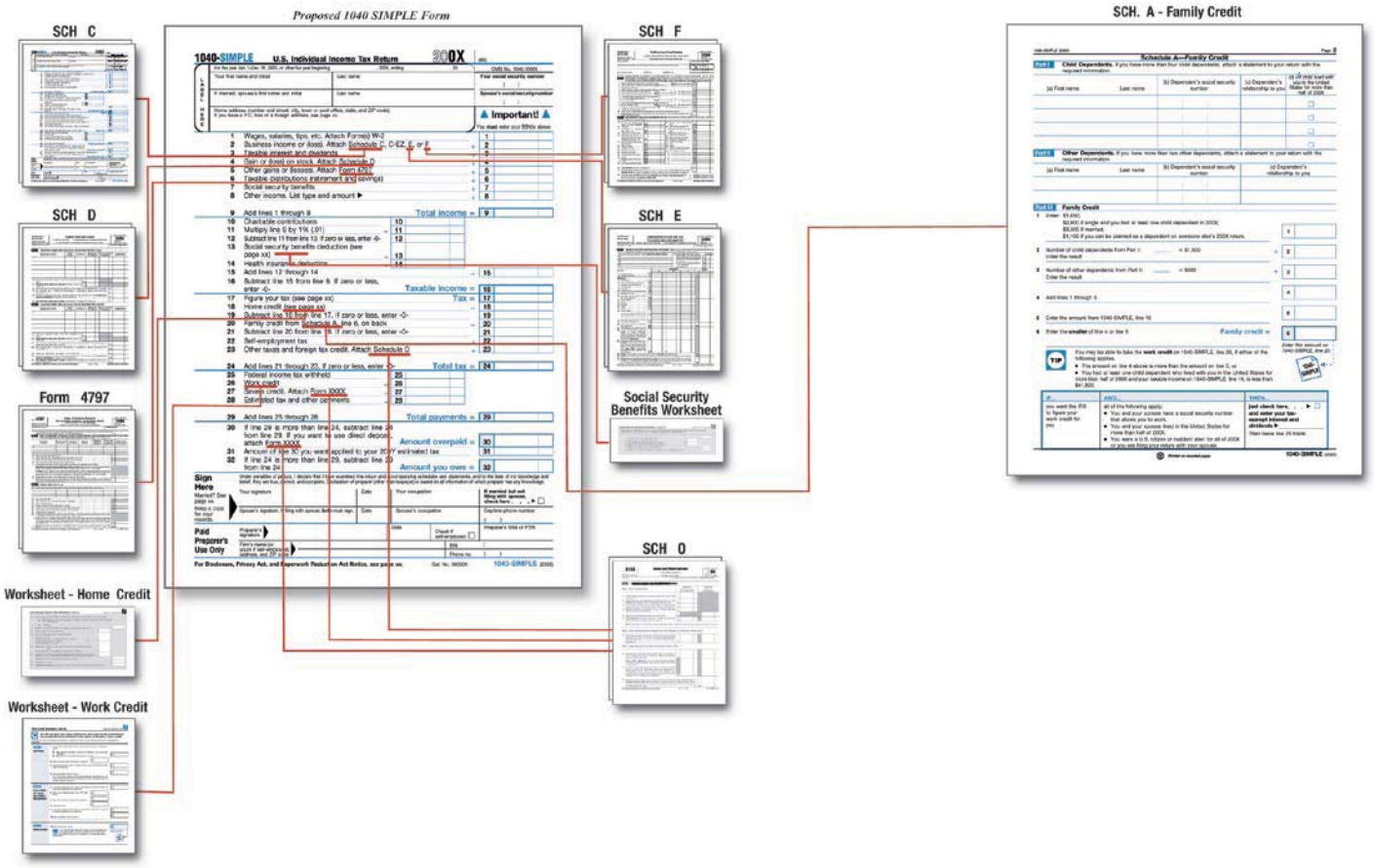

Current IRS Form 1040 (back)
SCH A
Form 8283
PEASE Worksheet
PEP Worksheet
Form 8814
Form 4972
Form 4684
Form 2106
Form 6251
Form 2441
Worksheet - AMT
Worksheet - Std. Ded. for Dependents
Form 1116
SCH R
Worksheet - A EIC
SCH J
Worksheet - Child Tax Credit
Form 2210
Form 5329
Form 8880
Worksheet - B EIC
Form 8863
Worksheet - Dividend and Capital Gain
Form 8885
Form 8615
Form 4137
Form 8859
Form 8839
SCH H
Form 4136
Form 8396
Form 8801
Form 8812
Form 3800
Form 2439

Figure 6.12. Form 1040 SIMPLE with Related Schedules, Forms, and Worksheets



Revenue Neutrality

The Treasury Department advises the Panel that the Simplified Income Tax Plan would be revenue neutral. The plan would collect the same amount of tax revenue as the current law baseline from both individual income taxes and corporate income taxes over the ten-year period.

As noted in Chapter Four, the Panel's baseline for determining revenue neutrality includes the full effects of the AMT. Some members of the Panel believe that it is more likely that lawmakers will extend the current-law provision, often referred to as the AMT "patch," that provides a higher exemption amount, and possibly index this higher amount for inflation. If the Panel did not need to account for the cost of the patch, estimated to be $886 billion, tax rates could be lowered by five percent. In such a scenario, the top rate would have been reduced from 33 percent to 31.5 percent.

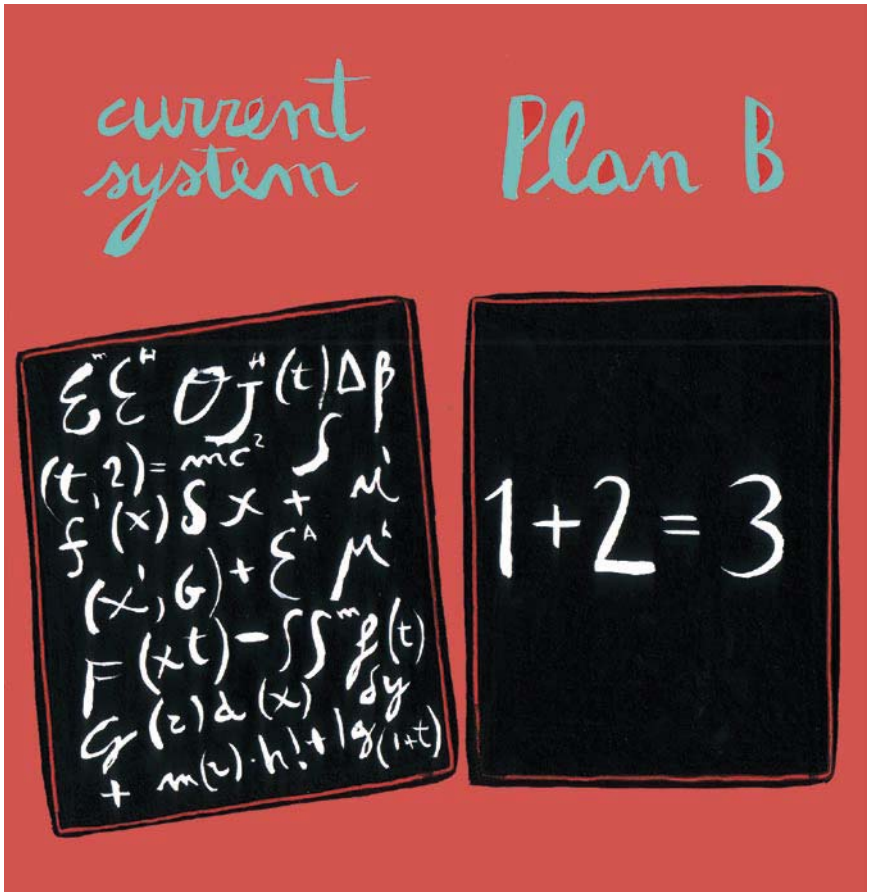
A More Pro-Growth Tax System

The Simplified Income Tax Plan would provide a number of long-term economic benefits. First, it would use a cleaner tax base and would eliminate the need for the AMT, which represents a long-term tax hike for tens of millions of Americans. Second, the system would offer lower tax rates, which by definition improve the conditions for economic growth and job creation. In addition, the Save at Work, Save for Retirement, and Save for Family accounts would encourage more taxpayers to save, which would support greater individual wealth and ownership, as well as an increase in the capital stock.

The Simplified Income Tax Plan also would provide a more uniform method for calculating the taxation of business investment, and would lower the cost of that investment. The removal of the double tax on corporate earnings would represent a significant reduction in the taxation of business investment. In addition, the Simplified Income Tax Plan would reduce the top tax rate on corporations from 35 percent to 31.5 percent. And the new territorial-based international tax system would be simpler for corporations to navigate, and would reduce some of the distortions and wasteful tax planning in the current system.

Estimates from the Treasury Department macroeconomic models described in the Appendix indicate that the Simplified Income Tax Plan could increase output (national income) by up to 0.5 percent over the budget window, by up to 1 percent over 20 years, and by up to 1.2 percent over the long run. The Treasury Department models also suggest that the Plan could have a significant impact on the growth of the capital stock (the economy's accumulation of wealth). The estimates for an increase in the capital stock range from 0.1 percent to 0.4 percent over the budget window, from 0.3 percent to 1.4 percent over 20 years, and from 0.9 percent to 2.3 percent over the long run.

Chapter Seven
The Growth and Investment Tax Plan



Courtesy of Marina Sagona

The Panel evaluated a number of tax reform proposals that would shift our current income tax system toward a consumption tax. The Panel focused on consumption tax proposals that would collect taxes in a progressive manner. These proposals are designed to eliminate the disincentives to save and invest found in our current code, without dramatically altering the way the federal tax burden is shared.

The Panel considered a pure consumption tax that would completely eliminate the difference between the pre-tax and the after-tax return on new investment. It also considered a blended tax structure that would move the current tax system towards a consumption tax, while preserving some elements of income taxation. The Growth and Investment Tax Plan, which is one of the Panel's two recommendations, is an example of a blended structure. It would combine a progressive tax on labor income and a flat-rate tax on interest, dividends, and capital gains with a single-rate tax on business cash flow. Under this tax system, households would file tax returns and pay tax on their wages and compensation using three tax rates, ranging from 15 to 30 percent.

Most households would face lower marginal tax rates than they do under the current income tax system. In addition, the individual tax structure would accommodate the common elements described in Chapter Five, including the Work and Family Credits, the deduction for charitable gifts and health insurance, and the Home Credit. The Growth and Investment Tax Plan departs from a pure consumption tax by imposing a 15 percent tax on household receipts from interest, dividends, and capital gains.

Several panel members were concerned that the Growth and Investment Tax Plan would not move far enough towards a consumption tax because it retains a household-level tax on capital income. The Panel therefore developed a proposal for a consumption tax, referred to as the Progressive Consumption Tax Plan, which would not tax capital income received by individuals. Although the Progressive Consumption Tax Plan proposal did not emerge as a consensus recommendation, the interest in it led to substantial discussion.

Under the Growth and Investment Tax Plan, businesses would file annual tax returns. They would pay tax at a single rate of 30 percent on their cash flow, which is defined as their total sales, less their purchases of goods and services from other businesses, less wages and other compensation paid to their workers. Thus, businesses would be allowed an immediate deduction for the cost of all new investment. Non-financial businesses would not be taxed on income from financial transactions, such as dividends and interest payments, and would not receive deductions for interest paid or other financial outflows.

This chapter begins by summarizing the key differences between income and consumption taxes and explaining the likely impact of consumption taxes on the rate of economic growth. It then describes the Growth and Investment Tax Plan, which offers many of the benefits of a consumption tax even though it retains some elements of income taxation. Next, the chapter explores how adopting the Growth and Investment Tax Plan would affect the distribution of the tax burden. Finally, a brief discussion of the Progressive Consumption Tax Plan considers both how it would differ from the Growth and Investment Tax Plan and how it would affect the saving and investment incentives facing households and firms.

Shifting the tax structure toward a consumption tax would represent a fundamental change in the U.S. tax system. Such a shift would raise a number of implementation issues, many of which are addressed in this chapter. Other issues related to implementation are discussed in more detail in the Appendix.

Comparison of a Consumption Tax with an Income Tax

The key difference between an income tax and a consumption tax is the tax burden on capital income. An income tax includes capital income in the tax base, while a consumption tax does not. Taxing capital income reduces the return to savings and raises the cost of future consumption relative to current consumption. This is likely to cause people to spend more and save less, thereby depressing the level of capital accumulation.

Our current tax system has both income tax and consumption tax features, such as the provisions that permit tax-free saving for retirement (e.g., IRAs and 401(k) plans) and other purposes. Yet the current tax code imposes a penalty on the return to many types of saving. It also taxes different types of investment at different rates, which leads to a misallocation of capital in the economy. Projects treated relatively favorably by the tax code, such as debt-financed investment, are encouraged relative to projects that are heavily taxed, such as equity-financed corporate investment. A consumption tax would not distort saving and investment decisions, and would treat all investment projects the same way.

Although a consumption tax would remove the tax bias against savings and level the playing field between different types of investments, it is important to recognize that an income tax and the type of consumption tax discussed here would both tax a significant portion of the return to capital. To understand why, it is helpful to distinguish four different components of the return to capital. The first is the "normal," or risk-free, return that represents compensation for deferring consumption. This is sometimes described as the "return to waiting." The second is the expected risk premium for a project with uncertain returns – the return to risk taking. The third component is "economic profit" and represents returns due to entrepreneurial skill, a unique idea, a patent, or other factors. This component is sometimes referred to as "supernormal returns." The last component is the unexpected return from good or bad luck. This is the difference between the expected return at the start of an investment, and the after-the-fact, actual return.

A pure income tax and a "postpaid" consumption tax (described in Chapter Three) differ only in their treatment of the return to waiting. The other components of capital income are taxed similarly under both systems. The return to risk-taking and any additional returns that result from good or bad luck are treated similarly under both an income and consumption tax. In both cases, the government becomes a partner in the risks and rewards of the investment through increased tax revenues in the case of positive returns and reduced revenues if returns fall short of expectations. Supernormal returns are taxed equally under both a postpaid consumption tax and an income tax.

Removing the tax on the first component, the return to waiting, is the key to removing taxes from influencing savings and investment decisions. As discussed later in this chapter, recognizing that these other components of the return to capital are taxed under both an income tax and the type of consumption tax discussed here has important implications for the distributional effects of this type of reform.

Box 7.1. Differences in the Treatment of Returns to Business Investment Under a Consumption Tax and an Income Tax

To illustrate how a consumption tax treats normal returns differently than an income tax, consider an entrepreneur who has just earned $100 and can invest in a new machine that will earn a risk-free 10 percent return one year from now. If the tax rate is 35 percent, under an income tax, the entrepreneur pays $35 of tax on the $100 of profits and has $65 left to invest. In the next year, the investor earns $71.50 and subtracts $65 in depreciation for the cost of the machine (assuming for simplicity it is only good for one year), leaving taxable income of $6.50. After paying $2.28 in tax (35 percent of $6.50) the entrepreneur would be left with $4.22. The investor chooses between consuming $65 today or $69.22 in the future – an after-tax return of 6.5 percent.

In contrast, when new investments can be expensed, as under a consumption tax, the investor would choose between investing all $100 in the machine or receiving $65 after taxes for spending. If the entrepreneur invests, the entrepreneur would have $110 in receipts in the next year, but no depreciation deductions. After paying $38.50 in tax (35 percent of $110), the investor will have $71.50 left. Thus, the investor can choose between consuming $65 today or $71.50 in the future – an after-tax return of 10 percent.

To see how a postpaid consumption tax and an income tax treat supernormal returns equally, assume that the investment described above actually yields a return of 20 percent. Under an income tax, the investor now has $78 in profit. After subtracting the $65 depreciation allowance, the entrepreneur would have taxable income of $13 – representing normal returns of $6.50 plus an additional $6.50 supernormal return. After paying $4.55 in tax (35 percent of $13), the entrepreneur would be left with $8.45. Thus under an income tax, the investor chooses between consuming $65 today or $73.45 in the future – an after-tax return of 13 percent.

Under the consumption tax, as before, the investor deducts the $100 investment in the first year, but pays tax of $42 (35 percent of $120) in the next year. This leaves $78 ($120 less $42) after taxes. The investor chooses between consuming $65 today or $78 in the future – a 20 percent after-tax return. However, the investor pays $3.50 more in tax ($42 less $38.50 in the first consumption tax example) as a result of the project's supernormal returns. This additional tax represents 35 percent of the $10 of supernormal returns. Thus, the consumption tax described in this example levies the same tax burden as the income tax on supernormal returns.

A Consumption Tax Would Encourage Economic Growth

Taxing consumption rather than income would remove the saving disincentives that are central to income tax systems. Although one cannot know with absolute certainty the effect of raising the return on private saving by lowering the tax burden, most economic models suggest that such a change would result in higher household saving and a greater level of capital accumulation. Allowing businesses to deduct the cost of new investment immediately, rather than to depreciate assets over time, would encourage new investment. It also would eliminate the tax-induced differences between before-tax and after-tax returns on investment projects that are found in our current system.

Numerous studies have evaluated the economic impact of replacing the current income tax with a consumption tax. These studies typically consider reforms that

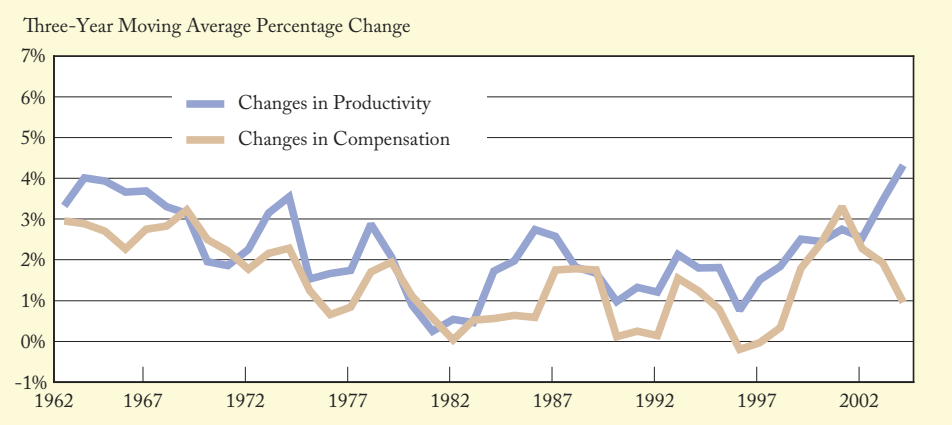
more closely resemble the Progressive Consumption Tax Plan, rather than the Growth and Investment Tax Plan discussed below. These studies use a range of different assumptions in analyzing tax reform, and they consider both the near-term and long-run consequences of modifying the tax structure. While the studies produce different estimates of how taxing consumption rather than income would affect economic growth, virtually all such studies suggest that the long-run level of national income would be higher. The Treasury Department used three different economic models to evaluate both the long-run and short-run effects of adopting the Progressive Consumption Tax Plan. Their findings suggested a long-run increase in economic activity of between 2 and 6 percent. These findings are broadly consistent with the results of previous economic analyses, most of which yielded estimates of at least a 3 percent increase in long-run output. Most of these models do not consider the potential efficiency gains that result from an improved allocation of capital across investments, but focus instead only on the benefits of lowering the overall capital tax burden. The potential economic gains from shifting to a consumption tax may therefore exceed these estimates.

To place these values in perspective, a 5 percent expansion of the U.S. economy in 2005 would increase Gross Domestic Product by over $600 billion and would likely raise wages and compensation by over $400 billion. Such an increase in economic output would improve living standards for most Americans.

The increased level of capital accumulation that would follow the adoption of a consumption tax is likely to result in more rapid productivity growth, which is the key to raising standards of living for American workers. Figure 7.1 shows the historical relationship between changes in wages and productivity growth. The two move closely together: wages grow when productivity grows, and wages stagnate when productivity falls.

Productivity growth ultimately depends on investments in human, physical, and intangible capital. Human capital investment is affected by the tax burden that

Figure 7.1. Productivity and Compensation Trends



Source: 2004 Economic Report of the President, Table B-49.

individuals expect to face after they have invested time and money to acquire skills that raise their earning capacity. Both the level and the progressivity of tax rates are important. Low marginal tax rates on labor income make it more attractive for individuals to make investments in education. In contrast, large differences in labor tax rates when individuals forego earnings to obtain new skills, and when they earn the return on those investments, can discourage human capital investment. All of the Panel's recommendations preserve incentives for human capital investment by avoiding increases in (and in many cases, reducing) the marginal tax rates on labor.

The incentive for businesses and individuals to invest in physical and intangible capital is affected by the difference between the before-tax and the after-tax return to new investments. Taxing business investment reduces the aggregate stock of capital that is available to raise worker productivity. Moreover, under the current tax system, investments in physical capital, such as plant and equipment, are taxed at substantially higher rates than investments in marketing, research and development, and other intangibles. Business investments are also taxed much more heavily than investments in owner-occupied housing. This uneven tax treatment of investment leads to an inefficient allocation of investment resources.

An Overview of the Growth and Investment Tax Plan

The Growth and Investment Tax Plan would raise revenue in a progressive fashion, while preserving many of the important features found in our current income tax. It would provide work incentives to low-income taxpayers through Family and Work Credits and encourage home ownership and charitable giving. Like the Simplified Income Tax, it would eliminate the worst features of our current income tax system, such as targeted tax benefits, phase-outs, and the AMT. It would simplify the tax system for individual taxpayers using an approach that is similar to the Simplified Income Tax Plan by incorporating a number of elements that are common to both plans.

Table 7.1. Growth Investment Tax Plan for Households	
Households and Families	
Tax rates	Three tax brackets: 15%, 25%, 30%
Alternative Minimum Tax	Repealed
Personal exemption	Replaced with Family Credit available to all taxpayers: $3,300 credit for married couples, $2,800 credit for unmarried taxpayers with child, $1,650 credit for unmarried taxpayers, $1,150 credit for dependent taxpayers; additional $1,500 credit for each child and $500 credit for each other dependent
Standard deduction	
Child tax credit	
Earned income tax credit	Replaced with Work Credit (and coordinated with the Family Credit); maximum credit for working family with one child is $3,570; with two or more children is $5,800
Marriage penalty	Reduced. Tax brackets and most other tax parameters for couples are double those of individuals
Other Major Credits and Deductions	
Home mortgage interest	Home Credit equal to 15% of mortgage interest paid; available to all taxpayers; mortgage limited to average regional price of housing (limits ranging from about $227,000 to $412,000)
Charitable giving	Deduction available to all taxpayers (who give more than 1% of income); rules to address valuation abuses
Health insurance	All taxpayers may purchase health insurance with pre-tax dollars, up to the amount of the average premium (estimated to be $5,000 for an individual and $11,500 for a family)
State and local taxes	Not deductible
Education	Taxpayers can claim Family Credit for some full-time students; simplified savings plans
Individual Savings and Retirement	
Defined contribution plans	Consolidated into Save at Work plans that have simple rules and use current-law 401(k) contribution limits; AutoSave features point workers in a pro-saving direction (Save at Work accounts would be "prepaid" or Roth-syle)
Defined benefit plans	No change
Retirement savings plans	Replaced with Save for Retirement accounts ($10,000 annual limit) available to all taxpayers
Education savings plans	Replaced with Save for Family accounts ($10,000 annual limit); would cover education, medical, new home costs, and retirement saving needs; available to all taxpayers; refundable Saver's Credit available to low-income taxpayers
Health savings plans	
Dividends received	Taxed at 15% rate
Capital gains received	Taxed at 15% rate
Interest received (other than tax exempt municipal bonds)	Taxed at 15% rate
Social Security benefits	Replaces three-tiered structure with a simple deduction. Married taxpayers with less than $44,000 in income ($22,000 if single) pay no tax on Social Security benefits; fixes marriage penalty; indexed for inflation

For businesses, the Growth and Investment Tax Plan would establish a more uniform tax on investment by allowing immediate expensing of business assets and eliminating interest deductions. One measure that economists often use to describe the net effect

of the tax system on investment incentives is the "marginal effective tax rate." This yardstick is not the statutory tax rate, but rather a measure of the difference between an investment's pre-tax and after-tax return. The higher the marginal effective tax rate, the lower the after-tax return relative to the pre-tax return, meaning that some investors would not undertake an investment because of the tax burden. If the effective tax rate is zero, any project that an investor would choose to undertake in a world without any taxes would still be undertaken in a world with taxes.

Table 7.2. Growth and Investment Tax Plan for Businesses

Small Business	
Tax rates	Sole proprietorships taxed at individual rates (top rate lowered to 30%); Other small businesses taxed at 30%
Recordkeeping	Business cash flow tax
Investment	Expensing of new investment
Large Business	
Tax rate	30%
Investment	Expensing for all new investment
Interest paid	Not deductible (except for financial institutions)
Interest received	Not taxable (except for financial institutions)
International tax system	Destination-basis (border tax adjustments)
Corporate AMT	Repealed

Under the current income tax system, effective tax rates differ widely across assets and across projects that are financed in different ways. The average marginal effective tax rate on all types of business investment under the policy baseline is approximately 22 percent. The Growth and Investment Tax Plan would lower the marginal effective tax rate to 6 percent and equalize the tax burden on different types of investments. The Panel is confident that the very substantial reduction in the tax burden on investment would stimulate capital formation, keep American capital that would have gone to other countries at home, and attract foreign capital to the United States.

The Growth and Investment Tax Plan for Households

For households, the Growth and Investment Tax Plan is nearly identical to the Simplified Income Tax. Under the Growth and Investment Tax Plan, households would be taxed on their wages, salaries, and other compensation. The Growth and Investment Tax Plan would incorporate the newly designed ways to help taxpayers receive tax benefits for home ownership, charitable giving, and health insurance coverage described in Chapter Five. It would incorporate the Family and Work

Credits, which would provide a tax threshold that is identical to the tax threshold under the Simplified Income Tax. Like the current system, the Growth and Investment Tax Plan would share the burdens and benefits of the federal tax structure in a progressive manner.

Under the Growth and Investment Tax Plan, wages, compensation, and other compensation would be taxed at three progressive rates of 15, 25, and 30 percent, instead of the six rates used in our current system. As summarized in the Table 7.3, the rate brackets for married taxpayers are exactly twice the amounts for unmarried taxpayers, which would reduce the marriage penalties.

Table 7.3. Tax Rates under the Growth and Investment Tax Plan (2006)

Tax Rate	Married	Unmarried
15%	Up to $80,000	Up to $40,000
25%	$80,001 - $140,000	$40,001 - $70,000
30%	$140,001 or more	$70,001 or more

An income tax collects more taxes from a family that saves for the future than it would from an identical family that spends the same amount today. The Growth and Investment Tax Plan would reduce, but not eliminate, this distortion. The Progressive Consumption Tax Plan discussed below, in contrast, would eliminate the tax burden on capital income and thereby make a family's tax burden independent of when they choose to spend their earnings.

The Growth and Investment Tax Plan deviates from a traditional consumption tax by imposing a low-rate tax on all household capital income, while also retaining a system of tax-exempt saving accounts that would enable many households to avoid taxation altogether on returns to savings. All dividends, interest, and capital gains on assets held outside these accounts would be taxed at a 15 percent rate. Under current law, dividends and capital gains are taxed at a maximum rate of 15 percent, while interest is taxed at ordinary income tax rates. Lowering the household-level tax on interest income would further reduce the incentive for families to spend now instead of saving more.

The Growth and Investment Tax Plan would incorporate the Save for Retirement and Save for Family accounts proposed as part of the Simplified Income Tax. In addition, the refundable Saver's Credit would provide a match for contributions made by low-income taxpayers.

The Growth and Investment Tax Plan also would provide employer-sponsored retirement accounts that are similar to the Save for Work accounts under the Simplified Income Tax. However, the Save at Work accounts under the Growth and Investment Tax Plan would be "pre-paid," meaning that contributions to these

accounts would be made on an after-tax basis like a Roth IRA. This change would not affect balances in existing pre-tax retirement accounts, which would continue to be tax-free until withdrawn Allowing future contributions to employer-sponsored accounts to be made on an after-tax basis under the Growth and Investment Tax Plan would provide a uniform treatment of all tax-free saving.

As with the Simplified Income Tax, these savings accounts would ensure that most American families would be able to save for retirement, housing, education, and health free of taxes. Given the opportunity and flexibility of these savings accounts, the Panel expects that relatively few families would pay the 15 percent tax on interest, dividends, and capital gains that would apply to assets held outside these accounts.

Box 7.2. Save at Work Accounts Under the Growth And Investment Tax Plan

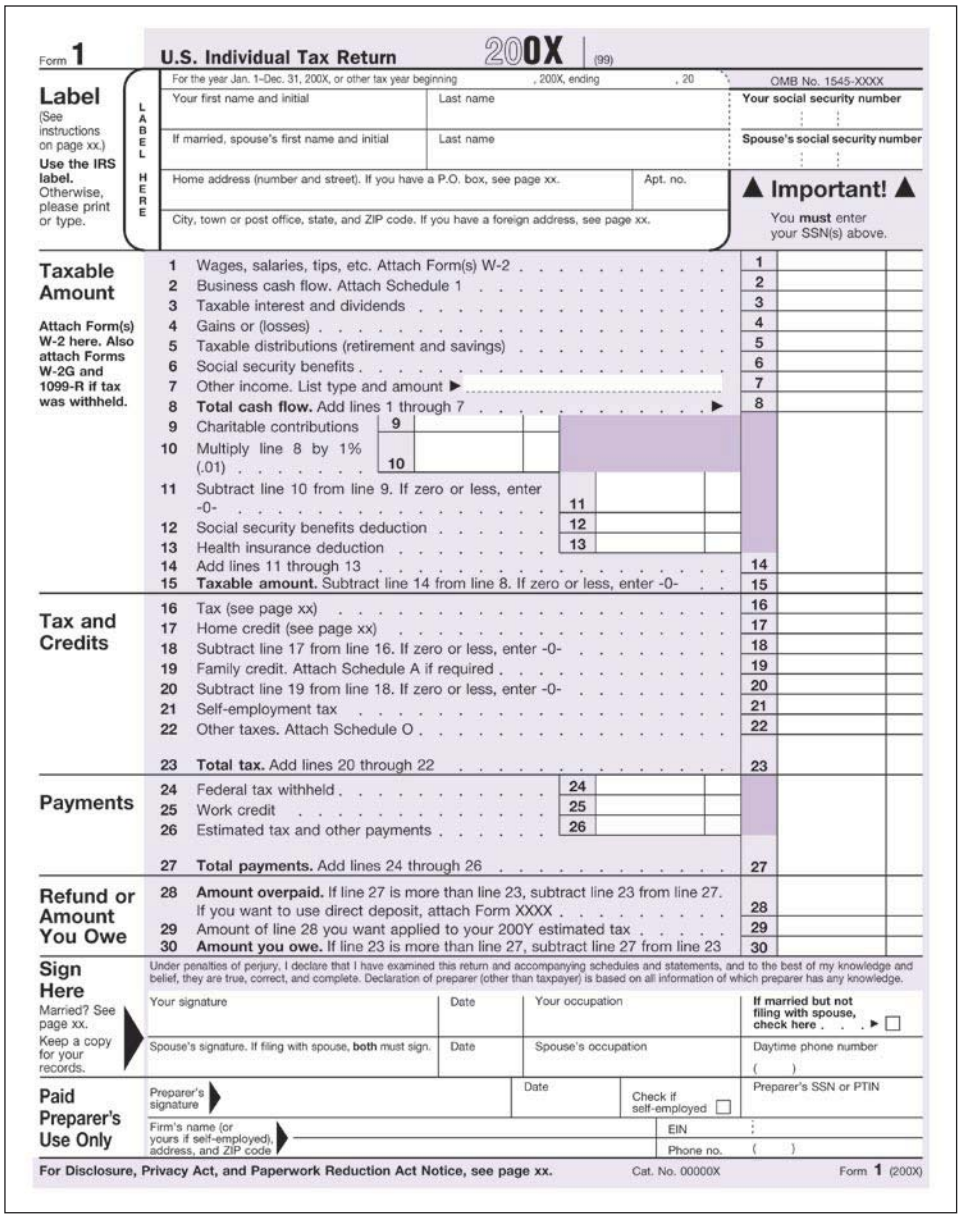
The Growth and Investment Tax Plan incorporates back-loaded, or Roth-style Save at Work accounts. These accounts would be similar to recently enacted provisions that will permit taxpayers to make after-tax contributions to their 401(k) and 403(b) accounts beginning next year.

The Growth and Investment Tax Plan differs from the Simplified Income Tax, which provides pre-tax Save at Work accounts that are structured like traditional IRAs and provide a tax deduction for contributions and tax all withdrawals as ordinary income. If a household's marginal tax rate is the same when contributions are made and withdrawn, the two structures offer the opportunity to accumulate assets at the before-tax rate of return. The Roth-style approach has the advantage of being simpler because the traditional IRA approach involves claiming a deduction when money is contributed and reporting income when the money is withdrawn.

These approaches yield different revenue implications over the ten-year budget window. The revenue cost of traditional IRA accounts is recorded "up front," when contributions are made. With Roth-style accounts, the pattern is reversed – there are no up-front revenue costs because contributions are included in taxable income. The discussion in Chapter Four noted that retirement saving programs affect revenues over horizons as long as three or four decades. The Simplified Income Tax Plan's Save at Work accounts would raise less tax revenues during the ten-year budget window than those of the Growth and Investment Tax Plan, even if identical amounts were contributed to these accounts. The Growth and Investment Tax Plan would raise less revenue from these accounts in the years beyond the budget window. It is worth noting that other provisions of the Growth and Investment Tax Plan have the opposite effect – expensing of new investment, for example, overstates revenue losses because deductions are shifted inside the ten-year budget window.

The Panel supports the use of Roth-style accounts in the Growth and Investment Tax Plan on policy grounds. The availability of the tax revenue from the Roth-style approach also made it possible to set the corporate and individual income tax rates lower than they would have been if the traditional IRA structure had been used. Nevertheless, the use of Roth-style accounts is not an essential feature of the plan, and it could be implemented with the traditional IRA-style accounts. If policymakers made the decision to use that structure, the tax rates would need to be higher in order to achieve revenue neutrality.

Figure 7.2. Tax Return for the Growth and Investment Tax Plan



Form **1** **U.S. Individual Tax Return** **200X** (99)

For the year Jan. 1–Dec. 31, 200X, or other tax year beginning , 200X, ending , 20 — OMB No. 1545-XXXX

Label (See instructions on page xx.) **Use the IRS label.** Otherwise, please print or type.

LABEL HERE

Your first name and initial | Last name | **Your social security number**

If married, spouse's first name and initial | Last name | **Spouse's social security number**

Home address (number and street). If you have a P.O. box, see page xx. | Apt. no.

City, town or post office, state, and ZIP code. If you have a foreign address, see page xx.

▲ Important! ▲ You **must** enter your SSN(s) above.

Taxable Amount — **Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.**

1	Wages, salaries, tips, etc. Attach Form(s) W-2		1
2	Business cash flow. Attach Schedule 1		2
3	Taxable interest and dividends		3
4	Gains or (losses)		4
5	Taxable distributions (retirement and savings)		5
6	Social security benefits		6
7	Other income. List type and amount ▶		7
8	**Total cash flow.** Add lines 1 through 7 ▶		8
9	Charitable contributions	9	
10	Multiply line 8 by 1% (.01)	10	
11	Subtract line 10 from line 9. If zero or less, enter -0-	11	
12	Social security benefits deduction	12	
13	Health insurance deduction	13	
14	Add lines 11 through 13		14
15	**Taxable amount.** Subtract line 14 from line 8. If zero or less, enter -0-		15

Tax and Credits

16	Tax (see page xx)	16
17	Home credit (see page xx)	17
18	Subtract line 17 from line 16. If zero or less, enter -0-	18
19	Family credit. Attach Schedule A if required	19
20	Subtract line 19 from line 18. If zero or less, enter -0-	20
21	Self-employment tax	21
22	Other taxes. Attach Schedule O	22
23	**Total tax.** Add lines 20 through 22	23

Payments

24	Federal tax withheld	24	
25	Work credit	25	
26	Estimated tax and other payments	26	
27	**Total payments.** Add lines 24 through 26		27

Refund or Amount You Owe

28	**Amount overpaid.** If line 27 is more than line 23, subtract line 23 from line 27. If you want to use direct deposit, attach Form XXXX	28
29	Amount of line 28 you want applied to your 200Y estimated tax	29
30	**Amount you owe.** If line 23 is more than line 27, subtract line 27 from line 23	30

Sign Here Married? See page xx. Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature | Date | Your occupation | **If married but not filing with spouse, check here** ▶ ☐

Spouse's signature. If filing with spouse, **both** must sign. | Date | Spouse's occupation | Daytime phone number ( )

Paid Preparer's Use Only

Preparer's signature | Date | Check if self-employed ☐ | Preparer's SSN or PTIN

Firm's name (or yours if self-employed), address, and ZIP code | EIN | Phone no. ( )

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page xx. Cat. No. 00000X Form **1** (200X)

The Growth and Investment Tax Plan would make computing taxes dramatically simpler than our current system and would significantly reduce the amount of information required to be gathered and retained by taxpayers and collected and processed by the IRS. Like the Simplified Income Tax Plan, individual tax returns would be shorter and simpler and would free of the parallel tax structure created by the AMT. The new tax return that would be used under the Growth and Investment Tax Plan would easy to understand, and would be no longer than one page, as shown in Figure 7.2.

The Growth and Investment Tax Plan for Businesses

The Growth and Investment Tax Plan would impose a flat tax on all business cash flow, defined as sales or receipts less the cost of materials, labor services, and purchases of business assets. The Growth and Investment Tax Plan would modify the current corporate income tax base in four important ways. First, businesses would be allowed to write-off immediately, or "expense" their capital expenditures. Second, for non-financial firms, financial transactions would be excluded from the cash flow computation. Businesses generally would not be entitled to deduct interest paid or be required to include interest and dividends received and capital gains on the sale of financial assets. Special rules would apply to businesses that provide financial services. Third, firms that generate losses would be allowed to carry them forward and to offset them against future tax liability. In contrast to the current tax system, however, losses would accrue interest when carried forward. Finally, international transactions would be taxed under the "destination basis" principle. The cash flow tax would be rebated on exports, and imports would not be deducted from cash flow. The Panel embraced the destination-based system because it is consistent with the use of domestic consumption as the tax base and because it is easier to administer than any other alternative.

Business Cash Flow Taxed Once at a Flat Rate

The Growth and Investment Tax Plan would apply a flat 30 percent tax on all businesses other than sole proprietorships, regardless of their legal structure. Removing the tax differential among business entities would eliminate economic inefficiency caused by the double tax on corporate firms that are unable to take advantage of flow-through treatment under current law for non-corporate organizational forms, such as limited liability companies (LLC), partnerships, or S corporations. The net positive cash flow of flow-through entities would be taxed at the business tax rate, although owners of these entities could report and compute the tax on business cash flow on a separate schedule of their individual returns. Similarly, the net positive cash flow of sole proprietorships would be reported on the tax return of its owner, but would be taxed at the graduated individual rates.

By focusing on cash flow, the new tax base would discard the complicated accounting rules that currently attempt to match income with deductions. Instead, for most businesses the tax base would be the difference between cash received and cash paid out. The business tax would resemble a "subtraction method" value-added tax (VAT), with the important exception that wages and other compensation would be a deductible expense.

Box 7.3. What is the Subtraction Method?

The business tax would be imposed on the difference between receipts and outlays – net cash flow. This is often referred to as the "subtraction method" because businesses subtract all expenses from receipts. It is one of two methods used to implement VATs. The other method is the credit or credit-invoice method. In that method, a business is taxed on all receipts but receives a credit for the amount of tax paid by the seller on the business' purchases. While the credit method is based on transactions and the subtraction method is based on the aggregate accounts of a business, in practice, the two methods are virtually identical – the subtraction method aggregates all expenses and receipts during the year into accounts made up of individual transactions, while the credit method starts with transactions, but businesses must ultimately aggregate transactions into accounts to file returns.

Any amount deducted under the subtraction method can be converted to an equivalent credit and vice versa. Suppose a business spends $100 on supplies and the tax rate is 35 percent. Under the subtraction method, the business gets a deduction of $100, saving it $35 in taxes that would otherwise be due. On the other hand, under the credit method the business would not be allowed to subtract the $100 of purchases, but would be given a $35 tax credit.

Most countries with credit method taxes require invoices to help ensure that a buyer only receives a tax credit if the seller in fact pays tax on the sale. The Growth and Investment Tax Plan, although implemented using the subtraction method, would similarly require that deductible purchases be allowed only from businesses that are subject to the tax, and that these purchases be substantiated. For example, goods or services received from foreigners, who are not taxed in the United States, would not be deductible.

The Growth and Investment Tax Plan would be implemented using the subtraction method because it is closer to current law methods of accounting, which would reduce the costs of switching tax systems.

The flat-tax rate of 30 percent on business cash flow would be the same as the top tax rate under the household tax, reducing tax planning strategies aimed at shifting income between the business and individual tax bases.

Expensing for All Business Investments

The Growth and Investment Tax Plan would enhance investment incentives by lowering the effective tax rate on new investment. It also would reduce distortions under current law that suppress and misallocate capital investment due to different tax rates across different types of business assets.

Our current depreciation system permits businesses to deduct the cost of their new investments from their taxable income over time. Although accelerated depreciation and expensing of some assets under our current system lowers the tax burden on returns from new investment, depreciation deductions provide an imperfect mechanism for measuring the actual decline in value of an asset. Current depreciation rules result in effective tax rates that differ substantially among different types of assets. Mismatches between the actual decline in the value of assets, or economic depreciation, and tax depreciation may discourage new investment in plant and equipment and distort the allocation of investment across asset classes.

Current-law tax depreciation also fails to account for inflation. Businesses claim tax depreciation based on an asset's nominal purchase price, even though inflation may have increased its replacement cost. This means that investors do not recover the full value of their investments. The current income tax leads businesses to forego investing in some projects that would have a positive net present value in a world without taxes, but that fail to earn enough to cover both taxes and the required return to investors. With a pure consumption tax, any project that is attractive in a no-tax world remains attractive.

The Growth and Investment Tax Plan would encourage new investment by replacing the patchwork of current incentives and credits with a simple rule: all business investment can be expensed the year when it is made. Moving from depreciation allowances to expensing would lower the tax burden on the returns to new investment and level the playing field across different types of business assets. With expensing, each dollar spent on a new investment asset would generate a deduction worth one dollar, regardless of the asset's type. It would also substantially simplify business taxes by eliminating the need to maintain detailed depreciation schedules and accounting for asset basis.

Because the Growth and Investment Tax Plan retains a low-rate tax on dividends, interest, and capital gains at the household level, it continues to place a tax burden, estimated by the Treasury Department to be approximately 6 percent, on all types of investment. Nevertheless, many projects that are not economical to undertake under the current income tax system would generate an acceptable after-tax return under the Growth and Investment Tax Plan.

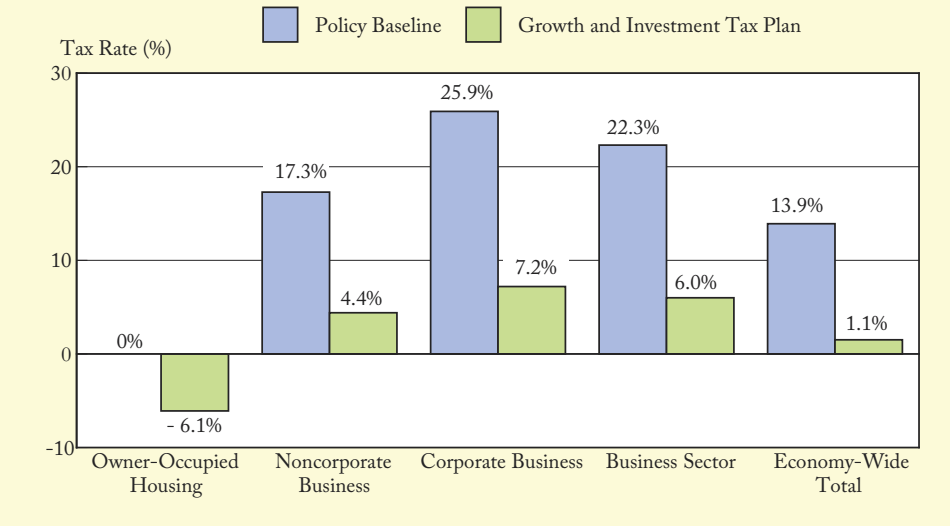
Consistent Treatment of Financial Transactions

The business tax base under the Growth and Investment Tax Plan would not include financial transactions, such as interest paid and received. The elimination of interest deductibility would equalize the tax treatment of different types of financing and would reduce tax-induced distortions in investment incentives. Current law places a lower tax burden on firms that have access to debt financing than on those that use the equity market to finance new projects.

Eliminating the business interest deduction for non-financial firms is an essential component of the Growth and Investment Tax Plan. Allowing both expensing of new investments *and* an interest deduction would result in a net tax subsidy to new investment. Projects that would not be economical in a no-tax world might become viable just because of the tax subsidy. This would result in economic distortions and adversely impact economic activity. Moreover, retaining interest deductibility would preserve differences in the tax burdens on debt-financed and equity-financed projects, thereby retaining distortions across asset and firm types. The Growth and Investment Tax Plan would eliminate the complicated distinctions between debt and equity finance and remove the tax system as a factor in firms' capital structure decisions. Removing the tax advantages of corporate debt also eliminates the tax code's incentive for firms to increase their debt load beyond the amount dictated by normal business

conditions. Figure 7.3 summarizes how the combination of expensing and more equal treatment of interest and dividends provides a lower, more uniform tax burden on the returns of marginal business investments.

Figure 7.3. Comparison of Effective Tax Rates on Different Types of Investment



Note: The tax rates for the policy baseline assume, among other things, that the 2001 and 2003 tax cuts will be made permanent and that the proposals contained in the President's Budget to create retirement savings accounts and lifetime savings accounts (each with a $5,000 limit) would be enacted.
Source: Department of the Treasury, Office of Tax Analysis.

Excluding financial transactions from the business tax of the Growth and Investment Tax Plan would create special difficulties in the case of businesses that provide financial services. To prevent distortions, financial services should be taxed like any other business good or service. The taxation of financial services is complicated, however, because "implicit fees" are typically imbedded in interest rate spreads and financial margins. For example, a bank typically pays interest to depositors at a lower rate than it collects from mortgage borrowers. Both of these transactions include two components – a service fee and a financial cost related to the use of money – that are included in a single payment of "interest." The problems with separating the components of financial services are not unique to a consumption tax – income taxes also do not properly tax financial services, but the under-taxation is more visible in a consumption tax. As a result of this conceptual difficulty, countries that administer VATs have adopted special regimes for financial services, with most exempting financial services from the VAT tax base.

The Panel determined that financial services should be taxed under the Growth and Investment Tax Plan. Exempting financial services from tax leads to a number of economic distortions and creates compliance and administrative difficulties. Absent special rules, however, businesses that primarily provide financial services would have perpetual tax losses under the Growth and Investment Tax Plan. This would occur because the cash flow tax base for these financial firms would not include the

revenues that they generate from lending and investing at rates above their cost of funds, but it would allow a deduction for the cost of compensation for workers as well as other purchases.

The Panel considered several options for the taxation of these firms, and recommends an approach under which financial institutions would treat all principal and interest inflows as taxable and deduct all principal and interest outflows. Customers would disregard financial transactions for tax purposes. To prevent the over-taxation of business purchases of financial services, financial institutions would inform business customers of the amount of financial cash flows that are attributed to deductible financial intermediation services. This amount would be deductible as an expense in computing the business customer's taxable cash flow under the Growth and Investment Tax Plan. Rules would be required under this regime to identify which businesses should be subject to the financial institutions regime, especially in the case of businesses that have both financial and non-financial business activities. In addition, an interest rate that would be used as a proxy for the "financial cost" component of financial cash flows would have to be established to determine the value of the separate taxable service component; the simplest approach would be to compare financial inflows and outflows to a single, short-term inter-bank interest rate.

The Panel recognizes that before implementing the Growth and Investment Tax Plan, it would be wise to consider alternative tax rules for financial firms and their potential impact on incentives for firm behavior. The Panel has identified some possible alternatives, which are discussed in more detail in the Appendix.

The Treatment of Tax Losses

The current tax system limits refundability of tax losses because of concerns that such losses can be generated through non-economic, tax-sheltering activity. Firms currently are allowed to carry back losses and to claim refunds for taxes paid in prior years, and to carry losses forward to offset tax liability in future years. Firms that in prior years earned positive income that exceeds their current losses, or that will earn such income in the future, will eventually be able to use their tax losses.

When losses are not refundable, but firms are taxed when they have positive cash flows, the tax system discourages risky ventures with substantial loss possibilities. In effect, such tax rules provide the government with a larger share of favorable returns than of adverse returns, which reduces the after-tax return to undertaking such an investment.

Denying current refunds of losses raises the effective tax rate on marginal investments relative to a system that features refundable losses. Consider a start-up firm that has substantial upfront capital expenditures but little initial revenue. In the early years, the firm has negative cash flow, but it expects to be profitable in the future. If the tax system does not refund losses until a firm is profitable, there is a delay in the receipt of the tax benefits associated with expensing its capital investments. The tax system would discourage firms from undertaking projects expected to have many years of negative cash flows. If there was some chance that the firm might go bankrupt before

receiving the benefit of its start-up losses, this would raise the effective tax burden on new investment.

Under the Growth and Investment Tax Plan, losses would not be refundable. To mitigate the impact that denying loss refundability would have on the effective tax rate on marginal investments, the Panel recommends providing interest on loss carryforwards. If the current interest rate is 10 percent, and a firm incurs a $1 million loss this year, it may claim a $1.1 million loss offset next year (adding 10 percent of $1 million), or a $1.21 million loss in two years (adding 10 percent of $1.1 million). Losses would be carried forward indefinitely. By providing interest on the amount of tax later refunded, the tax system would achieve nearly the same effect as having full loss refunds for firms that eventually earn positive cash flows, provided that the interest rate paid on loss carryforwards is equal to the firm's borrowing rate. Allowing interest on losses carried forward alleviates the problem of firms losing the time value of money on carryforwards, but does not eliminate the risk of losing carryforwards entirely if a firm goes out of business.

Another strategy for allowing firms to capture the full value of the tax benefits associated with negative cash flow is to allow losses to be traded from one firm to another. If trading is not costly to firms, then allowing such trading may be equivalent to allowing full and immediate loss refundability. The Panel decided that losses should not be tradable under the Growth and Investment Tax Plan. Allowing tradable or refundable losses may encourage tax avoidance schemes in which the taxpayers make investments that would not have been worth undertaking in a no-tax setting. The value of tax losses created by such an investment may be a key component of its appeal. In addition, allowing loss trading could make it much more important to police so-called "hobby losses" and losses generated by various forms of disguised consumption, rather than investment, because those losses could generate tax savings even when the person incurring them would never realize offsetting positive cash flow.

Under current law, several provisions prevent the transfer of losses to taxpayers with positive income and the transfer of income to taxpayers with losses. One set of rules generally limits the ability to apply the losses of one corporation against income from another when the corporations are combined. Similar rules would be adopted under the Growth and Investment Tax Plan to limit the transferability of negative and positive cash flow.

"Destination-Basis" Taxation of Cross-Border Transactions

International transactions, including both imports and exports of goods and services, as well as financial transactions such as the repatriation of earnings by corporate subsidiaries, pose important challenges for all tax systems. The Growth and Investment Tax Plan is no exception. The tax could be implemented on either a "destination-basis" or an "origin-basis" to address international transactions. The former treats all domestic consumption equally, while the latter treats all domestic production equally. The Panel recommends using the destination-basis to implement the Growth and Investment Tax Plan.

A destination-basis consumption tax levies the same tax on consumption that occurs in the United States, regardless of where the good was produced. Under this system, sales to customers in other nations (exports) are excluded from the tax base while purchases from abroad (imports) are included. Thus, if a domestic manufacturer produces a product in the United States at a cost of $90 that it sells abroad for $100, the manufacturer is not taxed on the $100. The manufacturer receives a rebate of the tax on the $90 of production costs. This has the effect of eliminating the tax burden on goods that are sold abroad. The tax rebate that the manufacturer receives at the point of export is commonly known as a border tax adjustment. Purchases from abroad are taxed by either making them nondeductible to the importing business or by imposing an import tax.

The alternative "origin-basis" system taxes goods based on where they were produced – their origin. The tax base is domestic production, which equals domestic consumption plus net exports. Exports are included in the tax base because they are part of domestic production and imports are excluded because they are not. If a manufacturer produces a product in the United States at a cost of $90 that it sells abroad for $100, it is taxed on the sale. This means that identical items produced for domestic and for foreign consumption are taxed in the United States in exactly the same way. Purchases from abroad are either deducted by the importing business or not taxed at the point of entry into the United States.

Border Tax Adjustments and International Trade

The VATs imposed by our major trading partners are implemented on a destination-basis. They include border tax adjustments. While these taxes are often viewed as subsidizing exports because they exempt exports and tax imports, economic analysis indicates that destination-based taxes do not affect the balance of trade. To illustrate this proposition, suppose that the United States was trading with a foreign country in a completely tax-free environment. Trade would be conducted at a level at which each country enjoyed comparative advantage – selling to others the products and services that nation produces best. Now suppose that the United States imposed a destination-basis consumption tax. A domestic exporter would still sell its product in the foreign country at the same price as without the tax.

Similarly, a good sold in the United States by a foreign producer would be subject to the U.S. consumption tax. As a result, the foreign importer would compete in the United States on the same basis as local sellers. Consumers in the United States would make the same choices regarding imports and domestically-produced goods as they had made before the tax was imposed, since both are subject to the same tax. Economic theory suggests, therefore, that imposing a destination-basis tax does not affect a country's trade position.

The preceding discussion might suggest, in contrast, that an origin-basis tax could disadvantage domestic producers relative to foreign producers in the worldwide market. However, border tax adjustments are not the only mechanism working to maintain neutrality. Adjustments that take place through the market, such as changes

in exchange rates or in other economic variables, including wages and the prices of other inputs, should wholly offset any potentially detrimental trade effects on the value of exported goods under an origin-basis tax.

Returning to the previous example, assume instead that the United States imposes an origin-basis tax. Before the tax is imposed, the United States is trading in a completely tax-free environment. Recall that under an origin-basis system, exports are taxed and imports are exempt. If markets are competitive, the exporter will not be able to reduce his price and remain in business after the tax on exports is imposed. However, the U.S. currency may depreciate so that although the nominal price increases by the amount of the tax, the price paid for the export by foreign consumers in their currency is unchanged from its before-tax level. Therefore, trade will not be affected. As explained above, however, if exchange rates did not fully adjust, the price adjustment could occur through adjustments in domestic prices and wages.

The observation that a neither a destination-basis nor an origin-basis tax distorts the pattern of trade that would exist in the absence of any taxes does not imply that moving from the current income tax structure to a consumption tax would not affect trade. The current tax system places heavier burdens on some industries than on others. Replacing the current tax system with a system that is equivalent to a system with no taxes at all could raise exports in the industries that are currently taxed heavily.

Administration

The Panel recommends imposing the Growth and Investment Tax Plan on a destination-basis because such a tax will be easier to administer than a comparable tax on an origin-basis. An origin-basis system will engender serious disputes as a result of "transfer pricing." The term transfer pricing refers to amounts charged (or not charged) for sales and transfers between related entities, often controlled by a single corporate parent. Because the different entities are related, they do not really care what price they charge each other. If they are located in different taxing jurisdictions they may have an incentive to set prices to minimize overall taxes rather than to reflect the actual value of the goods and services they are providing one another. Current tax rules use the internationally accepted standard for setting transfers prices; these prices must be set at the level that would have prevailed if the parties had been dealing at "arm's length." The application of this standard raises difficult compliance and administrative problems.

Under a destination-basis tax, transfer prices do not affect the computation of tax liabilities. Border adjustments make the tax base domestic consumption, which at the business level equals domestic sales minus domestic purchases. As a result, the prices established for cross-border transactions are irrelevant, and there are no opportunities to use transfer prices to minimize tax liabilities.

The same is not true under an origin-basis tax. Transfer pricing would continue to be a problem since export sales would be taxable and imports would be deductible. There is an incentive, as in the current system, to overcharge for imports and undercharge

for exports to shift income out of the United States. Related but more complex tax avoidance schemes are more difficult to accomplish under a destination-basis system for similar reasons (see Box 7.4 for an example).

Box 7.4. An Example of a Tax Avoidance Scheme under an Origin-Basis System

A foreign company purchases a $100 product from a U.S. business by promising to pay $110 in one year (a purchase on credit). The transaction is documented as the purchase of a $90 good with $20 of interest. By overstating interest on the sale, the business reduces its taxable receipts under an origin-basis tax while not changing its cash flows. The foreign company is indifferent to how the transaction is structured. Under a destination-basis system, the transaction with the foreigner is not subject to tax since it is an export and, as a result, there is no incentive to engage in this tax avoidance scheme in the course of cross-border transactions.

Besides reducing incentives for tax-minimizing transfer pricing, a destination-basis tax is easier to apply to royalty income from abroad. Royalties received from abroad represent payments for exports of intangible assets, and so would be exempt from taxation under the Growth and Investment Tax Plan. The owner of the intangible would be taxed when he uses the proceeds to consume. Royalties paid for foreign-created intangible assets would not be deductible since they are payments for imports. Transfer pricing problems may be particularly severe in the case of royalties, because it is difficult to establish arm's length prices for intangible assets. The destination-basis tax closes down opportunities to inappropriately set transfer prices since the prices established for cross-border royalty transactions would be out of the tax base.

Choosing the destination-basis for the treatment of cross-border transactions under the Growth and Investment Tax Plan "closes" the tax system. This means that businesses are only able to claim deductions from the tax base that are offset by corresponding inclusions in the tax base. Closing the system through border adjustments precludes tax avoidance opportunities that involve structuring cross-border transactions to generate tax deductions for payments to foreigners who are outside the system.

While closure is attractive on balance, it has some drawbacks. Deductions should only be allowed for purchases from domestic suppliers and sales should be exempted only if they are truly to foreigners. This makes it essential to monitor deductions and exemptions. Moreover, citizens of the United States can avoid import taxes by consuming foreign-produced goods purchased outside of the United States. This creates an incentive for citizens to buy goods abroad.

Location Incentives

The presence of expensing for new investment under the Growth and Investment Tax Plan would make the United States an attractive place to invest foreign capital. The investment incentives discussed above would apply to all firms operating in the United States, not just to firms headquartered in the United States. At the same

time, the tax code would no longer give U.S. multinational corporations an incentive to move production overseas because the tax burden would be based on *sales* within the U.S., regardless of where the goods are produced. As explained in detail earlier in this chapter, the Growth and Investment Tax Plan also would eliminate many of the complex cross-border tax planning activities that reduce the revenue collected under current corporate income taxes. Reducing the incentive for such tax planning would be an important step toward simplifying the tax system.

Refunds for Exports

The border tax adjustment described above would provide tax refunds to exporting firms. The amount of the refund would be determined by the costs incurred in producing an export, including the firm's labor costs. For firms that sell primarily in the export market, their border tax adjustment rebate could exceed any tax liability that they face on their domestic sales. Exporting firms whose border tax adjustments exceed their taxes on domestic cash flow would be provided a refund for their excess border tax adjustment. In addition, until exchange rates or domestic prices adjust after the imposition of the tax on imports, businesses that import significant amounts of goods could operate at a loss after taxes, because they would receive no deduction from income for the costs of their imports. They could thus be paying taxes greater than their net pretax cash income.

Although the excess deductions generated by an export business and those generated by a domestic business suffering losses are conceptually similar, they would be treated differently under the Growth and Investment Tax Plan. Domestic firms suffering losses would most likely prefer an immediate rebate of taxes if given a choice, notwithstanding that their loss carryforwards would be increased by an interest factor under the plan. Thus, special rules may be needed to police the allocation of expenses between domestic businesses generating losses and export businesses when both are operated within the same firm or through affiliates.

Border Tax Adjustments and the World Trade Organization

Multilateral trade rules originally developed as part of the General Agreement on Tariffs and Trade (GATT), and now incorporated into the rules of the World Trade Organization (WTO), affect the use of border adjustments. GATT/WTO rules treat border tax adjusting "direct taxes" as a prohibited export subsidy. In contrast, "indirect taxes" on exports may be border adjusted so long as the amount remitted does not exceed the amount of indirect tax "levied in respect of the production and distribution of like products when sold for domestic consumption."

Many developed countries with border-adjustable VATs couple those VATs with a single-rate tax on capital income at the individual level. Some of these countries also have wage subsidies, progressive taxation of wages, or both. The Growth and Investment Tax Plan is equivalent to a credit-method VAT at a 30 percent rate, coupled with a progressive system of wage subsidies and a separate single-rate tax on capital income. The Panel therefore believes that the Growth and Investment Tax Plan should be border adjustable.

However, given the uncertainty over whether border adjustments would be allowable under current trade rules, and the possibility of challenge from our trading partners, the Panel chose not to include any revenue that would be raised through border adjustments in making the Growth and Investment Tax Plan revenue neutral. If border adjustments are allowed, then the plan would generate about $775 billion more revenue over the ten-year budget window than is currently estimated in the scoring of this plan.

Other Issues Associated with the Implementation of the Growth and Investment Tax Plan

The Growth and Investment Tax Plan, like any other tax system, will rely on rules and definitions that must be broadly applied to a wide variety of taxpayers and activities. Taxpayers inevitably respond to taxes by altering their behavior to minimize or avoid taxes. In addition, complexity is added as rules are crafted to prevent tax avoidance or abuses. For example, current law distinguishes between interest and dividend payments by corporations. This creates opportunities for tax planning and avoidance that, over the years, have spawned countless complex rules to clarify definitions and deny favorable treatment in specific circumstances.

In designing the Growth and Investment Tax Plan, the Panel attempted to avoid distinctions between types of taxpayers, transactions, or activities that would create distortions and complexity. However, there would still be a need for some rules to delineate when specific transactions or activities are subject to tax. For example, rules to distinguish between financial and non-financial transactions, and rules regarding the treatment of transactions between businesses and taxpayers not subject to the cash flow tax (such as individuals and non-profits), are likely to be particularly important to the implementation of the tax. These issues, and others, are examined in more detail in the Appendix.

Transition

Replacing the current income tax with the Growth and Investment Tax Plan would affect the value of many assets. The Panel recognizes that transition issues are central to the analysis of fundamental tax reform, and therefore recommends providing some transition relief.

The basic issues associated with transition relief can be illustrated by considering an owner of business assets that were recently purchased for $100 and that could be depreciated under the current income tax system over ten years. This business owner would not be able to recover this tax basis in an immediate and transition-free switch to a cash flow tax. Returns on the asset – either on the sale of the asset or through cash generated by deploying the asset – would be taxed, but pre-enactment basis could not be used to offset this income. For example, if the business owner sold the asset for $100 soon after the new tax system with a 30 percent tax rate was in effect, all $100 of the sales proceeds would be taxable and $30 of tax would be due – even though the owner's economic position had not changed. On the other hand, investors who purchased new, but otherwise identical, physical assets after the Growth and Investment Tax Plan took effect would be able to expense their purchases, effectively receiving $30 of tax benefits for purchasing $100 of new equipment. This transitional

loss would be offset by future gains that the business owner would receive under the Growth and Investment Tax Plan, as returns from new investments would be taxed at a lower rate.

The Growth and Investment Tax Plan also would affect the tax treatment of existing financial assets, such as bonds and mortgages. For borrowers, eliminating interest deductions will increase future tax liabilities. For lenders, these effects will vary greatly. Individuals would pay a lower 15 percent tax on interest income, providing a windfall to these debt holders. Similarly, non-financial businesses will no longer pay tax on interest income and the value of their loans would increase.

The Panel recognizes that adoption of the Growth and Investment Tax Plan might have a negative impact on a number of households and on some business taxpayers. The Panel therefore recommends several types of transition relief. First, there should be transition relief on existing depreciation allowances. Depreciation allowances on assets put in place prior to the effective date for the Growth and Investment Tax Plan should be phased out evenly over a five-year period. In the year when the Growth and Investment Tax Plan is enacted, taxpayers with depreciable assets would be able to claim a deduction for 80 percent of the depreciation they would have been eligible to receive under the old system. In the second year this percentage will drop to 60 percent, the third year it would be 40 percent, the fourth year it would be 20 percent, and it would be zero after five years.

Second, for businesses with outstanding debt, the Panel recommends the same five-year phase-out structure, followed by deductions of 60, 40, and 20 percent. Eighty percent of an interest deduction that would have been allowed under the old law would be permitted in the first year after the effective date of the Growth and Investment Tax Plan. A similar set of rules would apply to interest income that would have been taxed under the old tax regime. Eighty percent of such interest would be included in cash flow in year one, followed by inclusion shares of 60, 40, and 20 percent. Any modifications to existing contracts would be treated as new contracts, and would terminate the transition relief for these contracts. Sales of physical assets would similarly terminate the benefits of pre-enactment depreciation allowances. As described in Chapter Five, transition relief would also apply to the deductibility of interest on home mortgages that were outstanding on the effective date of the Growth and Investment Tax Plan.

Third, the Panel proposes special transition relief for firms that might be affected by border tax adjustments. If exchange rates do not adjust as rapidly as economic theory predicts they should, then border tax adjustments would place an undue burden on imports and importers. The Panel therefore recommends a four-year phase-in period for border tax adjustments. The phase-in rules would be administered on a firm-by-firm basis, and they would be limited to a base amount, calculated as the average value of import purchases, or export sales, in the two years before the Growth and Investment Tax Plan took effect. In the first year, an importer would be able to deduct 90 percent of import purchases up to their import base. Imports that exceeded that base would not be deductible. Exporters would pay tax on 90 percent of exports up to the base amount. Exports that exceeded the base would not be taxed. In the second year, 60 percent of imports up to the firm's base amount would be deductible and 60 percent of exports would be taxed. The percentage would be reduced to 30 percent

in the third year. In the fourth year, the border adjustment would be fully phased in: Cash flow taxes on exports would be rebated at the border and imports would not be deductible from cash flow.

Finally, the Panel recommends specialized transition rules for financial institutions. If the Panel's recommended approach to the taxation of financial institutions is adopted, special transition rules would be needed to determine the status of outstanding loans made by these companies. Because financial firms never received a deduction against cash flow when raising the capital for outstanding loans, it would be unfair to levy tax on returns of capital when the lending firm receives them. Interest on loans extended prior to the effective date of the Growth and Investment Tax Plan, however, would be taxed as a component of individual cash flow. As with debt contracts for homeowners and non-financial businesses, any modifications to existing contracts would be treated as new contracts and not entitled to transition relief.

The Panel recognizes that there are other potentially important transitional issues, such as the tax treatment of existing tax loss carryforwards and tax credits and the treatment of inventory holdings when the Growth and Investment Tax Plan is implemented. In addition, the transition to the Growth and Investment Tax Plan would have a substantial impact on the financial statements of many large companies as the expected change in future tax liabilities – after considering transition relief – must be recorded for financial accounting purposes. The Panel does not specifically address these transition issues, but it recognizes that they are important concerns that would need to be addressed.

There is a fundamental tradeoff between the amount of transition relief provided when a consumption tax is adopted and the growth and efficiency gains from the tax reform. Providing generous transition relief to households and firms that lose tax benefits that are available under an income tax, but not a consumption tax, reduces the efficiency gains of reform. This occurs because financing such transition relief requires raising tax rates in the consumption tax regime, which increases tax-induced distortions in labor supply and other aspects of household behavior. If transition relief is financed with a temporary increase in tax rates for some period after tax reform is enacted, then the efficiency costs will be concentrated in this period, and the net growth impact of adopting a consumption tax may be much smaller than the long-run analysis suggests. Once the transition period ends, however, the economy will ultimately achieve the long-run gains associated with the consumption tax. If tax rates are raised permanently to finance transition relief, then there will be some reduction in long-run economic growth relative to the benchmark case of no transition relief.

The revenue costs of the foregoing recommendations regarding transition relief are incorporated in the Panel's calculations of the Growth and Investment Tax Plan's ten-year revenue cost. More generous transition relief would require higher tax rates on businesses and individuals, or tighter limits on mortgage interest deductions, the exempt amount of employer-provided health insurance, or other tax subsidies. More limited transition relief, by comparison, could be paired with even more significant tax rate reductions.

The Panel views transition relief as a critical and very difficult issue in moving from the current hybrid income tax to a consumption-based tax system. Ultimately, the

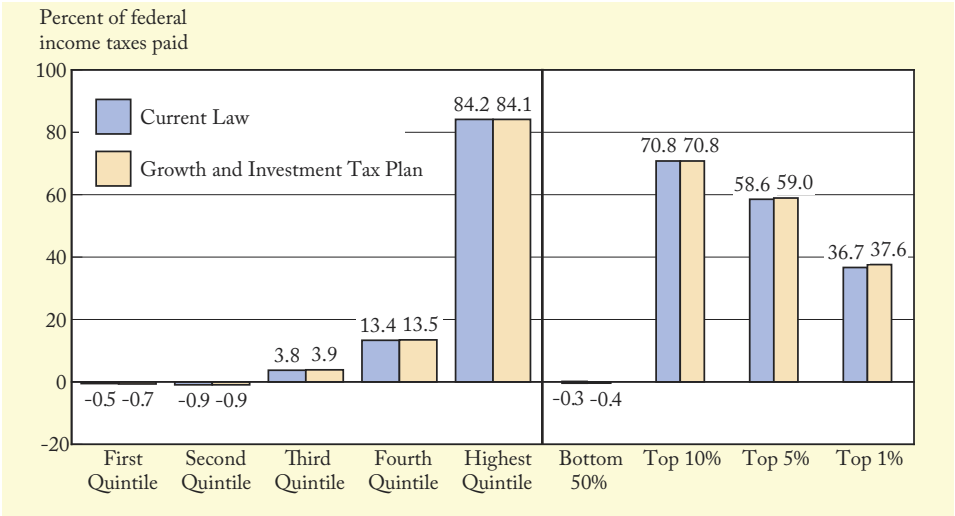
political process must determine the appropriate level of transition relief. The Panel urges those who consider transition issues to recognize that the costs of transition relief are measured not just in the additional revenue needed to fund transition provisions, but also in the reduced efficiency gains that flow from higher marginal tax rates.

A Progressive Tax System

The Growth and Investment Tax Plan removes impediments to saving and investment, and promotes long-term productivity growth, while largely preserving the current distribution of the federal income tax burden across income classes. While there are some variations in the income classes shown below, the overall distribution closely tracks current law.

The Treasury Department provided distribution tables for the Growth and Investment Tax Plan. Estimates for 2006 are shown in Figures 7.4 and 7.5. Similar to what was presented for the Simplified Income Tax Plan, Figure 7.4 breaks the population into fifths – or quintiles – and also shows the bottom 50 percent of the population (ranked by income), along with the top 10, 5, and 1 percent of the population. Figure 7.5 groups taxpayers by using income levels ranging from zero to $15,000 of income to more than $200,000 of income.

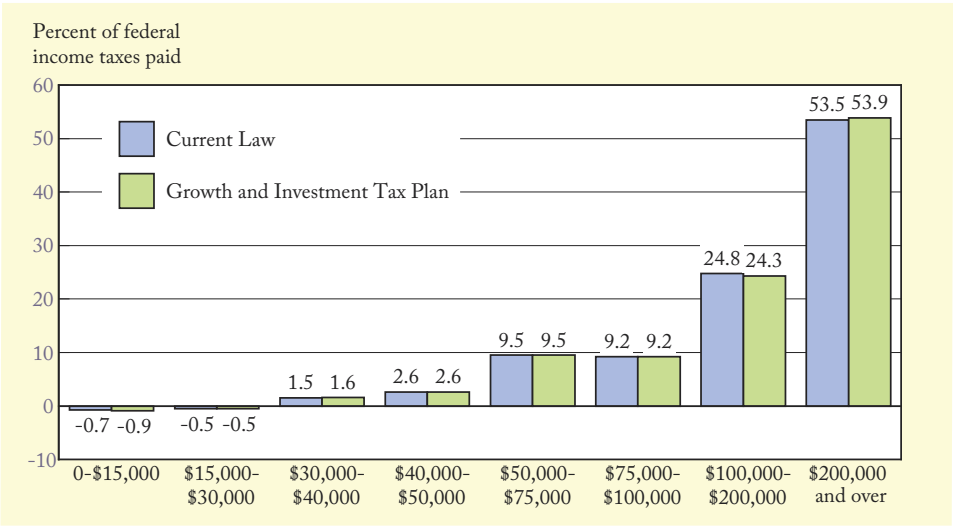
Figure 7.4. Distribution of Federal Income Tax Burden Under Current Law and the Growth and Investment Tax Plan by Income Percentile (2006 Law)



Note: Estimates of 2006 law at 2006 cash income levels. Quintiles begin at cash income of; Second $12,910; Third $27,461; Fourth $45,345; Highest $84,124; Top 10% $123,076; Top 5% $169,521; Top 1% $407,907; Bottom 50% below $36,738.

Source: Department of the Treasury, Office of Tax Analysis.

Figure 7.5. Distribution of Federal Income Tax Burden Under Current Law and the Growth Investment Tax Plan by Income Level (2006 Law)

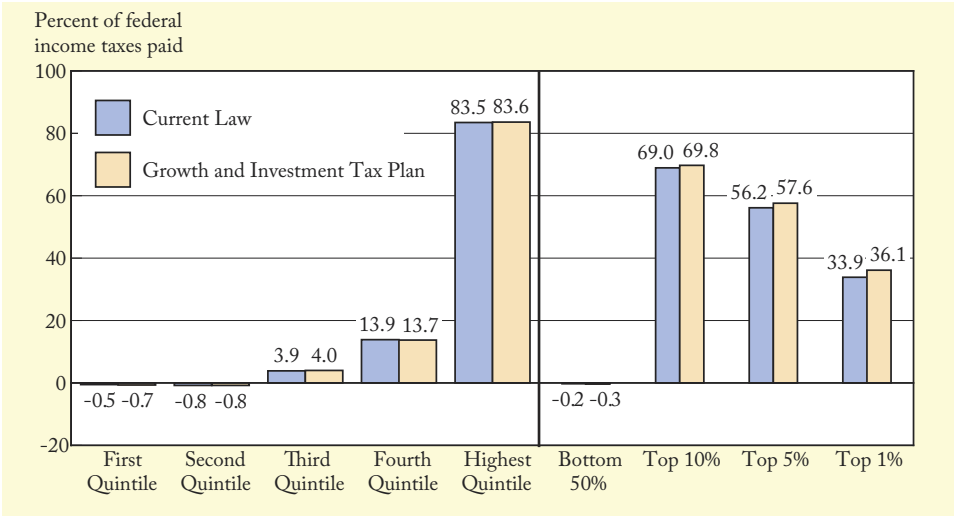


Note: Estimates of 2006 law at 2006 cash income levels.
Source: Department of the Treasury, Office of Tax Analysis.

To provide additional information about the effect of the Growth and Investment Tax Plan on the distribution of the tax burden, the Panel asked the Treasury Department to provide a distribution of the plan for the tax law that would be in place in 2015, the last year of the budget window, while holding income constant at 2006 levels. This distribution would account for provisions that change over time, such as transition relief for business and individuals and the rapid growth of the AMT under current law.

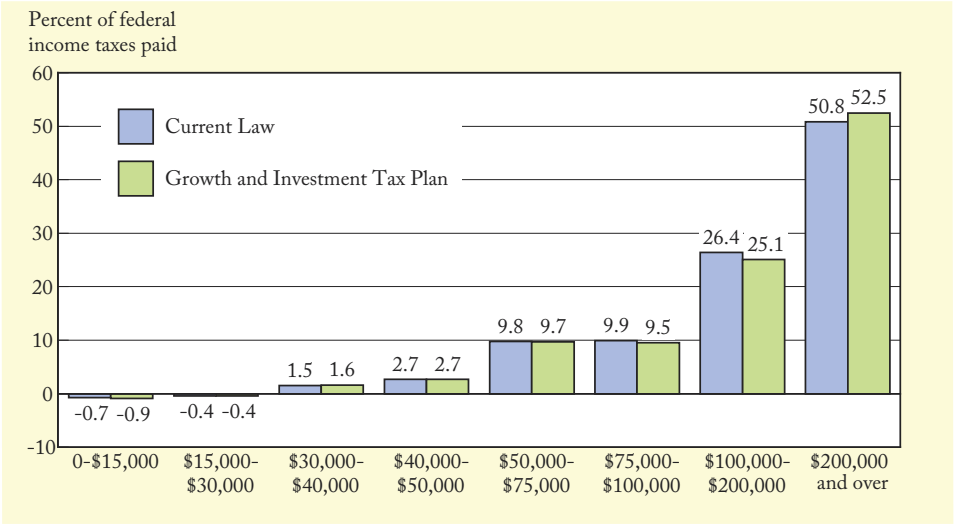
One of the most expensive items in the Panel's proposed reforms is the repeal of the AMT. Covering the $1.2 trillion cost of this repeal over the ten-year budget window requires changes in other components of the tax code. While taxpayers are aware of the cost of tax changes that may limit some itemized deductions, many taxpayers who are likely to pay the AMT in future years, but who have not yet paid this tax, may not recognize the benefits associated with AMT repeal. Figures 7.6 and 7.7 demonstrate how the distribution of the tax burden under the current income tax system, with the AMT, will evolve over the next ten years, as well as how the Growth and Investment Tax Plan will affect that distribution in 2015.

Figure 7.6. Distribution of Federal Income Tax Burden Under Current Law and the Growth and Investment Tax Plan by Income Percentile (2015 Law)



Note: Estimates of 2015 law at 2006 cash income levels. Quintiles begin at cash income of; Second $12,910; Third $27,461; Fourth $45,345; Highest $84,124; Top 10% $123,076; Top 5% $169,521; Top 1% $407,907; Bottom 50% below $36,738.
Source: Department of the Treasury, Office of Tax Analysis.

Figure 7.7. Distribution of Federal Income Tax Burden Under Current Law and the Growth and Investment Tax Plan by Income Level (2015 Law)



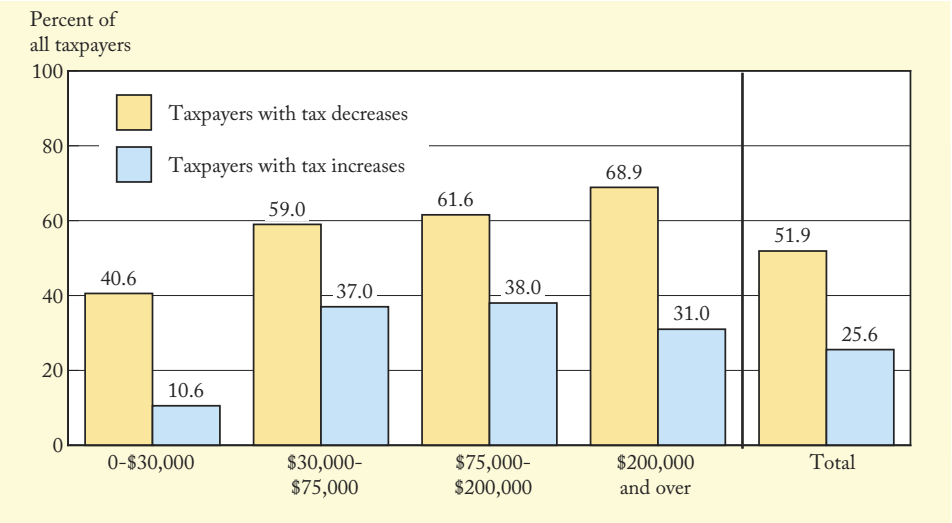
Note: Estimates of 2015 law at 2006 cash income levels.
Source: Department of the Treasury, Office of Tax Analysis.

The Treasury Department also provided two additional sets of distribution tables that are explained and presented in the Appendix. One table demonstrates the tax burden under the Growth and Investment Tax Plan for the entire ten-year budget period. The other shows the tax burden if the corporate income tax is distributed 50 percent to owners of capital and 50 percent to labor, rather than solely to owners of capital income.

Another way to evaluate the distributional effects of a tax reform proposal is to consider the number of taxpayers who would face higher or lower taxes under the proposal. The constraint of revenue neutrality implies that any tax relief provided to one taxpayer must be financed with higher taxes on somebody else. Looked at solely from the perspective of one's tax bill, any revenue neutral tax reform is certain to generate both "winners" and "losers." The Panel recognizes that this comparison is inevitable, but at the same time urges taxpayers to recognize other benefits of tax reform. Greater simplicity in the tax system would allow taxpayers to save time and money, and would inspire confidence that the tax system is straightforward and fair, and not providing hidden loopholes to others. Greater economic growth, which is projected to occur under the Growth and Investment Tax Plan, would also generally benefit all Americans by increasing their incomes.

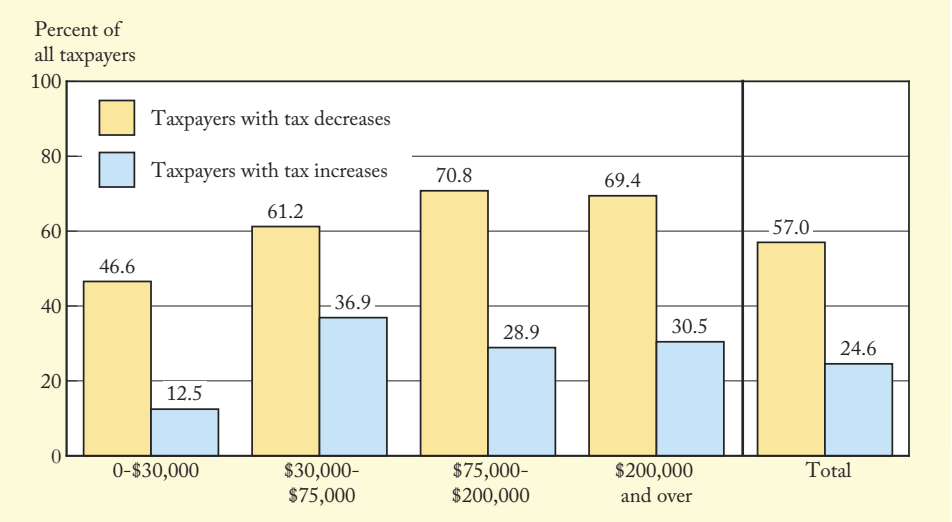
Figures 7.8 and 7.9 demonstrate that at each income level in both 2006 and 2015, there would be many more taxpayers who would pay less in taxes than those who would pay more in taxes. In total, under the Growth and Investment Tax Plan, there would be more than twice as many taxpayers who would receive a tax cut.

Figure 7.8. Percentage of Taxpayers with Decreases and Increases in Tax Liability Under the Growth and Investment Tax Plan (2006 Income Levels)



Note: Estimates of 2006 law at 2006 income levels. Figure does not show the percentage of taxpayers who have neither an increase nor a decrease in tax liability.
Source: Department of the Treasury, Office of Tax Analysis.

Figure 7.9. Percentage of Taxpayers with Decreases and Increases in Tax Liability Under the Growth and Investment Tax Plan (2015 Income Levels)



Note: Estimates of 2015 law at 2006 income levels. Figure does not show the percentage of taxpayers who have neither an increase nor a decrease in tax liability.
Source: Department of the Treasury, Office of Tax Analysis.

The preceding figures describe the overall effects on groups of taxpayers. While this is informative, the Panel understands that many taxpayers would like to have a greater level of specificity, and would like to know what would happen to their own tax bill. In order to provide that type of information, the Panel has developed an array of hypothetical taxpayers and calculated their taxes under the Growth and Investment Tax Plan.

The Panel chose these hypothetical taxpayers using a methodology that has already been described in Chapter Six. In short, the Panel asked the IRS to construct a set of stylized taxpayers with different family structures, age, income, and deductions, using data from actual tax returns. These examples reinforce an essential point: looking at elements of the Growth and Investment Tax Plan alone can lead to very misleading conclusions. Just like the Simplified Income Tax Plan, the Growth and Investment Tax Plan has been carefully crafted to achieve substantial improvements in the tax system while minimizing the changes in total tax liabilities experienced by individual taxpayers and the overall distribution of the tax burden. While some elements of the plan, considered in isolation, may increase the taxes paid by some taxpayers, other elements will have offsetting effects. The focus should be on the aggregate changes in tax liability that would result from the Growth and Investment Tax Plan.

Table 7.3 shows how a set of hypothetical taxpayers would be affected in 2006. For example, a stylized married couple under age 65 earning about $100,000 would expect to pay $9,340 in taxes in 2006. Under the Growth and Investment Tax Plan, that couple would pay $9,004, a decrease of 3.6 percent. A stylized married couple under age 65 at the median income level of $66,200 would expect to pay $3,307

under current law. Under the Growth and Investment Tax Plan, that couple would pay $2,349 in taxes, a decrease of 29 percent.

Much like the Simplified Income Tax Plan, a single taxpayer under age 65 at the median income level of about $24,000 would receive a tax cut of 4 percent. A head of household taxpayer at the median income of about $23,000 would have his or her tax bill remain roughly the same. Single taxpayers and heads of households who are at the 95th percent of income would face a tax increase under the Growth and Investment Tax Plan.

The Panel also felt that it would be instructive to see how this plan affected taxpayers living in high-tax and low-tax states. Accordingly, the Panel asked the IRS to vary the amount of state and local taxes paid by each of the taxpayer groups under age 65. Using the methodology described in Chapter Six, the Treasury Department then calculated how tax liabilities would change for those taxpayers.

The examples in Table 7.4 show that because of the interaction between the alternative minimum tax and other provisions, there would be no difference in the treatment of the stylized married couple earning about $100,000 or in the treatment of the married couple earning about $207,000. In other words, regardless of whether those couples live in high-tax or low-tax states, they would still benefit from a reduced tax bill under the Growth and Investment Tax Plan. The stylized couple earning about $66,000 living in a low-tax state would receive a tax cut of $1,081 while the same couple living in a high-tax state would receive a tax cut of $781. Under the Growth and Investment Tax Plan, these taxpayers would pay the *same* level of tax, regardless of where they live.

For single taxpayers and heads of household who itemize and are not subject to the AMT under current law, there would be a larger tax increase for those who are living in high tax states. This is due to the fact that taxpayers in high tax states currently pay less in tax than taxpayers in low tax states. Under the Growth and Investment Tax Plan, this would no longer be the case – taxpayers with similar income and characteristics would face the same tax bill.

Table 7.4. Examples of Taxpayers Under the Growth and Investment Tax Plan in 2006 (in dollars)

Model Taxpayer Percentile		Income	Salaries and Wages	Taxable Interest, Dividends, & Capital Gains	Itemized Deductions				Income Tax under 2006 Law at 2006 Levels		
					State and Local Taxes	Mortgage Interest	Charitable Contributions	Misc (before 2% floor)	Current Law	Growth and Investment Tax Plan	Percentage Change in Tax Liability
Single Taxpayers Younger Than 65											
1	Bottom 25th	12,300	12,300				369		385	158	-59.0%
2	50th	24,300	24,300				729		2,003	1,922	-4.0%
3	Top 25th	41,000	40,700	300			1,230		4,758	4,447	-6.5%
4	Top 5th	82,800	80,500	2,300	4,000	6,400	2,000	2,200	13,541	14,523	7.3%
Heads of Household Younger Than 65 (bottom 25th and 50th percentile households have two child dependents; top 25th and top 5% household has one child dependent)											
5	Bottom 25th	14,000	14,000				420		-4,941	-5,488	-19.5%
6	50th	23,100	23,100				693		-4,225	-4,242	-2.4%
7	Top 25th	37,200	36,700	500			1,116		1,960	1,238	-9.5%
8	Top 5th	71,800	71,300	500	2,900	8,300	2,400	2,500	7,042	8,005	5.4%
Married Filing Jointly Younger Than 65 (all have two child dependents)											
9	Bottom 25th	39,300	38,600	700			1,179		-282	-783	-178.2%
10	50th	66,200	65,300	900	2,300	8,200	2,400	2,100	3,307	2,349	-29.0%
11	Top 25th	99,600	97,800	1,800	4,100	9,400	2,700	2,200	9,340	9,004	-3.6%
12	Top 5th	207,300	196,200	11,100	10,000	14,400	5,400	2,800	40,417	37,959	-6.1%
Single Taxpayers (and Surviving Spouses) Age 65 and Over*											
13	50th	24,800	0	4,900			555		1,919	2,338	21.8%
14	Top 25th	42,800	0	7,400			1,130		5,731	6,529	13.9%
Married Filing Jointly Age 65 and Over**											
15	50th	51,000	0	4,800			1,125		2,772	2,723	-1.8%
16	Top 25th	77,500	0	10,000			2,230		9,635	9,750	1.2%

Note: * The 50th percentile taxpayer has gross social security benefits of $6,300 and taxable pensions, annuities, and IRA distributions equal to $13,600. The top 25th percentile taxpayer has gross Social Security benefits of $12,000 and taxable pensions, annuities, and IRA distributions equal to $23,400.
** The 50th percentile taxpayer has gross social security benefits of $18,400 and taxable pensions, annuities, and IRA distributions equal to $27,800. The top 25th percentile taxpayer has gross Social Security benefits of $21,000 and taxable pensions, annuities, and IRA distributions equal to $46,500. See text for further explanation of sample taxpayers.
Source: Department of the Treasury, Office of Tax Analysis

Table 7.5. Examples of Taxpayers with "High" and "Low" State and Local Tax Deductions under the Growth and Investment Tax Plan in 2006

Taxpayer Characteristics and Placement in Income Distribution	Adjusted Gross Income	State and Local Taxes Deduction	Income Tax under 2006 Law at 2006 Levels		
			Current Law	Progressive Consumption Tax Plan	Growth and Investment Tax Plan
Single Taxpayers Younger Than 65					
Top 5% in "low-tax" state	82,800	3,500	13,666	16,244	14,523
Top 5% in "high-tax" state	82,800	6,400	12,941	16,244	14,523
Heads of Household Younger Than 65 (bottom 25th and 50th percentile households have two child dependents; top 25th and top 5% household has one child dependent)					
Top 5% in "low-tax" state	71,800	2,400	7,167	9,154	8,005
Top 5% in "high-tax" state	71,800	4,800	6,567	9,154	8,005
Married Filing Jointly Younger Than 65 (all have two child dependents)					
50th in "low-tax" state	66,200	1,900	3,307	2,727	2,349
50th in "high-tax" state	66,200	3,900	3,307	2,727	2,349
Top 25th in "low-tax" state	99,600	3,600	9,340	9,599	9,004
Top 25th in "high-tax" state	99,600	6,900	9,340	9,599	9,004
Top 5% in "low-tax" state	207,300	8,300	40,417	42,868	37,959
Top 5% in "high-tax" state	207,300	16,300	40,417	42,868	37,959

Notes: Taxpayers have same characteristics as those in Table 7.4 with the exception of state and local taxes. See text for further explanation of sample taxpayers.
Source: Department of the Treasury, Office of Tax Analysis

Beyond the Growth and Investment Tax Plan: The Progressive Consumption Tax Plan

The foregoing discussion emphasizes that the Growth and Investment Tax Plan is not a true consumption tax because it imposes a 15 percent tax on the interest, dividends, and capital gains received by individuals. This feature affects the distribution of the tax burden by raising the tax burden on those with substantial income flowing from their financial assets. It also raises the tax on saving and capital investment. In addition, just like the Simplified Income Tax, this provision preserves important components of the income tax system, and thus retains some of its compliance and administrative costs. For example, individuals would be required to keep track of their tax basis in financial and real assets. Many of the complex rules in the current income tax system, such as those that govern wash sales, hedges, and straddles, would be required under the Growth and Investment Tax Plan. It would also require firms to track earnings and profits in a way that makes it possible to distinguish dividend payments from returns of capital.

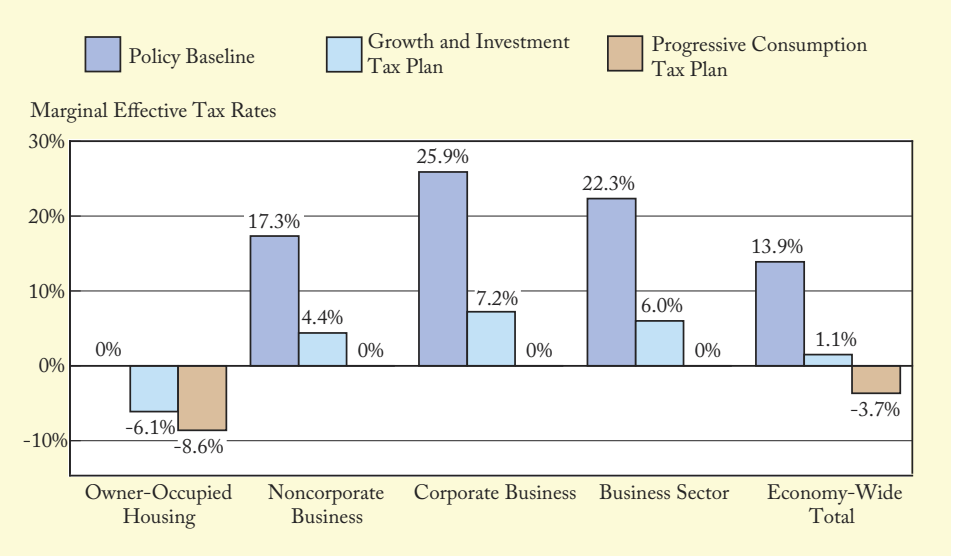
The Panel developed a consensus in support of the Growth and Investment Tax Plan, but many members supported an even more fundamental change in the tax structure, such as adopting the Progressive Consumption Tax Plan. Even some members who did not support the Progressive Consumption Tax Plan agreed that the structure described below is the most attractive way to implement consumption tax in the United States, should the political branches decide to pursue such a shift in the tax base. Such a tax would closely resemble the Growth and Investment Tax Plan, but there would be several important changes. First, there would be no taxation of capital income at the household level. Second, because there would be no taxation of capital, there would be no need for special saving accounts, like the Save for Retirement and Save for Family accounts, that would exempt certain savings from taxation. All saving would be tax-exempt. This would eliminate the complex record-keeping associated with various types of tax-preferred investment accounts. While record-keeping would be much less onerous under the Growth and Investment Tax Plan or the Simplified Income Tax Plan than under the current system, such record-keeping would be eliminated with the Progressive Consumption Tax Plan. Third, in order to achieve revenue neutrality, the deduction and exclusion for employee-provide health insurance coverage would be lowered by approximately 25 percent and both the top individual tax rate and the tax rate on business cash flow would rise to 35 percent. Table 7.6 summarizes the tax rate structure under the Progressive Consumption Tax Plan.

Table 7.6. Tax Rates under the Progressive Consumption Tax Plan (2006)

Tax Rate	Married	Unmarried
15%	Up to $80,000	Up to $40,000
25%	$80,001 - $115,000	$40,001 – $57,500
35%	$115,001 or more	$57,501 or more

The principal advantages of the Progressive Consumption Tax Plan relative to the Growth and Investment Tax Plan would be its more favorable treatment of saving and investment, and its greater simplicity and transparency. As summarized in Figure 7.10, the effective tax rate on new investment projects that are expected to just break even, the "marginal project" that economists consider in defining the investment incentives under different tax codes, would be zero under the Progressive Consumption Tax Plan. Moving from the low tax rate on capital under the Growth and Investment Tax Plan to the zero tax rate of the Progressive Consumption Tax Plan would provide additional stimulus to economic growth. The simplicity benefits of the Progressive Consumption Tax Plan would derive from eliminating the need for the record keeping and filing associated with capital income taxation of individuals.

Figure 7.10. Comparison of Marginal Effective Tax Rates on Different Types of Investments



Note: The tax rates for the policy baseline assume, among other things, that the 2001 and 2003 tax cuts would be permanent and that the proposals contained in the President's Budget to create retirement savings accounts and lifetime savings accounts (each with a $5,000 limit) would be enacted.
Source: Department of the Treasury, Office of Tax Analysis.

Although the conceptual difference between the Progressive Consumption Tax Plan and the Growth and Investment Tax Plan is substantial, with the latter a hybrid tax system combining income tax and consumption tax elements, it is important to point out that for most households, the effect of the two taxes would be virtually identical. Because the Growth and Investment Tax Plan includes a variety of provisions to provide tax-exempt saving opportunities, most individuals would find that the bulk, if not all, of their returns to capital would not be taxed under either the Progressive Consumption Tax Plan or the Growth and Investment Tax Plan. Save for Family and Save for Retirement accounts, in particular, would mean that most individuals could earn the full before-tax return on their investments. Since business investment would be fully expensed under both plans, the only tax provisions that would discourage investment in new, marginal investment projects would be the 15 percent tax on dividends, interest, and capital gains under the Growth and Investment Tax Plan. The Growth and Investment Tax Plan would move our system a long way toward the Progressive Consumption Tax Plan, and would capture most of the associated efficiency benefits, while still preserving some elements of the progressive taxation of capital income.

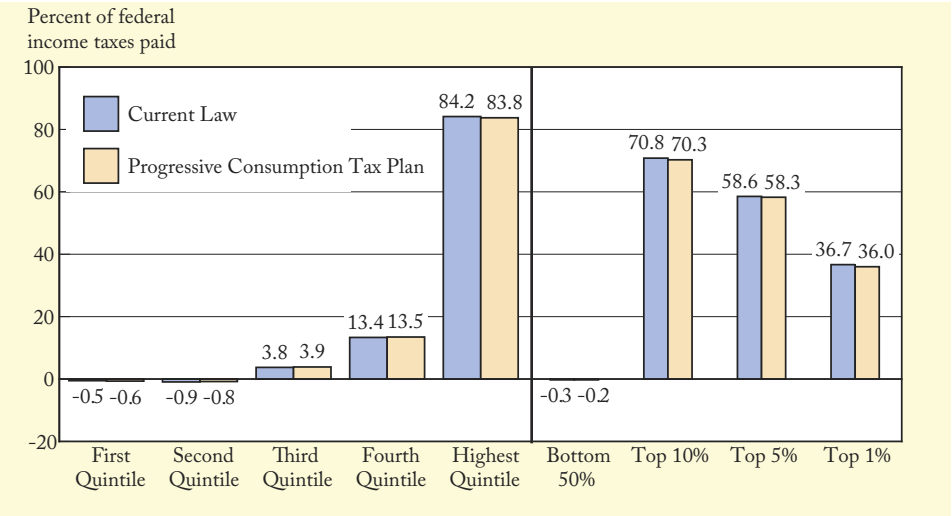
The principal objection to the Progressive Consumption Tax Plan was that it would result in a less progressive distribution of tax burdens. While there would certainly be households that would not need to write any checks for taxes under this tax system, it is important to point out that they would still pay taxes. The Progressive Consumption Tax Plan collects taxes from firms on supernormal returns to businesses investment, rather than from households. Thus, an individual who receives a dividend

payment receives the distribution after the firm has already paid taxes. This tax burden on the business reduces the amount that the firm is able to pay in dividends to shareholders, but the shareholder does not write a check to the government and so does not *appear* to make a tax payment. Distinguishing between the economic burden of taxes and the point of collection of taxes is essential in analyzing the differences between various tax structures.

Distribution of the Progressive Consumption Tax Plan

The Treasury Department computed the distribution of tax burdens under the Progressive Consumption Tax Plan, as under the Growth and Investment Tax Plan, and compared those burdens with the distribution under the current tax system. Figures 7.11 and 7.12 show the estimates for 2006.

Figure 7.11. Distribution of Federal Income Tax Burden Under Current Law and the Progressive Consumption Tax Plan by Income Percentiles (2006 Law)



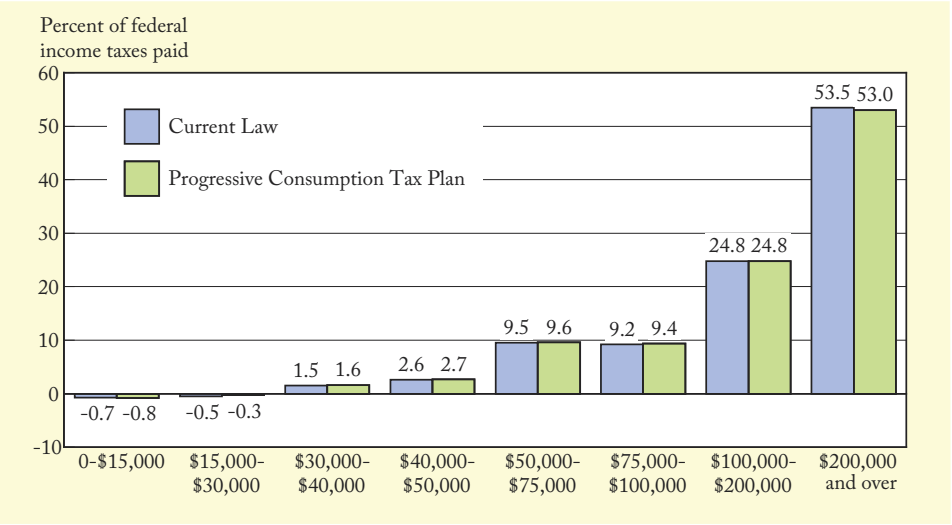
Note: Estimates of 2006 law at 2006 cash income levels. Quintiles begin at cash income of; Second $12,910; Third $27,461; Fourth $45,345; Highest $84,124; Top 10% $123,076; Top 5% $169,521; Top 1% $407,907; Bottom 50% below $36,738.
Source: Department of the Treasury, Office of Tax Analysis.

Just like for the Simplified Income Tax Plan and the Growth and Investment Tax Plan, the Treasury Department also produced an analysis of the Progressive Consumption Tax Plan for 2015, using 2006 income levels. Figures 7.13 and 7.14 show those estimates.

As shown in the above figures, a combination of tax credits for low- and middle-income households combined with the broadening of the tax base and the progressive tax rate schedule makes it possible to generate very similar distribution of the tax burden under the Progressive Consumption Tax Plan and the current system. This finding is important: Many previous analysts have dismissed structures like the Progressive Consumption Tax Plan as inevitably shifting the burden of taxes toward

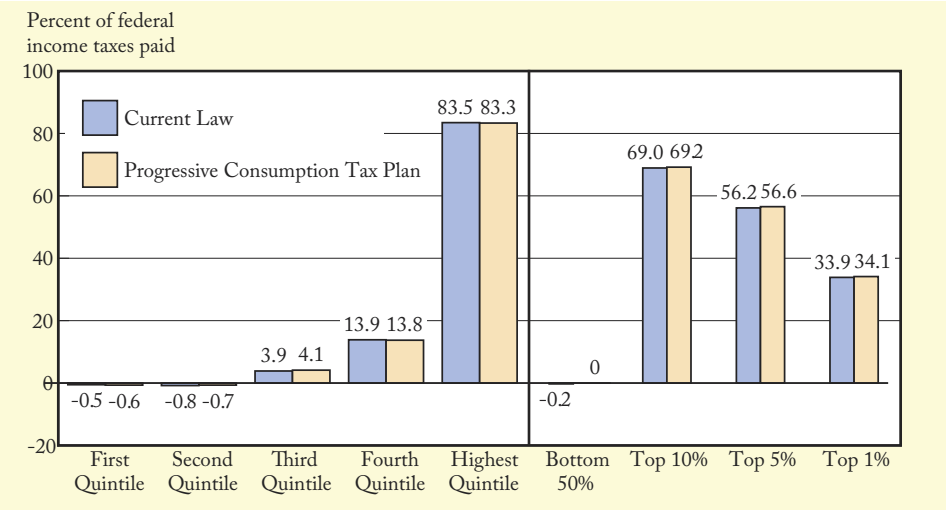
lower-income households, on the grounds that such households spend a greater share of their income than their higher-income counterparts. Figures 7.11 through 7.14 suggest it is possible to implement a consumption tax without this distributional effect.

Figure 7.12. Distribution of Federal Income Tax Burden Under Current Law and the Progressive Consumption Tax Plan by Income Level (2006 Law)



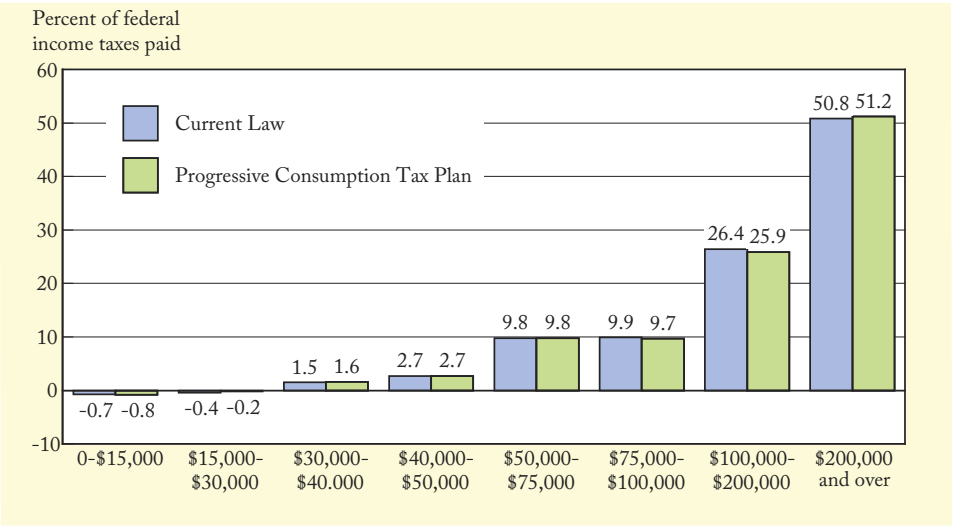
Note: Estimates of 2006 law at 2006 cash income levels.
Source: Department of the Treasury, Office of Tax Analysis.

Figure 7.13. Distribution of Federal Income Tax Burden Under Current Law and the Progressive Consumption Tax Plan by Income Percentile (2015 Law)



Note: Estimates of 2015 law at 2006 cash income levels. Quintiles begin at cash income of; Second $12,910; Third $27,461; Fourth $45,345; Highest $84,124; Top 10% $123,076; Top 5% $169,521; Top 1% $407,907; Bottom 50% below $36,738.
Source: Department of the Treasury, Office of Tax Analysis.

Figure 7.14. Distribution of Federal Income Tax Burden Under Current Law and the Progressive Consumption Tax Plan by Income Level (2015 Law)



Note: Estimates of 2015 law at 2006 cash income levels.
Source: Department of the Treasury.

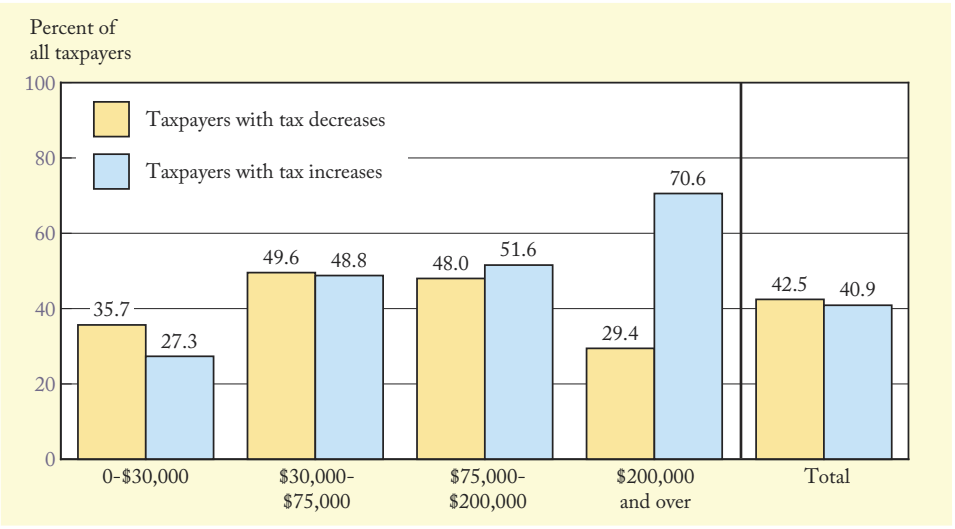
Furthermore, the Treasury Department calculated the number of taxpayers who have tax decreases and tax increases under the Progressive Consumption Tax Plan. Figures 7.15 and 7.16 show those estimates for 2006 and 2015. In both years, there are more taxpayers who have a tax decrease than who have a tax increase. However, there are more taxpayers with incomes of more than $200,000 who would have a tax increase. It is unclear why this occurs, but it is likely that the benefit of removing the tax on capital income was not enough to offset the effect of higher tax rates, which were increased to make this plan revenue neutral.

Using the same methodology as the other plans, the Treasury Department provided examples of hypothetical taxpayers for 2006. These examples are shown in Table 7.7. Examples of hypothetical taxpayers in high-tax and low-tax states are shown in Table 7.5.

Revenue Neutrality

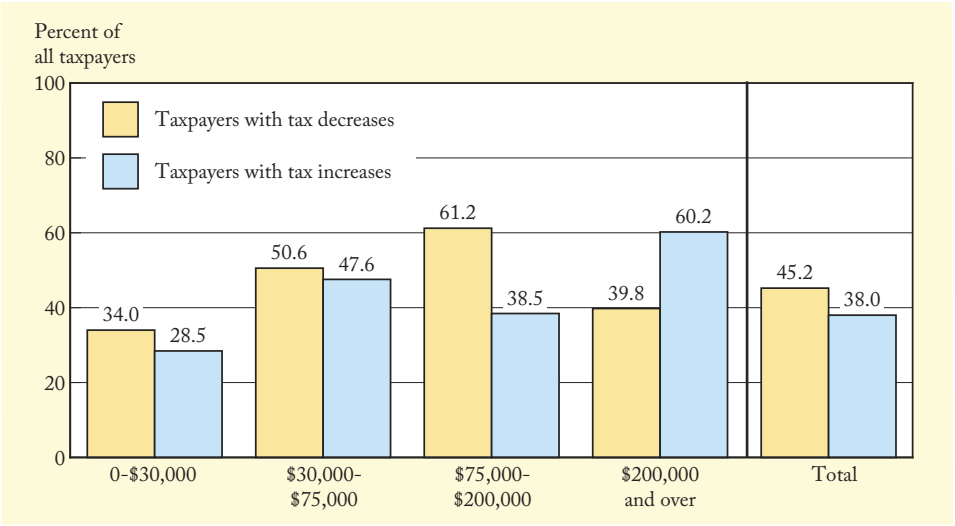
The Treasury Department estimated that both the Growth and Investment Tax Plan and the Progressive Consumption Tax Plan would be revenue neutral. It is worth noting that the plans are balanced without using any revenues from the shift to a destination based tax system through border adjustments. The amount of revenue gained from border adjustments during the budget window would be approximately $775 billion under the Growth and Investment Tax Plan and approximately $900

Figure 7.15. Percentage of Taxpayers with Decreases and Increases in Tax Liability Under the Progressive Consumption Tax Plan (2006 Income Levels)



Note: Estimates of 2006 law at 2006 income levels. Figure does not show the percentage of taxpayers who have neither an increase nor a decrease in tax liability.
Source: Department of the Treasury.

Figure 7.16. Percentage of Taxpayers with Decreases and Increases in Tax Liability Under the Progressive Consumption Tax Plan (2015 Law)



Note: Estimates of 2015 law at 2006 income levels. Figure does not show the percentage of taxpayers who have neither an increase nor a decrease in tax liability.
Source: Department of the Treasury.

billion under the Progressive Consumption Tax Plan. If policymakers were to propose either of these plans and decide to use the revenues from border adjustments, the additional revenue could be used to further reduce tax rates or make other adjustments to the plans. Both plans also provide transition relief, which has been

Table 7.7. Examples of Taxpayers Under the Progressive Consumption Tax in 2006 (in dollars)

Model Taxpayer Percentile		Income	Salaries and Wages	Taxable Interest, Dividends, & Capital Gains	Itemized Deductions				Income Tax under 2006 Law at 2006 Levels		
					State and Local Taxes	Mortgage Interest	Charitable Contributions	Misc (before 2% floor)	Current Law	Progressive Consumption Tax	Percentage Change in Tax Liability
Single Taxpayers Younger Than 65											
1	Bottom 25th	12,300	12,300				369		385	270	-29.9%
2	50th	24,300	24,300				729		2,003	2,034	1.5%
3	Top 25th	41,000	40,700	300			1,230		4,758	4,590	-3.5%
4	Top 5th	82,800	80,500	2,300	4,000	6,400	2,000	2,200	13,541	16,244	20.0%
Heads of Household Younger Than 65 (bottom 25th and 50th percentile households have two child dependents; top 25th and top 5% household has one child dependent)											
5	Bottom 25th	14,000	14,000				420		-4,941	-5,600	-13.3%
6	50th	23,100	23,100				693		-4,225	-3,433	18.7%
7	Top 25th	37,200	36,700	500			1,116		1,960	1,177	-40.0%
8	Top 5th	71,800	71,300	500	2,900	8,300	2,400	2,500	7,042	9,154	30.0%
Married Filing Jointly Younger Than 65 (all have two child dependents)											
9	Bottom 25th	39,300	38,600	700			1,179		-282	-94	66.6%
10	50th	66,200	65,300	900	2,300	8,200	2,400	2,100	3,307	2,727	-17.5%
11	Top 25th	99,600	97,800	1,800	4,100	9,400	2,700	2,200	9,340	9,599	2.8%
12	Top 5th	207,300	196,200	11,100	10,000	14,400	5,400	2,800	40,417	42,868	6.1%
Single Taxpayers (and Surviving Spouses) Age 65 and Over*											
13	50th	24,800	0	4,900			555		1,919	1,673	-12.8%
14	Top 25th	42,800	0	7,400			1,130		5,731	5,287	-7.8%
Married Filing Jointly Age 65 and Over**											
15	50th	51,000	0	4,800			1,125		2,772	1,853	-33.1%
16	Top 25th	77,500	0	10,000			2,230		9,635	7,973	-17.2%

Note: * The 50th percentile taxpayer has gross Social Security benefits of $6,300 and taxable pensions, annuities, and IRA distributions equal to $13,600. The top 25th percentile taxpayer has gross Social Security benefits of $12,000 and taxable pensions, annuities, and IRA distributions equal to $23,400.
** The 50th percentile taxpayer has gross Social Security benefits of $18,400 and taxable pensions, annuities, and IRA distributions equal to $27,800. The top 25th percentile taxpayer has gross Social Security benefits of $21,000 and taxable pensions, annuities, and IRA distributions equal to $46,500. See text for further explanation of sample taxpayers.
Source: Department of the Treasury, Office of Tax Analysis

described earlier in the chapter. The cost of transition relief in both plans is about $400 billion.

Moreover, as noted in Chapter Six, some members of the Panel believe that it is likely that lawmakers will extend a current-law provision, referred to as the "patch," to ease the effects of the AMT on millions of unsuspecting taxpayers. If the Panel did not need to account for the cost of the patch, estimated to be about $866 billion, tax rates could be reduced further in both plans. For example, the tax rates in the Growth and Investment Tax Plan could be reduced across the board by 5.6 percent, so the

top rate could be lowered from 30 percent to 28.3 percent. Similarly, the rates in the Progressive Consumption Tax Plan could be reduced by 5.3 percent, so the top rate could be lowered from 35 percent to 33 percent.

Pro-Growth Tax Plans

The Growth and Investment Tax Plan retains a tax burden on capital income, while the Progressive Consumption Tax Plan eliminates this burden. Both plans would encourage economic growth, but the effects would be larger under the Progressive Consumption Tax Plan. The Treasury Department has evaluated the growth effects of both plans using a range of economic models.

The Treasury Department estimates that the Progressive Consumption Tax Plan could increase national income by up to 2.3 percent over the budget window, by up to 4.5 percent over 20 years, and by up to 6.0 percent over the long run. The Treasury Department models also suggest that the Plan could increase the capital stock (the economy's accumulation of wealth), with estimates ranging from 0.7 percent to 5.1 percent over the budget window, from 2.5 percent to 16.7 percent over 20 years, and from 8.0 percent to 27.9 percent over the long run.

For the Growth and Investment Tax Plan, Treasury estimates that the plan could increase output (national income) by up to 2.4 percent over the budget window, by up to 3.7 percent over 20 years, and by up to 4.8 percent over the long run. The Treasury Department models also suggest that the plan could increase the capital stock, with estimates ranging from 0.5 percent to 3.7 percent over the budget window, from 1.8 percent to 12.1 percent over 20 years, and from 5.6 percent to 20.4 percent over the long run.

Chapter Eight
Value-Added Tax

"Thanks for my pocket money Dad. But you forgot to add 17.5% v.a.t."

The Panel developed and analyzed a proposal to adopt a value-added tax (VAT) that would replace a portion of both the individual and corporate income taxes. The VAT is a type of consumption tax that is similar to a retail sales tax but is collected in smaller increments throughout the production process.

The "Partial Replacement VAT" proposal studied by the Panel would combine a VAT and a lower-rate version of the Simplified Income Tax Plan described in Chapter Six. As shown in Table 8.1, a VAT imposed at a 15 percent rate would allow the top individual income tax rate in the Simplified Income Tax Plan to be reduced to 15 percent. The top corporate income tax rate would also be lowered to 15 percent. Both the income tax and VAT rates are presented on a tax-inclusive basis, as is the norm for income tax rates and the way they are presented throughout this report. The tax-exclusive rates would be 17.6 percent. A discussion of the difference between tax-exclusive and tax-inclusive rates is provided in Chapter Nine.

Table 8.1. Proposed Income Tax Rates for Married and Unmarried Taxpayers

Simplified Income Tax Individual Rates - Modified with a VAT		
Tax Rate	**Married**	**Unmarried**
5%	Up to $64,000	Up to $32,000
15%	Above $64,000	Above $32,000

Simplified Income Tax Individual Rates		
Tax Rate	**Married**	**Unmarried**
15%	Up to $78,000	Up to $39,000
25%	$78,001 - $150,000	$39,001 - $75,000
28%	$150,001 - $200,000	$75,001 - $100,000
33%	$200,001 or more	$100,001 or more

Panel members recognized that lower income tax rates made possible by VAT revenues could create a tax system that is more efficient and could reduce the economic distortions and disincentives created by our income tax. However, the Panel could not reach a consensus on whether to recommend a VAT option.

Some members of the Panel who supported introducing a consumption tax in general expressed concern about the compliance and administrative burdens that would be imposed by operating a VAT without eliminating the income tax or another major tax. Some members were also concerned that introducing a VAT would lead to higher total tax collections over time and facilitate the development of a larger federal government – in other words, that the VAT would be a "money machine." Other Panel members suggested that studies of the international experience and domestic political realities did not support the "money machine" argument. Some argued that adopting a VAT, whether to reduce income taxes or payroll taxes, would make it more likely that higher taxes would be used to solve the nation's long-term fiscal challenges, especially unfunded obligations for the Social Security, Medicare, and Medicaid programs. Others expressed the opposite view and regarded the VAT as a stable and efficient tool that could be used to reduce income taxes, fund entitlement programs, or serve as a possible replacement for payroll taxes. A proposal to use the VAT to replace payroll taxes was beyond the scope of the Panel's mandate, which focused only on income taxes.

Despite the lack of consensus to recommend a VAT option, the Panel views a Partial Replacement VAT as an option worthy of further discussion. This chapter will highlight issues that policymakers would need to consider in evaluating such a proposal. First, the chapter describes modifications to the Simplified Income Tax Plan that would be made possible by the VAT and the resulting distribution of the overall federal income tax and VAT tax burden. The chapter then discusses how businesses would compute their VAT liability and the advantages and disadvantages of a Partial Replacement VAT from a tax policy perspective. Finally, the chapter addresses

arguments regarding whether the VAT would facilitate the growth of the federal government.

How it Would Work: Adjustments to the Simplified Income Tax Plan

The Partial Replacement VAT proposal studied by the Panel combined a VAT with a low-rate income tax modeled on the Simplified Income Tax Plan. This VAT would collect about 65 percent of the amount of revenue currently collected by our individual and corporate income taxes. As a result, tax rates under the income tax system could be substantially reduced.

The Simplified Income Tax Plan does not materially alter the current distribution of the federal tax burden. By contrast, a VAT absent other modifications would change the current distribution because the VAT is imposed directly on consumption, and therefore would tax all families equally on each dollar they spend on items subject to the VAT. Households with lower incomes generally spend a larger portion of their income than higher-income households, and therefore the VAT would generally impose a larger tax as a percentage of income on lower-income households. In considering the Partial Replacement VAT, the Panel sought to relieve the additional VAT burden through an appropriate income tax rate and credit structure. The Panel's goal was to maintain a distribution of the overall federal VAT and income tax burden that would be approximately distributionally neutral relative to current law.

In response to the Panel's request, the Treasury Department modified the Family and Work Credits described in Chapter Five to alleviate the additional burden of the VAT on lower-income families. This approach would be more effective than exempting food and other necessities from taxation because it could be targeted to lower and middle-income families alone, rather than all taxpayers.

The base credit amount of the Family Credit would be increased by $1,000 for married couples and $500 for all other taxpayers except dependent taxpayers. The additional Family Credit amount based on the number of children and other dependents would be increased by $500 for each child or other dependent. Like the Family Credit in the Panel's recommended options, this Family Credit would not phase-out; it would be available to all taxpayers.

The Work Credit would also be increased, so that the maximum credit amount in the first year would be: $1,832 for workers with no children, $6,820 for workers with one child, and $9,750 for workers with two children. The Work Credit would increase as the amount of work income increases, be refundable, and phase-out gradually above certain income levels. Further details regarding the modifications to the Family and Work Credits made by the Treasury Department in estimating the Partial Replacement VAT can be found in the Appendix.

Box 8.1. Reducing the Number of Individuals Who Pay Income Tax

If the Family Credit and Work Credit were expanded as described in this chapter, 101.1 million taxpayers would have no income tax liability, 51.1 million more than the 47.4 million taxpayers that would have no income tax liability under the Simplified Income Tax Plan. Some members of the Panel felt that it was inappropriate to increase the number of taxpayers who do not make a direct contribution to the cost of maintaining the federal government through income taxes. Others took the opposite position, commenting that taking additional lower and middle-income taxpayers off the income tax rolls would make the federal tax system simpler. Those taxpayers would continue to pay taxes, at the cash register through the VAT and through payroll taxes.

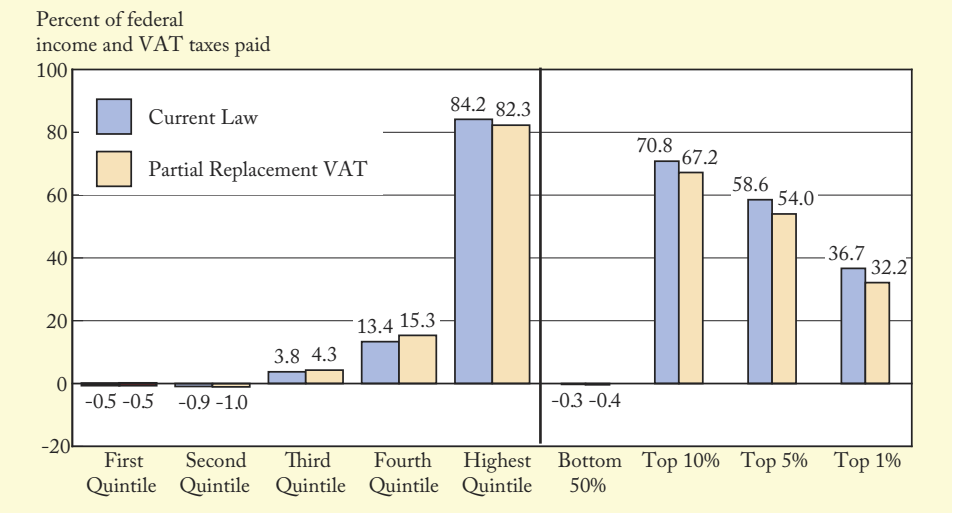
Who Pays the Tax?

As shown in Figures 8.1 through 8.4, the Family and Work Credits as modified by the Treasury Department would ensure that the tax system would be roughly as progressive as current law for families with incomes in the bottom two quintiles of the income distribution. However, for families in the third and fourth quintiles, the modified Work and Family Credits and rate structure presented here do not fully offset the increased burden of the VAT. Families in the highest quintile would bear less of the total tax burden.

The Treasury Department did not develop a modified credit and rate structure that would make the Partial Replacement VAT proposal approximately as progressive as current law. While the Partial Replacement VAT described in this chapter does not entirely alleviate distributional concerns, the Panel believes that with additional work, it would be possible to develop an approximately distributionally neutral tax credit and rate structure. Such a structure might, however, require somewhat higher income tax or VAT rates.

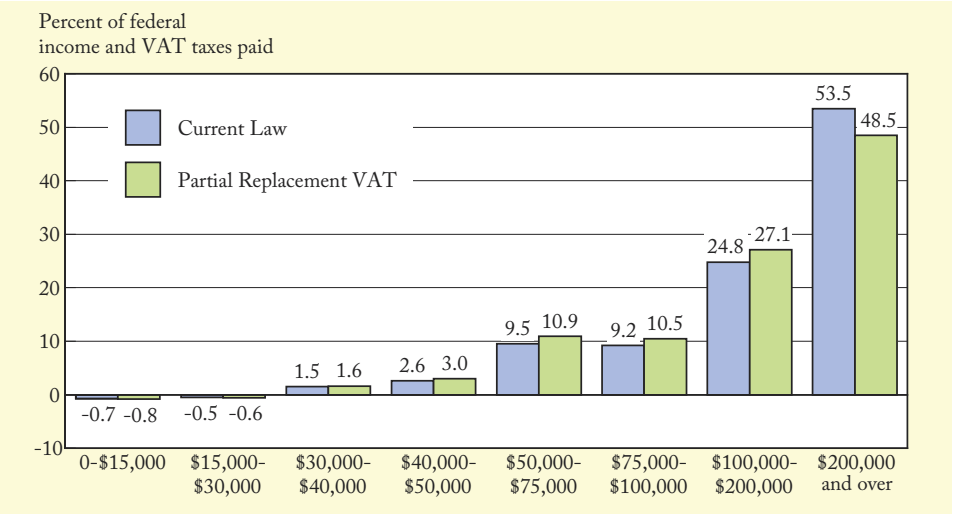
Figures 8.1 and 8.2 show how the distribution of the burden of the individual and corporate income taxes under current law for 2006 would compare to the distribution of the income and VAT taxes under the Partial Replacement VAT proposal.

Figure 8.1. Distribution of Federal Tax Burden Under Current Law and the Partial Replacement VAT Proposal by Income Percentile (2006 Law)



Note: Estimates of 2006 law at 2006 cash income levels. Quintiles begin at cash income of; Second $12,910; Third $27,461; Fourth $48,345; Highest $84,124; Top 10% $123,076; Top 5% $169,521; Top 1% $407,907. Bottom 50% below $36,738.
Source: Department of the Treasury, Office of Tax Analysis.

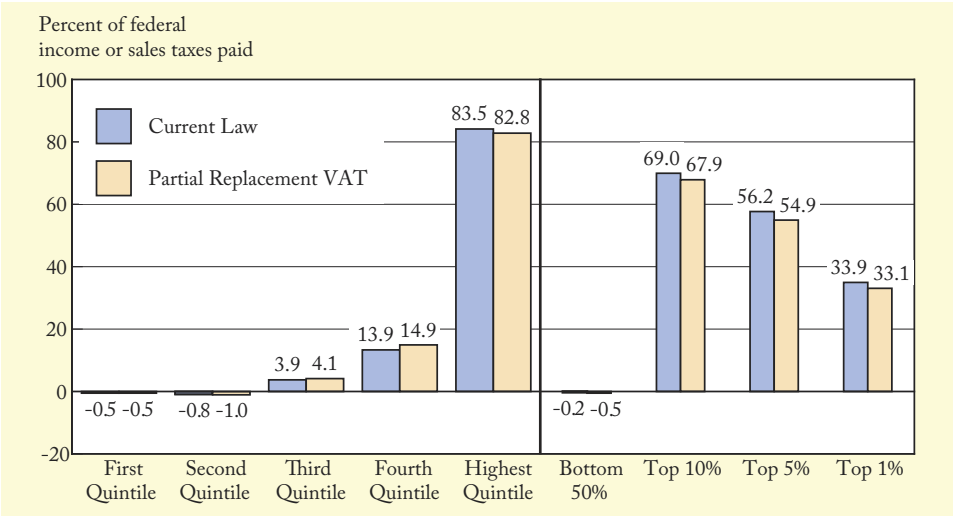
Figure 8.2. Distribution of Federal Income Tax Burden Under Current Law and the Partial Replacement VAT Proposal by Income Level (2006 Law)



Note: Estimates of 2006 law at 2006 cash income levels.
Source: Department of the Treasury, Office of Tax Analysis.

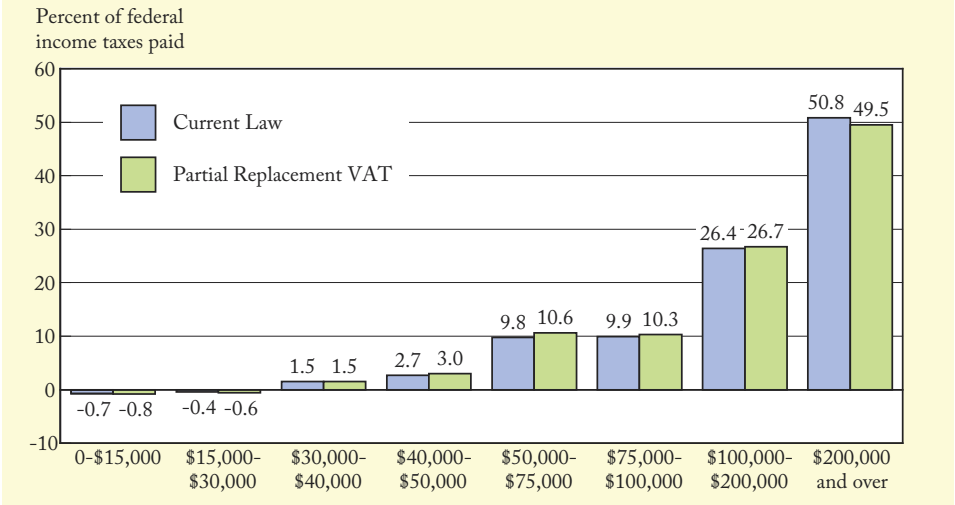
Figures 8.3 and 8.4 provide distributional estimates for 2015, the last year of the budget window.

Figure 8.3. Distribution of Federal Income Tax Burden Under Current Law and the Partial Replacement VAT Proposal by Income Percentile (2015 Law)



Note: Estimates of 2015 law at 2006 cash income levels. Quintiles begin at cash income of; Second $12,910; Third $27,461; Fourth $48,345; Highest $84,124; Top 10% $123,076; Top 5% $169,521; Top 1% $407,907. Bottom 50% below $36,738.
Source: Department of the Treasury, Office of Tax Analysis.

Figure 8.4. Distribution of Federal Income Tax Burden Under Current Law and the Partial Replacement VAT Proposal by Income Level (2015 Law)



Note: Estimates of 2015 law at 2006 cash income levels.
Source: Department of the Treasury, Office of Tax Analysis.

How it Would Work: Implementing the VAT

The VAT can be thought of as a retail sales tax that is collected in stages, instead of all at once from the final consumer. The tax is collected by all entities providing taxable goods and services and is imposed on sales to all purchasers. A business calculates its VAT liability by taking the total value of its taxable sales and multiplying by the VAT rate. The business is then permitted to offset its VAT liability by the amount of VAT paid for its purchases of goods and services. The simple example first provided in Chapter Three provides an easy way to understand the process.

Imagine that a boot maker makes and sells custom-made cowboy boots. He buys leather and other supplies enough for one pair from a leather shop at a cost of $200 before taxes. The boot maker sells each pair of boots he makes for $500 before taxes.

If a 10 percent retail sales tax were in place, the boot maker would add the tax to the cost of the $500 pair of boots, and the consumer would pay $550 per pair. In the meantime, the leather shop would not impose a retail sales tax on its sale to the boot maker because such a business-to-business transaction would not be treated as a retail sale.

Under a VAT, the tax calculation works somewhat differently. The VAT, like a sales tax, is separately stated on invoices or receipts. However, because the VAT is charged on all sales of goods and services, and not just sales to consumers, the leather shop would collect a VAT of 10 percent, or $20 on the $200 of supplies purchased by the boot maker. The boot maker would pay the leather shop $220, and the leather shop would send the $20 to the government. When the boot maker sells the boots, he computes the VAT as $50, and charges the purchaser $550 for the boots.

Instead of sending $50 to the government, the boot maker would subtract the $20 of VAT already paid to the leather shop and remit $30 to the government. The government would receive $50 total — $20 from the leather shop and $30 from the boot maker. The $20 credit that the boot maker applies against his VAT liability is called an "input credit," and the invoice received from the leather shop showing $20 of VAT paid serves as proof that the boot maker can take the credit. The government receives the same revenue under a VAT as it would under a retail sales tax, and from the consumer's perspective the taxes look identical.

Design Assumptions

In studying the proposal, the Panel made certain decisions about the appropriate design for a VAT if it were ever adopted at the federal level.

- The VAT should be imposed on the broadest consumption base consistent with:
    - The structure of our federal system of government, and
    - The need to maintain neutrality between public and private sector provision of goods and services.

- The VAT should use the credit-invoice method.
- The VAT should be border adjusted.
- The VAT should be imposed at a single uniform rate.
- The VAT should be set at a rate that is high enough to raise sufficient revenue to accomplish substantial income tax reform, justify the administrative burden of the VAT on businesses and government, and discourage subsequent rate increases.

Tax Base

The Partial Replacement VAT base considered by the Panel would be broad in order to prevent economic distortions between taxed and non-taxed goods and services. The proposed VAT base would include all domestic consumption except for non-commercial government services, primary and secondary education, existing residential housing, and charitable and religious services. Special rules would apply to financial services and certain other goods and services that are difficult to tax. A more detailed discussion regarding the proposed VAT base and the mechanics of VAT exemptions are provided in the Appendix.

Government Services

Noncommercial services provided by federal, state, or local government would be outside the VAT base. However, commercial activities conducted by the government, such as electricity supplied by a government-owned power plant, would be taxed like any private sector business. The rationale for this treatment is to prevent federal, state, or local government from having an advantage over the private sector in areas where the two might compete to supply similar products. Rules would be necessary to distinguish between commercial and non-commercial government services. Further discussion of these issues appears in the Appendix.

Box 8.2. State and Local Government Services

Taxing the imputed value of noncommercial state and local government services would be technically feasible. New Zealand, for instance, does this by requiring local governments to pay a VAT on the total value of the salaries they disburse to their employees. However, if the federal government assessed a VAT on state and local government services in this way, those governments would need to raise taxes to pay the VAT on their purchases and on the imputed value of their services. The Panel concluded that it may be inappropriate for the federal government to directly assess an excise tax of this sort on state and local governments in the context of our federal system. Instead, state and local governments would pay a VAT on their purchases, but would receive refunds from the federal government for VAT paid.

Border Adjustments

Because the VAT is intended to tax domestic consumption, exports are outside the VAT tax base. However, because the VAT is assessed at every level of production and distribution, a "border adjustment" is necessary to exclude exports from the VAT. These adjustments are made by allowing businesses to claim input credits on exports while exempting their sales from the VAT. All of America's major trading partners remove the VAT from their exports in this way, and the World Trade Organization specifically defines a VAT as border-adjustable tax. Border adjustments are discussed in greater detail in Chapter Seven.

Small Business

Because the compliance costs associated with a VAT may be low overall but require a significant investment for some small businesses, it would be important to consider how to treat such businesses under a VAT. One advantage of the VAT is that it is possible to exempt many small businesses from collecting the tax without significant revenue loss. There are two reasons for this result. First, because the VAT is collected at every stage of production (rather than once at the retail level like a retail sales tax), and many small businesses buy many of their inputs from larger businesses, exempted small businesses would still pay tax on their inputs. As a result, much of the tax on any final good sold by a small business would still be collected. Second, exempted small businesses would be allowed to voluntarily register to collect the VAT. Some exempted businesses that sell primarily to other businesses would choose to collect VAT voluntarily in order for them and their customers to be able to claim input tax credits on their purchases.

The Partial Replacement VAT designed by the Panel would not require businesses with less than $100,000 in taxable annual gross receipts to collect the VAT. The Government Accountability Office estimated in 1993 that a VAT collection threshold at this level would reduce the number of businesses filing VAT returns from about 24 million to about 9 million. They further estimated that approximately 19 percent of small businesses qualifying for the exemption would nonetheless voluntarily collect the VAT. Preliminary estimates for 2003 suggest that only 1.8 percent of gross receipts are collected by businesses with less than $100,000 in annual gross receipts. Thus, a VAT collection threshold at this level likely would not lose significant revenue, particularly when voluntary collection is taken into account. Whether a higher VAT collection threshold would be feasible could be the subject of future study.

Tax Policy Considerations — Advantages and Disadvantages of Adopting a VAT

Economic Growth

A Partial Replacement VAT could achieve many of the advantages of moving to a consumption-based tax system discussed in Chapter Seven. Economic research shows that consumption taxes have a positive effect on economic growth compared with an income tax.

A broad-based VAT applied at a single rate is economically efficient because it generally does not distort consumers' choices among goods and services and does not discourage savings or distort the allocation of capital. Economists agree that a well-designed VAT imposes a lower excess burden than most other taxes for any given amount of revenue raised. Reducing the excess burden of taxation on the economy is an important way that the tax system can encourage economic growth.

The Partial Replacement VAT also would make it possible to substantially reduce income tax rates for all individual and corporate taxpayers. Lower marginal income tax rates on individuals and businesses would strengthen incentives to save, invest, work, and innovate while making our tax system more efficient.

U.S. Competitiveness

Reducing the corporate income tax rate should improve incentives for investment of capital in the United States by both U.S. residents and foreigners. U.S.-based multinational corporations and multinationals based in countries with territorial tax systems would have incentives to shift investment and operations to the United States to take advantage of the lower income tax rates relative to other countries. These incentives would be similar to those discussed in Chapter Seven, although the incentives would not be as strong as those discussed with respect to the Progressive Consumption Tax Plan because an income tax would be retained, albeit at lower rates.

The Partial Replacement VAT also would be compatible with existing bilateral tax agreements with our major trading partners because it would retain a corporate income tax. These agreements facilitate cross-border investment and ensure that U.S. multinationals operating in foreign markets receive tax treatment comparable to the tax treatment of companies based in the country in which the U.S. multinational is operating.

Box 8.3. Border Adjustments and Competitiveness

Border adjustability has been a longstanding priority for many American businesses with substantial export sales. All our major trading partners border adjust their VATs, and exporters of goods and services imported into the United States receive VAT rebates.

American businesses sometimes argue that the lack of border adjustability of the U.S. income tax system puts U.S. exports at a competitive disadvantage in global markets. However, economists generally believe that exchange rate adjustments or other price level changes offset border tax adjustments in the long term and eliminate any advantage or disadvantage border adjustments might otherwise create. Regardless, a border-adjustable VAT that reduces corporate income tax rates could positively affect the competitiveness of U.S. goods and services in the global marketplace. Further discussion of border adjustments and the advantages of destination-based taxes appears in Chapter Seven.

Benefiting from International Administrative Experience

In implementing the VAT, the United States would be able to take advantage of the wealth of worldwide experience in administering and complying with the tax. The VAT has been adopted by every major developed economy except the United States. Thus, the Treasury Department and IRS could study and apply best practices from around the world. Moreover, U.S. multinational corporations already have extensive experience in complying with the VAT, as they currently collect and remit VAT taxes in most countries in which they operate outside the United States.

Compliance and Administration Costs

One significant benefit of the Simplified Income Tax Plan is that it would reduce administration and compliance costs for the government and taxpayers. In contrast, having to collect and pay both VAT and a business income tax might increase total compliance costs for businesses. It would also create an additional set of administrative responsibilities and costs for the IRS.

On the other hand, the Panel heard testimony that taxpayers' compliance costs for the current income tax amount to approximately 13 cents per dollar of tax receipts, whereas compliance costs for European VATs ranges from 3 to 5 cents per dollar of tax receipts. Further, compliance costs per dollar of income tax revenue could fall as a result of reduced incentives for income tax evasion due to the lower income tax rates accompanying the introduction of a VAT. Thus, it is not clear whether the overall compliance and administration cost savings from introducing a Partial Replacement VAT and lowering income tax rates would be larger or smaller than the cost to businesses of complying with the VAT.

Noncompliance

Some evasion is inevitable in any tax system. For 2001, the IRS estimates that the evasion rate for the income tax was between 18 and 20 percent of taxes due. Some analysts suggest that evasion rates for a Partial Replacement VAT could be somewhat lower. One reason is that invoices used to claim input credits under a VAT create a paper trail based on third-party information reporting that facilitates audits and may induce businesses to comply more fully with both the VAT and the corporate income tax. Under the current income tax, compliance rates are highest where there is third-party information reporting or withholding.

Further, business-level tax evasion is often concentrated in smaller businesses, and the VAT exempts many of these businesses from the collection process. To the extent that tax avoidance and evasion are motivated by high income tax rates, lowering income tax rates with a Partial Replacement VAT might also reduce incentives to avoid or evade the remaining income tax.

However, the VAT would not put an end to tax evasion. Evasion in a VAT can range from simple non-filing and non-payment of tax by businesses to complex schemes in which goods pass through a series of transactions designed to generate counterfeit input tax refunds. The Organization for Economic Cooperation and Development (OECD) reports noncompliance rates of 4 percent to 17.5 percent in major developed economies with VAT systems. United Kingdom Revenue and Customs, which employs one of the most sophisticated approaches to estimating VAT evasion, found VAT evasion of 12.9 percent in the U.K. as of April 2004. One should note, however, that the U.K. VAT base is substantially narrower than the Partial Replacement VAT base studied by the Panel and includes more than one VAT rate. VATs are more prone to evasion when they exclude more categories of goods and services and utilize multiple rates. In its revenue estimates, the Treasury Department assumed a noncompliance rate of 15 percent for the VAT.

Coordination of State Sales Taxes and the VAT

Coordinating between states' retail sales taxes and the VAT would be a major challenge. States likely would view a VAT as an intrusion on their traditional sales tax base. Differing federal and state consumption tax bases, with different forms and administrative requirements, would be complex for business. In states that continued to apply their pre-existing sales taxes, the weighted average combined tax-exclusive state and federal tax rate would be approximately 24 percent.

If states were to bring their sales tax bases into conformity with the broad federal base and coordinate their sales tax collection systems with the federal regime, the economic efficiency of state sales taxes would be improved. Compliance burdens for multistate businesses and administrative costs for states could be reduced. Even greater gains in terms of simplicity and lower compliance burdens might be achieved if the states moved to impose state level VATs.

However, the result of a similar harmonization effort in Canada is not encouraging. Canada considered adopting a unified federal and provincial VAT base in 1987, but intergovernmental discussions failed to produce an agreement to standardize the existing provincial sales tax bases with the base for Canada's federal goods and services tax. The United States has many more sales tax jurisdictions than does Canada, and so it is quite likely that the U.S. experience could be fraught with even greater difficulties.

Macroeconomic Effects of Transition

Some observers have worried about potential macroeconomic disruptions associated with moving from an income tax to a VAT. Although there may be some such consequences, those considerations were secondary in the Panel's decision not to recommend the Partial Replacement VAT. Any consequences associated with price level adjustments under a Partial Replacement VAT would be less severe than those under a full replacement retail sales tax or a full replacement VAT, because the tax rate would be lower and therefore any required adjustments would be less extensive.

Political Economy Concerns

The Partial Replacement VAT proposal would add a major new federal tax without eliminating any existing taxes from the federal system. One important factor in the Panel's decision not to recommend the Partial Replacement VAT proposal was several Panel members' concern about how introducing a supplemental VAT might affect the size of the federal government in the medium or long run. These Panel members were concerned that adding a VAT on to the current income tax structure could, over time, lead to growth of federal outlays as a share of GDP — as the tax rate for the Partial Replacement VAT could rise, or corporate and individual income tax rates could return to their present levels. The Panel members who were concerned about this possibility viewed growth in the government's share of the economy as undesirable. Other Panel members were not concerned about this possibility, either because they were more confident that Congress would use the VAT only to offset existing taxes, or because they believed that allowing some growth in tax revenues as a share of GDP would offer a means to finance the growing cost of entitlement programs.

There are relatively few empirical studies on the relationship between the adoption of a VAT and the growth of government spending. None of these studies resolve the fundamental difficulty of determining the direction of causality between the tax structure and the size of government. Simple country comparisons suggest that countries without VATs, like the United States, have a smaller government sector than countries with a VAT. However, more sophisticated statistical studies that control for other factors that may affect the relationship between the size of government and the presence of a VAT yield mixed results. The evidence neither conclusively proves, nor conclusively disproves, the view that supplemental VATs facilitate the growth of government.

Even if the findings were conclusive, studies of VATs in other nations may not provide much guidance on the effect of adopting a VAT in the United States. Most developed countries initially used a VAT to reduce or eliminate other consumption taxes, such as existing sales or excise taxes. The VAT proposal studied by the Panel would replace part of the income tax with a VAT. The United States has no broad-based pre-existing federal consumption tax to replace. Thus, whether adopting a VAT would fuel the growth of U.S. federal spending remains an open question.

Box 8.4. Visibility of the VAT

Some critics of the VAT express concerns about its visibility to taxpayers, because in some countries VAT is included in marked prices and no reference is made to the tax on receipts. However, the Panel assumed the VAT would be separately stated on all sales, so consumers would know the amount of VAT paid with each purchase.

Some members of the Panel suggested that even a separately stated VAT would be less visible to taxpayers than the burden of the income tax. These members pointed out that taxpayers would not know their total VAT liability for any given year unless they kept all their receipts and added together all VAT paid. Others noted that a similar observation could be made about the income tax, which many taxpayers pay over time through withholding from their compensation, and about payroll taxes, where the employer-paid portion is "invisible" to most workers. These members stated that taxpayers are much more likely to know the amount of the refund check they received as a result of excess tax withholding than the amount of their overall tax liability. Others responded that if true, these observations were an argument against tax withholding, not an argument for a Partial Replacement VAT.

Some members of the Panel who opposed a Partial Replacement VAT suggested that once a VAT was enacted, it would never be repealed. International experience suggests that few countries retreat from a VAT, and that VAT rates generally do not decline. These Panel members were unwilling to support the Partial Replacement VAT proposal given the lack of conclusive empirical evidence on the impact of a VAT on the growth of government. Others were more confident that voters could be relied upon to understand the amount of tax being paid through a VAT, in part because the proposal studied by the Panel would require the VAT to be separately stated on each sales receipt provided to consumers. These members of the Panel envisioned that voters would appropriately control growth in the size of the federal government through the electoral process.

Box 8.5. Comparing the Enforcement of a VAT and a Retail Sales Tax

Because the VAT is similar to a retail sales tax, one might ask why the Panel chose to study a VAT rather than a retail sales tax as a partial replacement to the income tax. Although they are similar taxes, there are four principal reasons for concluding that a VAT may be more enforceable than a retail sales tax.

First, VAT taxpayers – especially intermediate producers – have an incentive to demand VAT invoices from suppliers because they are needed to claim the VAT credits that reduce the buyer's VAT liability. The invoices used to claim a tax credit create a paper trail that may induce businesses to comply more fully with the law. Most taxable transactions will appear on two tax returns – the buyer's and the seller's – so that tax authorities will have two opportunities to detect evasion. Further, because sellers provide the tax administration a record of their purchases by claiming input credits, tax administrators are more able to estimate what sales and therefore VAT due should be and thereby can detect evasion more easily in a VAT than in a retail sales tax.

Second, the credit-invoice system eliminates the need for business exemption certificates. Under the credit-invoice system, every taxpayer pays tax on its purchases, and then taxpayers show proof to the government that they are entitled to input tax credits, rather than presenting an exemption certificate to a supplier. As described in Chapter Nine, the business exemption system requires retailers to play an enforcement role and is fraught with evasion opportunities.

Third, under the VAT the amount of tax liability at risk in most transactions is only a fraction of the total tax assessed on the sale of the good or service to a consumer. This is because the VAT is collected in smaller pieces at each stage of production, while the entire retail sales tax is collected on a final consumer sale. The lower effective tax rate on each transaction may reduce the incentive to evade the VAT.

Finally, in contrast to a VAT, the proper administration of a retail sales tax would require all small retailers to collect tax. With a tax collected solely at the retail level, a small business exemption would be unworkable from enforcement, efficiency, and revenue perspectives. Because the compliance costs associated with a retail sales tax or a VAT may be low overall, but significant for small retailers, the need to require small retailers to act as collecting agents in a retail sales tax is a significant disadvantage.

The VAT's advantages over the retail sales tax in minimizing evasion should not be overstated. Because large firms are less likely to cheat, evasion problems in either system are likely concentrated in smaller firms. When those firms are retailers, the incentive to cheat at the margin under the VAT and the retail sales tax is roughly equal, assuming the same tax rate applies.

Further, more transactions are subject to a VAT than to a retail sales tax, creating additional opportunities for evasion. Under a VAT, firms could fabricate invoices to claim input credits, even if such purchases were never made. Claiming excess input credits in a VAT also can produce a tax refund for a business. This temptation does not exist under the retail sales tax.

Chapter Nine

National Retail Sales Tax

The Panel considered a number of proposals to reform the income tax, including replacing the entire income tax system with a broad-based national retail sales tax. A retail sales tax is perhaps the most obvious form of consumption tax because it is imposed on the final sales of goods and services to consumers. Like other consumption taxes, the retail sales tax does not tax normal returns to saving and investment and thus may lead to greater economic growth than our current tax system.

After careful evaluation, the Panel decided to reject a complete replacement of the federal income tax system with a retail sales tax for a number of reasons. Two considerations were particularly important to the Panel's decision:

- Replacing the income tax with a retail sales tax, absent a way to ease the burden of the retail sales tax on lower and middle-income Americans, would not meet the requirement in the Executive Order that the Panel's options be appropriately progressive.

- Although a program could be designed to reduce the burden of a retail sales tax on lower-income and middle-income taxpayers by providing cash grants, such cash grants would represent a new entitlement program – by far the largest in American history. Adjusting the distribution of the burden of the retail sales tax through a cash grant program would cost approximately $600 billion to $780 billion per year and make most American families dependent on monthly checks from the federal government for a substantial portion of their incomes. The Panel concluded that such a cash grant program would inappropriately increase the size and scope of government.

The Panel also had additional concerns with replacing the current tax system with a retail sales tax:

- Even with favorable assumptions, a retail sales tax on a broad base with a cash grant program would require a tax rate of at least 34 percent, and likely higher over time if the base erodes, creating incentives for significant tax evasion. A discussion of the range of potential estimates of the tax rate is provided later in this chapter.
- The federal administrative burden for a retail sales tax may be similar to the burden under the current system. A federal agency, such as the IRS, would be required to administer the tax in order to ensure adequate collection of federal revenues and uniform enforcement of the rules and regulations underlying the tax. Indeed, two types of administrations would be required – one to collect the tax and another to keep track of the personal information that would be necessary to determine the size of the taxpayer's cash grant.
- Taxpayers likely would continue to file state income tax returns, which would limit the potential simplification gains from replacing the federal income tax system with a retail sales tax.

Box 9.1. Comparing "Tax-Exclusive" and "Tax-Inclusive" Rates

The 34 percent tax rate mentioned in the introduction to this chapter is a tax-exclusive rate. Sales tax rates are typically quoted on a tax-exclusive basis, while income tax rates typically are quoted on a tax-inclusive basis. If a good costs $100 and bears an additional $34 sales tax, the tax-exclusive sales tax rate is 34 percent. The tax-inclusive rate is 25 percent – $34 (the tax paid) divided by $134 (the total amount the consumer paid). An individual who earns $134 and pays $34 in income taxes would think of themselves as paying approximately 25 percent ($34/$134 = 0.254) of their income in taxes.

Although tax-exclusive and tax-inclusive rates are both valid ways of thinking about tax rates, the easiest way to compare the retail sales tax rate to the state sales taxes paid by most Americans is to consider the tax-exclusive rate. On the other hand, it is appropriate to compare the retail sales tax rate with current income tax rates by utilizing the tax-inclusive rate. For ease of understanding, this chapter uses tax-exclusive rates unless otherwise specified in the text. Tax-inclusive rates are provided in the Appendix.

As explained in Chapter Three, the retail sales tax and the VAT represent similar ways to tax consumption of goods and services. A VAT and a retail sales tax that share the same tax base, tax rate, and compliance rates would generate the same amount of tax revenue. The Panel, therefore, analyzed a full replacement VAT at the same time it considered a full replacement retail sales tax. Although the Panel concluded that the full replacement VAT might mitigate some of the compliance challenges encountered with a retail sales tax, the Panel's primary objections to a retail sales tax applied equally to a full replacement VAT. As a result, the Panel does not recommend the full replacement VAT as a tax reform option.

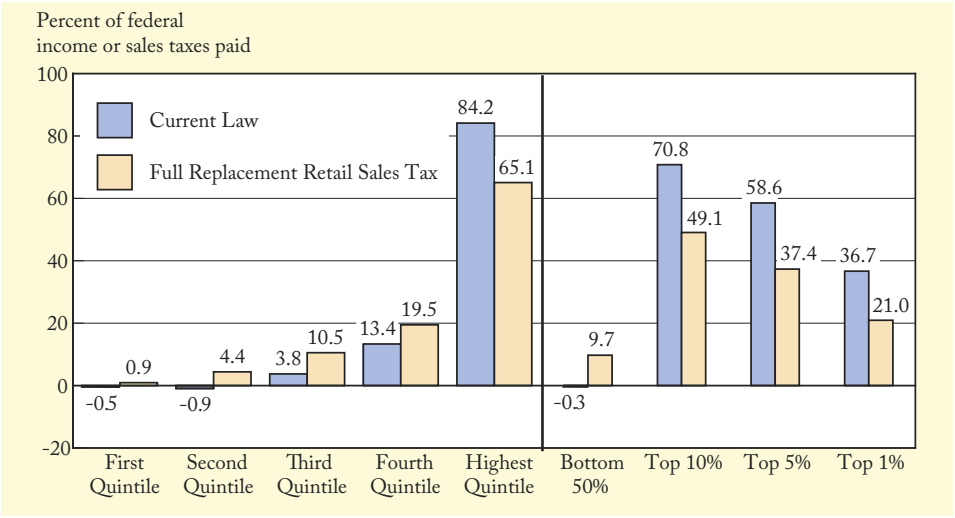
Retail Sales Tax with No Cash Grant

Forty-five states and the District of Columbia currently have retail sales taxes. Many states use multiple sales tax rates and exempt many goods and services from tax. The Panel, however, considered a single-rate tax that would be imposed on a broad tax base because such a tax would be simpler to administer and create fewer economic distortions. The Panel's broad tax base would apply to sales of goods and services to consumers, but, to prevent multiple taxation or "cascading," it would not apply to purchases of goods or services by business that are used to produce other goods or services for sale to households.

The Panel initially evaluated the federal retail sales tax using the broad tax base described by advocates of the "FairTax" retail sales tax proposal. That tax base (the "Extended Base") would exempt only educational services, expenditures abroad by U.S. residents, food produced and consumed on farms, and existing housing (or what economists refer to as the imputed rent on owner-occupied and farm housing). The long-term likelihood of maintaining this broad tax base is addressed later in this chapter.

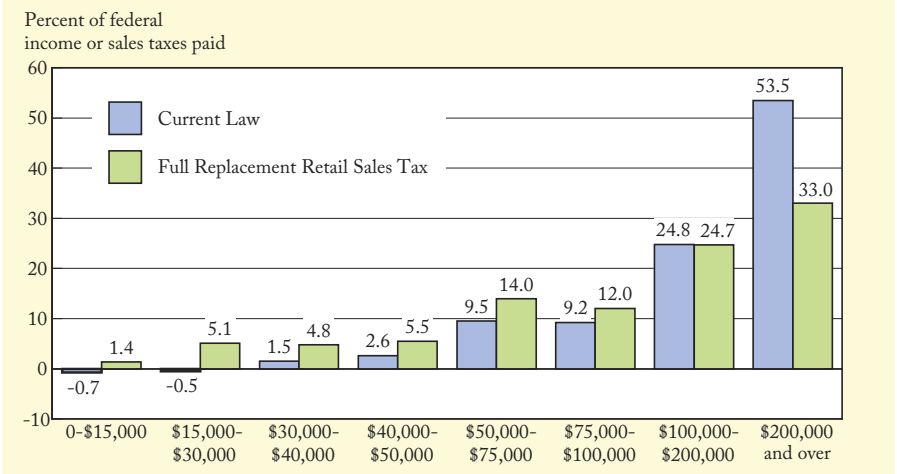
Using the Extended Base and assuming low rates of evasion, the Treasury Department calculated that the tax rate required to replace the federal income tax with a retail sales tax would be 22 percent on a tax-exclusive basis. This tax rate, however, does not include a program designed to ease the burden of the tax on lower-income Americans. Moreover, unless the states repealed their existing sales taxes, most consumers would pay both federal and state sales tax on many goods. The weighted average state and local sales tax rate is approximately 6.5 percent on a tax-exclusive basis. Thus, for sales subject to both federal retail sales tax and state and local sales taxes, the weighted average combined tax-exclusive sales tax rate would be approximately 28.5 percent.

Figure 9.1. Distribution of Federal Tax Burden Under Current Law and the Full Replacement Retail Sales Tax Proposal without Prebate by Income Percentile (2006 Law)



Note: Estimates of 2006 law at 2006 cash income levels. Quintiles begin at cash income of; Second $12,910; Third $27,461; Fourth $45,345; Highest $84,124; Top 10% $123,076; Top 5% $169,521; Top 1% $407,907. Bottom 50% below $36,738.
Source: Department of the Treasury, Office of Tax Analysis.

Figure 9.2. Distribution of Federal Income Tax Burden Under Current Law and the Full Replacement Retail Sales Tax Proposal without Prebate by Income Level (2006 Law)



Note: Estimates of 2006 law at 2006 cash income levels.
Source: Department of the Treasury, Office of Tax Analysis.

Figures 9.1 and 9.2 compare the current distribution of federal taxes paid with the distribution that would exist under a "stand-alone" retail sales tax at a 22 percent tax rate. Adopting this retail sales tax would impose a larger tax burden on lower-income households than the current system because a retail sales tax is imposed directly on

consumption and does not provide deductions, exemptions, or credits to reduce the tax burden on lower-income Americans. Replacing the current income tax with a stand-alone retail sales tax would increase the tax burden on the lower 80 percent of American families, as ranked by cash income, by approximately $250 billion per year. Such families would pay 34.9 percent of all federal retail sales taxes, more than double the 15.8 percent of federal income taxes they pay today. The top 20 percent of American taxpayers would see their tax burden fall by approximately $250 billion per year. Such families would pay 65.1 percent of all federal retail sales taxes, compared to the 84.2 percent of federal income taxes they pay today.

Lower- and middle-income families would be especially hard hit by a stand alone retail sales tax. For example, the Treasury Department estimates that a hypothetical single mother with one child making $20,000 per year currently pays $723 in total federal taxes (including both the employee and employer shares of the Social Security and Medicare taxes). Under the stand-alone retail sales tax, her tax bill would go up to $6,186 – a tax increase of over 750 percent. A hypothetical married couple with two children making $40,000 per year would pay an additional $6,553 in taxes, an increase of more than 110 percent of total federal tax liability. In contrast, a hypothetical married couple with two children and $300,000 of income currently pays about $89,000 in total federal taxes. Under the stand-alone retail sales tax, this hypothetical family would pay about $72,000, a tax cut of 19 percent. Further discussion of the Treasury Department's hypothetical taxpayer analysis appears in the Appendix.

The Panel concluded that the distribution of the tax burden under a stand-alone retail sales tax would not meet the requirement in the Executive Order that the Panel's tax reform options be appropriately progressive.

Retail Sales Tax with a Cash Grant Program

Universal Cash Grant Program

Retail sales tax proposals generally recognize the distributional effects of a stand-alone retail sales tax. For this reason, such proposals usually include a cash grant program to relieve the burden of the retail sales tax on lower and middle-income families.

The Panel considered the cash grant program advocated by proponents of the FairTax. This program (sometimes called a "Prebate") would provide a monthly monetary grant to all U.S. citizens and residents. The goal of the program would be to provide families with cash sufficient to pay retail sales tax on all their spending up to the poverty level. The program would not be income based so there would be no need to have a federal agency to keep track of personal income. Nevertheless, it would require a federal agency to keep track of family characteristics, such as family size, on which the cash grant would be based.

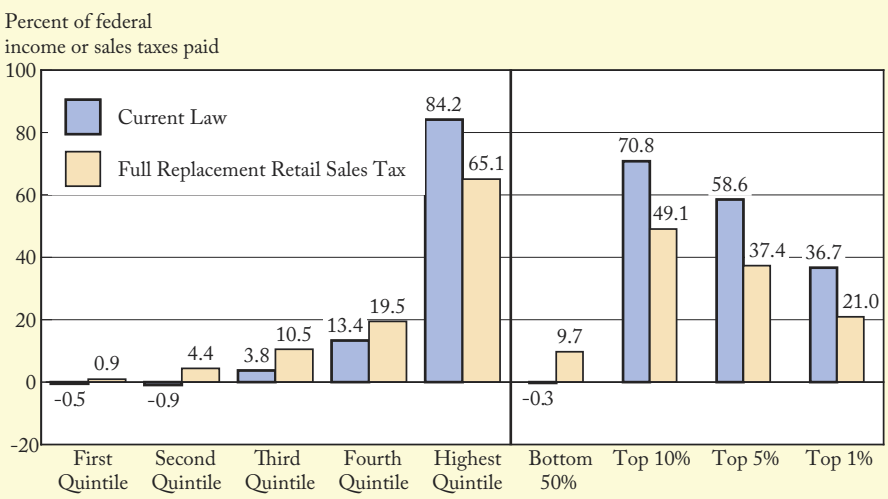
This cash grant program would be expensive, and would require raising the retail sales tax rate. To pay for the cash grant program and remain revenue-neutral, the required

tax rate, assuming evasion rates somewhat lower than those under the income tax, would be 34 percent. Using a higher evasion rate assumption, discussed further below, the tax rate would be 49 percent. If a narrower tax base were used instead of the Extended Base, the tax rate would be even higher.

How would the cash grant program work? The federal government would be required to send monthly checks to every family in America, regardless of their income level. If the tax rate was 34 percent and the before-tax poverty level for an individual was $10,000, all single individuals would receive $3,400 a year from the government. The cash grant would also be adjusted for marital status and family size. For married couples with two children, the cash grant amount in 2006 would be $6,694 per year.

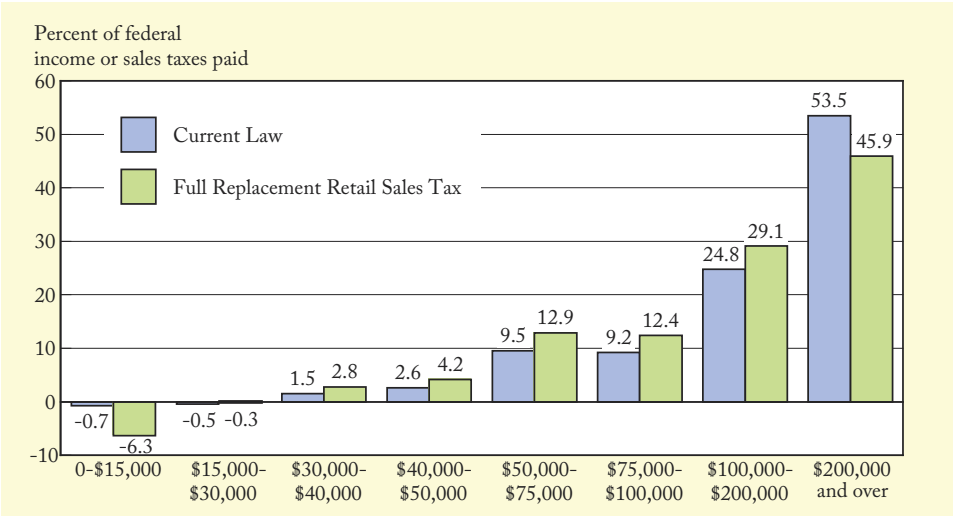
The Prebate-type program would cost approximately $600 billion in 2006 alone. This amount is equivalent to 23 percent of projected total federal government spending and 42 percent of projected total federal entitlement program spending, exceeding the size of Social Security, Medicare, and Medicaid. The Prebate program would cost more than all budgeted spending in 2006 on the Departments of Agriculture, Commerce, Defense, Education, Energy, Homeland Security, Housing and Urban Development, and Interior combined.

Figure 9.3. Distribution of Federal Tax Burden Under Current Law and the Full Replacement Retail Sales Tax Proposal with Prebate by Income Percentile (2006 Law)



Note: Estimates of 2006 law at 2006 cash income levels. Quintiles begin at cash income of; Second $12,910; Third $27,461 Fourth $45,345; Highest $84,124; Top 10% $123,076; Top 5% $169,521; Top 1% $407,907; Bottom 50% below $36,738.
Source: Department of the Treasury, Office of Tax Analysis.

Figure 9.4. Distribution of Federal Income Tax Burden Under Current Law and the Full Replacement Retail Sales Tax Proposal with Prebate by Income Level (2006 Law)



Note: Estimates of 2006 law at 2006 cash income levels.
Source: Department of the Treasury, Office of Tax Analysis.

Figures 9.3 and 9.4 show that low-income and high-income Americans would benefit from the retail sales tax with a Prebate, while middle-income Americans would pay a larger share of the federal tax burden. Separate figures with distributional estimates for 2015 law are not provided because the distribution of the retail sales tax burden in these estimates was identical to the distribution shown in Figures 9.3 and 9.4. American families with the lowest 20 percent of cash incomes currently pay negative 0.5 percent of total federal income taxes because the tax credits they claim exceed their total positive tax liability. Under the retail sales tax with a Prebate, this group would pay negative 5.6 percent of the federal sales tax burden because the amount they would receive in monthly checks from the government would exceed what they would pay in retail sales tax at the cash register. In total, the bottom quintile would bear 5.1 percentage points less of the tax burden. Families with the top 10 percent of cash incomes would also benefit substantially from the retail sales tax. Their share of the tax burden would fall by 5.3 percentage points – from 70.8 percent to 65.5 percent.

Middle-income Americans, however, would bear more of the federal tax burden under the retail sales tax with a Prebate. The Treasury Department's analysis of hypothetical taxpayers shows that married couples at the bottom 25th percentile, 50th percentile, and 75th percentile of the income distribution for married taxpayers would see substantial tax increases under a full replacement retail sales tax. A typical married couple at the bottom 25th percentile of the income distribution earns $39,300 per year and would pay $5,625 dollars in federal taxes in 2006. Under the retail sales tax with a Prebate, the same family would pay $7,997 in net federal taxes after subtracting the Prebate of $6,694, resulting in a tax increase of $2,372, or 42 percent. A typical married couple at the 50th percentile of the income distribution making $66,200

would pay an additional $4,791, a tax increase of 36 percent, and a typical married couple in the 75th percentile, making $99,600 would pay an additional $6,789, a 29 percent tax increase. A typical single mother at the bottom 25th percentile of the income distribution for head of household taxpayers has $23,100 of income per year and, compared to current law, would pay $5,866 more under the retail sales tax with a Prebate.

Targeted Cash Grant Program

The Panel requested that the Treasury Department develop a more targeted cash subsidy program to alleviate the burden of a retail sales tax on lower- and middle-income American families. The resulting program required a cash grant of up to $7,068 to married couples, plus $2,570 per dependent per year, with a phase-in and a phase-out. Further details regarding the program are provided in the Appendix, as well as a brief discussion of an alternative targeted subsidy program.

The Treasury Department's proposed targeted cash grant program would cost $780 billion in 2006. It would represent 30 percent of total federal government spending, and would dwarf all other federal entitlement programs and exceed the combined size of Social Security and Medicaid. To implement the program, the government would need to collect 34 percent more revenue and redistribute an additional 6 percent of GDP. The Panel concluded that this substantial increase in the amount of revenue collected from taxpayers and redistributed by the federal government was undesirable. Some Panelists were also concerned that the precedent set by the large cash grant program could set the stage for further growth in the size and scope of the federal government. To pay for the targeted cash grant program and remain otherwise revenue-neutral, the tax rate would need to increase to at least 37 percent, assuming low evasion and using the Extended Base.

Administration of a Cash Grant Program Would be Complex

The proposed cash grant programs would require all eligible American families to file paperwork with the IRS or another federal government agency in order to claim their benefits under this new entitlement program. A federal agency would need to manage the program, verify individuals' marital status and number of eligible children, and write checks to every family in the United States. Eligibility rules would be necessary, for example, to ensure that a child claimed as a dependent could not also file for his or her own separate cash grant.

Substantial additional complexity would be imposed by a targeted cash grant program because determining eligibility would require additional information. For example, a program based on annual income would require the IRS or another federal government agency to make many of the same determinations now made under the current income tax.

Evasion, the Tax Base, and the Required Tax Rate Revisited

The tax rate necessary to replace the revenues from the current individual and corporate income taxes is one key consideration in evaluating a retail sales tax. The two major factors that determine the tax rate are the size of the tax base and the level of evasion. The tax rates and rebate program cost estimates presented thus far have been based on relatively optimistic assumptions about the breadth of the tax base and the evasion rate. As explained above, even under these optimistic assumptions, the Panel does not recommend a full replacement sales tax at the resulting 34 percent tax rate.

The Panel also had substantial concerns that a base as broad as assumed above would not be viable and that evasion rates could be higher than under the present income tax. The Panel believed that in evaluating the retail sales tax it was important to consider the tax rate required under less favorable assumptions regarding the tax base and evasion. Accordingly, the Panel requested that the Treasury Department estimate the required retail sales tax rate using the same tax base as the Partial Replacement VAT described in Chapter Eight and using a base equal to the average state sales tax base.

The Partial Replacement VAT base described in Chapter Eight is slightly narrower than the Extended Base – primarily because it excludes the value of state and local government services. The Extended Base would require state and local governments not only to pay retail sales tax on their purchases from businesses, but also to pay tax at the retail sales tax rate to the federal government on the total value of the salaries that state and local governments pay their employees – this would be equivalent to the value of services provided by state and local governments to their citizens. The Panel concluded that it may be inappropriate for the federal government to directly assess a tax of this sort on state and local government in our federal system. For this reason, the Panel excluded state and local government services from the Partial Replacement VAT base discussed in Chapter Eight.

Existing state sales tax bases are substantially narrower than either of the broad bases studied by the Panel. Most states exempt a variety of specific products and many services from their sales taxes. For example, every state sales tax exempts prescription drugs, most states do not tax health care, approximately 30 states exempt food for home consumption or tax it at a preferential rate, and many states exempt clothing. These exemptions are often justified as a means to ease the burden of a sales tax on basic necessities, but are not well targeted because they often decrease the tax burden on higher-income taxpayers as much or more than they decrease the tax burden on lower or middle-income taxpayers. To illustrate the impact of extensive base erosion on a retail sales tax, the Panel requested that the Treasury Department estimate the tax rate using the average state sales tax base. The Panel acknowledges there are structural differences between state tax systems and a federal tax system that would rely on a retail sales tax instead of an individual and corporate income tax, and that these differences would affect the nature of any base erosion. Nevertheless, the Panel believes that estimating the tax rate using a base equal to the average state sales tax base is illustrative of the impact of base erosion on the tax rate.

Table 9.1. shows the Treasury Department's estimates of the tax-exclusive retail sales tax rates required to replace the federal income tax using the alternative assumptions regarding evasion rates and the breadth of the tax base. The Extended Base and Partial Replacement VAT Base estimates include the Prebate-type universal cash grant program (calculated to provide all families with cash sufficient to pay a 34 percent retail sales tax on a poverty level amount of spending). The average state sales tax base estimate includes no cash grant program, because exclusions from the base are assumed to fulfill the burden-easing function of the cash grant. These tax rates should be compared both to each other and to the overall burden an individual faces under both the corporate and individual income tax today. Tax-inclusive rates are provided in the Appendix.

Table 9.1. Retail Sales Tax Rate Estimates – Range of Tax-Exclusive Rates

Evasion Rate	Extended Base	Partial Replacement VAT Base	Median State Sales Tax Base
Low Evasion (15%)	34%	38%	64 %
Higher Evasion (30%)	49%	59%	89%

Source: Department of the Treasury, Office of Tax Analysis.

Box 9.2. Comparing the Treasury Department's Revenue-Neutral Rate Estimate with Estimates Made by Retail Sales Tax Proponents

In their submission to the Panel, proponents of the FairTax claimed that a 30 percent tax exclusive sales tax rate would be sufficient not only to replace the federal income tax, but also to replace all payroll taxes and estate and gift taxes and fund a universal cash grant. In contrast, the Treasury Department concluded that using the retail sales tax to replace only the income tax and provide a cash grant would require at least a 34 percent tax-exclusive rate.

Some may wonder why the tax rate estimated by FairTax advocates for replacing almost all federal taxes (representing 93 percent of projected federal receipts for fiscal year 2006, or $2.0 trillion) is so much lower than the retail sales tax rate estimated by the Treasury Department for replacing the income tax alone (representing 54 percent of projected federal receipts for fiscal year 2006, or $1.2 trillion).

First, it appears that FairTax proponents include federal government spending in the tax base when computing revenues, and assume that the price consumers pay would rise by the full amount of the tax when calculating the amount of revenue the government would obtain from a retail sales tax. However, they neglect to take this assumption into account in computing the amount of revenue required to maintain the government's current level of spending. For example, if a retail sales tax imposed a 30 percent tax on a good required for national defense (for example, transport vehicles) either (1) the government would be required to pay that tax, thereby increasing the cost of maintaining current levels of national defense under the retail sales tax, or (2) if the government was exempt from retail sales tax, the estimate for the amount of revenue raised by the retail sales tax could not include tax on the government's purchases. Failure to properly account for this effect is the most significant factor contributing to the FairTax proponents' relatively low revenue-neutral tax rate.

Second, FairTax proponents' rate estimates also appear to assume that there would be absolutely no tax evasion in a retail sales tax. The Panel found the assumption that all taxpayers would be fully compliant with a full replacement retail sales tax to be unreasonable. The Panel instead made assumptions about evasion that it believes to be conservative and analyzed the tax rate using these evasion assumptions.

Evasion

Tax evasion occurs when taxpayers do not pay taxes that are legally due. Analysts agree that some evasion is inevitable in any tax, and that evasion rates for any tax tend to rise as the tax rate rises. At the request of the Panel, the Treasury Department estimated the revenue neutral retail sales tax rate assuming evasion rates of 15 and 30 percent of personal consumption spending. The Treasury Department assumed no evasion by state and local governments. By comparison, for 2001 the IRS estimates that the evasion rate for the individual income tax was between 18 and 20 percent and the evasion rate of the entire U.S. tax system was about 15 percent.

The retail sales tax would rely on retail businesses to collect all federal tax revenue and eliminate federal individual income tax filing. Therefore, the number of federal tax return filers would fall significantly under the retail sales tax. Further, the complexity of filing a business tax return would decline dramatically as compared to corporate income tax returns. Retail sales tax returns would indicate only total sales, exempt

sales (sales to businesses with exemption certificates plus export sales) and tax liability. From an enforcement perspective, both the reduced number of tax return filings and the simple nature of the retail sales tax return represent substantial advantages.

Nevertheless, the Panel concluded that a number of features of the retail sales tax would make it difficult to administer and enforce at the high tax rate necessary to be revenue-neutral. A federal retail sales tax assessed at a rate of at least 34 percent, added on to state retail sales taxes, would provide a substantial inducement for evasion at the retail level. Retailers and shoppers could use a number of techniques to evade a retail sales tax. For example, unregistered cash sales to a consumer would allow a transaction to escape taxation. Retailers facing a high retail sales tax might also misapply exemption criteria, whether intentionally or unintentionally, and fail to tax goods that should be taxed. Or, the retailer might collect the tax from customers, but keep the money rather than remit it to the government. At high tax rates, the gain to retailers from evasion is high.

Empirical evidence suggests third-party reporting substantially improves tax compliance, particularly when tax rates are high. For the portion of income from which taxes are not withheld and there is no third-party reporting, income tax evasion rates are estimated to be around 50 percent. There is no third-party reporting in a retail sales tax. Retailers would add their retail sales tax to the pre-tax price for their goods and would remit that amount to the government, but shoppers would not separately report what they bought, and at what price, to the government. The government would rely on retailers alone to report their own taxable and exempt sales.

To obtain exemption from tax, retail purchasers might try to fabricate exemption certificates or otherwise masquerade as tax-free buyers of retail products. For example, individuals might create "paper" businesses solely to obtain business exemption certificates and avoid taxes on purchases for personal use. A related problem involves individuals with legitimate businesses using their business exemptions for personal purchases or for goods or services to give to employees in lieu of cash compensation. Using their business purchase exemption would provide a discount equal to the retail sales tax rate.

With a retail sales tax, retailers would have the responsibility to determine whether the ultimate use of a good or service would be for a business purpose, and therefore would be deserving of the business purchase exemption. Retailers are often ill-equipped to carry out this role. State experience suggests that abuse of exemptions is common, in part because distinguishing between business and individual consumer purchases of so-called "dual use" goods and services – goods and services that are commonly purchased by both businesses and final consumers, such as a plane ticket – can be difficult and costly.

Box 9.3. Dual-Use Goods and the Problem of "Cascading"

The difficulty of identifying whether dual-use goods are used for business or individual purposes is one reason that states typically include a significant number of business-to-business transactions in their sales tax base. For example, states often do not ask retailers to determine whether a buyer will use a computer for entertainment at home (taxable) or to run a business (exempt). Instead, many states treat sales of computers as taxable unless the buyer certifies that they are purchasing the computer for resale. Thus, many businesses pay sales tax when purchasing computers. That tax then "cascades" into the cost of the goods and services the purchasing business sells to consumers. Taxing goods and services bought by businesses to produce other goods and services is economically inefficient because it haphazardly imposes double (or triple or quadruple) taxation on some consumer goods and services.

Cascading taxes create incentives for business to produce fewer goods or services, shift resources into tax-favored activities, or adopt tax-driven business structures. Cascading taxes also may have a negative impact on U.S. competitiveness because they impose some tax liability on exports and result in less tax being assessed on imports relative to competing domestically-produced goods.

Comparison with State Sales Tax Evasion and Administration

Retail sales tax advocates often note that evasion rates with sales taxes are lower than evasion rates with the income tax. However, state sales tax evasion rates are not likely to be representative of the evasion rate of a full replacement retail sales tax for several reasons.

First, state sales tax rates are a fraction of the tax rates required to replace the federal income tax. Among states that impose sales taxes, tax rates range from 3.5 percent in Virginia to 7.0 percent in Mississippi, Rhode Island, and Tennessee. When combined with local sales taxes, the highest sales taxes are found in Alabama (11.0 percent), Arkansas (10.625 percent), Oklahoma (10.5 percent) and Louisiana (10.5 percent).

Higher tax rates provide greater incentives for taxpayer evasion and avoidance. Those incentives also make administration and enforcement more expensive – and any failure to effectively administer the tax requires a higher tax rate to compensate for lost revenue. No state or country has ever levied a retail sales tax at a tax rate that even approaches the 34 percent required to replace the federal income tax system. State tax administrators told the Panel that they would expect significant compliance problems at such rates.

State sales taxes also do not broadly tax service providers, often because they are difficult to tax. For example, all U.S. state sales taxes exempt most financial services. Other dual-use services, such as utilities, transportation, and communication services are also difficult to tax properly and often are exempt from state sales taxes. It is reasonable to assume that trying to tax these services through a retail sales tax likely would result in more extensive evasion and higher compliance and administrative costs than existing state sales taxes. Although it is difficult to know with any measure of certainty what the evasion rate would be under the RST, the Panel believes that it would likely be at least as high as evasion under the current income tax and that a 30 percent rate of evasion would not be an unreasonable assumption.

Other Concerns

Response of the States to a Retail Sales Tax

Although some retail sales tax proposals claim the administration of the retail sales tax could be left to the states and the IRS could be eliminated, such a system would likely be unworkable. Existing state sales tax bases are both narrow and varied and it may be difficult to persuade the states to adopt the federal retail sales tax base.

The experience of Canada, which tried to federalize its provincial sales taxes, may be instructive. Canada considered adopting a unified federal and provincial sales tax base in 1987, but intergovernmental discussions failed to produce an agreement to standardize the existing provincial sales tax bases with the base for Canada's federal goods and services tax.

Variation in local sales tax rates within the United States could further complicate any effort to standardize U.S. sales tax bases and rates. As of 2001, Texas alone had 1,109 separate city tax rates, 119 county tax rates, and 67 other special tax jurisdictions. Texas is not atypical in having numerous local sales tax jurisdictions. While some states might bring their sales taxes into conformity with a federal retail sales tax, it is unlikely that all would do so. States have not adopted identical definitions, standards, and rules in their own income tax regimes as those that exist for the federal income tax, even though there would be many administrative and compliance advantages to such an approach.

Given the tremendous variance in the current taxation of retail sales across the United States, the IRS or another federal agency with substantial personnel and resources would almost certainly have to define, administer, and enforce a federal retail sales tax. For example, detailed rules would be necessary to ensure that exemption certificates were issued uniformly and only provided to legitimate businesses for use in purchasing actual business tools, materials, and other inputs. Further, the IRS or another federal agency would likely need to administer the retail sales tax directly in the five states that do not currently impose a sales tax. The same might be true in those states that do not bring their sales tax bases into conformity with the federal retail sales tax base. Finally, because failure to effectively enforce the sales tax would lower federal revenues, Congress might decide that the IRS should maintain a significant enforcement function as a backup mechanism to state tax administration efforts.

State Income Tax

At the Panel's public meetings, state and local tax officials suggested that a federal retail sales tax would encroach on a tax base that traditionally has been left exclusively to states and localities. Currently sales and gross receipts taxes account for about 37 percent of state general tax collections and about 17 percent of local revenues. However, if a federal retail sales tax were put in place at a rate of 34 percent or more, it could become unattractive for states to add their own rates on top of the federal retail sales tax.

If the federal government were to cease taxing income, states might choose to shift their revenue-raising to the income base from the sales base. State income taxes could rise, while state sales tax rates could fall. In any event, unless states found a substitute source of revenue, they likely would maintain their income taxes. For that reason, it is reasonable to expect that taxpayers would need to continue to keep track of income-related information and file income tax returns, regardless of whether the federal government eliminates the federal income tax. Furthermore, with an income-based cash grant program, tracking income at the federal level would remain a necessity.

Today, 45 states and the District of Columbia have state income taxes. Most states use federal adjusted gross income as the starting point in determining the state individual income tax base. Eliminating the federal income tax would remove the common basis upon which most state income taxes are now structured. State and local income tax returns would likely become much more complex if they could not be based on a pre-existing federal income tax return that includes a calculation of annual income. Greater disparities among state income tax systems and potential distortions would likely develop as state income tax structures diverge from each other over time in the absence of a common federal income tax base as a starting point.

State income tax compliance initiatives currently rely in large measure on information that the states receive from the third-party reporting structure created by the federal income tax – such as W-2 and 1099 forms as well as other standard tax forms that report income. In the absence of the federal third-party reporting system, states would need to impose information reporting requirements on individuals, employers, financial institutions, and others in order to maintain their income tax systems. States might bind together to coordinate enforcement of state income taxes and impose those reporting requirements. But if states chose to impose reporting requirements independently, multi-state businesses could face many different sets of reporting obligations. Simplification of the federal tax system through a retail sales tax might be achieved at the expense of greater overall complexity in the combined system of state and federal taxation.

Compliance Burden on Small Business

A retail sales tax also likely would place a disproportionate burden on small retail businesses. Few statistical studies exist on the compliance costs for retailers of different sizes. However, a well-regarded study conducted by the State of Washington Department of Revenue in 1998 suggests that, although such costs are low overall, they are disproportionately high for small retailers. In Washington, the cost of collecting sales tax for retailers with annual gross retail sales of between $150,000 and $400,000 was 6.5 percent of sales tax collected. By comparison, firms with annual gross retail sales greater than $1.5 million spent less than 1 percent of sales tax collected on compliance.

Small vendors, particularly those operating on a cash basis, account for a significant share of the noncompliance in many state sales taxes as well as our current income tax. A retail sales tax would cover all retailers, including small service providers,

such as dentists, car mechanics, or beauticians, as well as small retail stores. Small service providers would likely find retail sales tax compliance costly and would have noncompliance incentives that would be similar to those for small retail stores.

Macroeconomic Effects of Transition

Some observers have worried about potential macroeconomic disruptions associated with moving from an income tax to a retail sales tax. Although there may be some such disruptions, those considerations were secondary in the Panel's decision not to recommend a retail sales tax.

Full Replacement of the Income Tax with a VAT

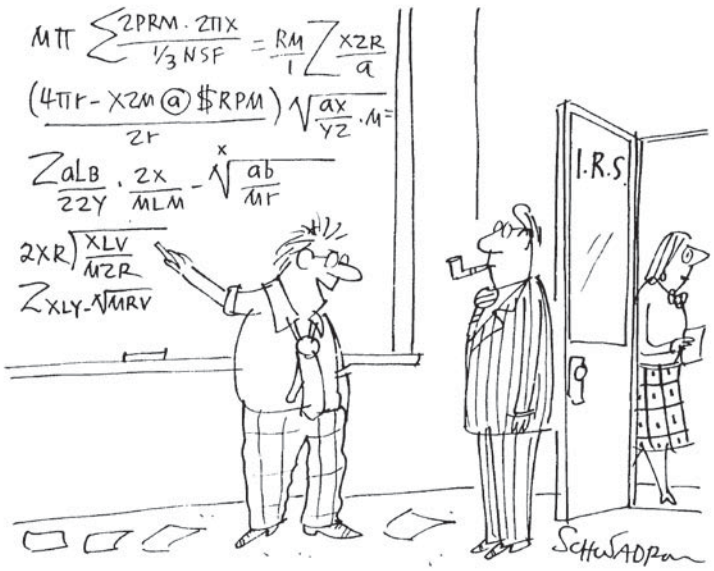
The Panel considered replacing the income tax with a VAT at the same time it analyzed a replacement retail sales tax because of the similarities between the two taxes. The Panel concluded that fully replacing the income tax with a VAT would be substantially more administrable than fully replacing the income tax with a retail sales tax. The advantages of a VAT over a retail sales tax with respect to enforcement and compliance are described in Chapter Eight. However, the Panel's objections regarding the increased tax burden on the middle class and increased size of government resulting from the full replacement retail sales tax apply equally to a full replacement VAT. Because of these concerns, the Panel did not recommend a full replacement VAT.

Conclusion

Like other consumption taxes, the full replacement retail sales tax has pro-growth features. Nevertheless, the Panel does not recommend a full replacement retail sales tax. Without a large cash grant program to ease the burden of the tax, a retail sales tax would not be appropriately progressive. A cash grant program to make the tax appropriately progressive would cost at least $600 billion per year – which would make it America's largest entitlement program. The Panel concluded that it was inappropriate to recommend a tax reform proposal that required the federal government to collect and redistribute this amount in additional revenue from taxpayers. The Panel also was concerned with administrative and compliance issues associated with a retail sales tax, as well as difficulties involving coordination with existing state sales taxes.

Appendix

Additional Details



"Now are you convinced that
the tax simplification plan will work, chief?"

During the course of its work, the Panel examined the current corporate and individual income tax systems and evaluated a variety of proposals for reform. The Panel relied on the help of experts who appeared before the Panel, the Panel staff, the Treasury Department, the Internal Revenue Service, and interested parties who submitted comments.

The Panel had a finite amount of time to develop options, and, therefore, focused its efforts on the goals it hoped to achieve. Although the Panel could not consider every issue or problem, there were several issues for which the Panel developed detailed solutions, these are presented in this Appendix. Much of the discussion is intended to provide background regarding implementation of the Panel's recommendations. The Panel believes that providing this information will aid in understanding its recommendations and will serve as a starting point as policymakers consider changes to the tax code.

This Appendix is not intended to be a comprehensive or systematic discussion of the issues addressed. Moreover, the range of issues addressed in the Appendix is not intended to imply that there are not other important issues. For every issue discussed

here, the Panel discovered that there were many more that could not be thoroughly analyzed in the limited amount of time the Panel had to accomplish its mission.

The Appendix is organized by report chapter. Additional distribution tables for the Simplified Income Tax Plan, the Growth and Investment Tax Plan, and the Progressive Consumption Tax Plan, and sample tax forms appear in the last section of this Appendix.

Chapter Four: Our Starting Point

Details on the Macroeconomic Analysis of the Tax Reform Proposals

The Treasury Department used variants of three standard economic growth models to estimate the dynamic response associated with the Panel's reform options. The use of multiple models reflects both the uncertainty in these types of estimates and provides a reasonable range of results that are consistent with the range of estimates found in the economic literature. These types of models have been used in academic research on the dynamic effects of tax reform and by the staffs of the Joint Committee on Taxation and the Congressional Budget Office.

The three models used by the Treasury Department were a neoclassical growth model, an overlapping generations (OLG) life-cycle model, and a Ramsey growth model. The Treasury Department used the OLG model developed by Tax Policy Advisors, LLC. All three models are supply-side models that emphasize the effects on economic growth of reducing the effective tax rates on capital and labor income. The models ignore demand-side or cyclical variations in the economy, assuming instead that the economy is always at full employment. The neoclassical and Ramsey growth models are closed economy models that ignore international capital flows and foreign trade. The OLG model includes a simple international sector.

The neoclassical growth model, which assumes fixed labor supply and a savings rate elasticity of 0.4 yields the smallest growth effects over the ten-year revenue window. This is primarily because it does not account for the labor supply responses that are built into the other models. The intertemporal elasticity of substitution in the Ramsey growth model is smaller (0.25) than that in the overlapping generations model (0.35). The within-period substitution elasticity between leisure and goods is greater in the Ramsey model (0.80) than in the overlapping generations model (0.60).

Each of the three models is calibrated to replicate certain economic aggregates using the Administration's policy baseline over the ten-year budget window. The changes to the tax system are assumed to occur simultaneously and without anticipation by households or firms. As households and firms respond to the effect of the tax changes on after-tax wages and interest rates, savings and investment increase, the capital stock increases and individuals change the amount of labor they are willing to supply. These changes occur for many years until eventually the economy returns to the original steady-state growth rate, at a higher level than the previous steady-state growth path. Before the tax changes are imposed, the economic growth rate equals

the combined population growth rate and rate of growth in technological change, both of which are held fixed over time.

Each of the recommended plans has been estimated by the Treasury Department to be revenue neutral over the budget window. Yet given the level of aggregation in the dynamic models, as well as the embedded behavioral responses, there is no reason to expect that budget neutrality would be maintained for any particular year by applying the implied labor and capital tax rates that result from Treasury's standard revenue estimating analysis into the dynamic models. There are numerous fiscal policy responses that could be applied to maintain the government's intertemporal budget balance through the period of reform. The analysis in this report assumes that average and marginal tax rates are adjusted in each year to maintain a constant level of real government spending for each year after the reforms.

The treatment of the initial tax system in the model, while similar across the models, is also slightly different. The initial tax system for the Ramsey model and the neoclassical growth model includes a flat rate tax on wages and an effective tax rate on capital income. Investment incentives (e.g., accelerated depreciation and tax exemption of the return to owner-occupied housing) reduce the effective tax rate on capital income below the statutory tax rate. The OLG model has a more detailed treatment of the tax system in that labor income taxes are progressive over the life cycle. The OLG model also includes state taxes and a simplified Social Security system, with both state spending and Social Security transfers held constant during the reform. Because the tax system is modeled in a stylized way in each of these models, and the models make simplifying assumptions about a variety of factors, including international capital flows and investment risk, they provide only rough guidance about how tax reforms might affect economic growth. Nevertheless, these models are representative of the types of models that are commonly applied in academic and government research.

Chapter Five: The Panel's Recommendations

The New Family and Work Credits

Eligibility for Family and Work Credits

Chapter Five describes the Family and Work Credits that individuals would be entitled to claim instead of the complex system of tax benefits provided for families under current law. The base amount of the Family Credit depends on family status, as described below. It also allows an additional non-refundable tax credit of $1,500 for each child dependent and $500 for each other dependent. The refundable Work Credit provides higher credits and income ceilings for taxpayers who have at least one child dependent.

Chapter Five describes the Panel's recommendations for simpler set of eligibility rules for the Family and Work Credits. Under current law, each family tax benefit, such as the personal exemption, the child tax credit, and the EITC, requires its own

complex determination of whether the taxpayer can claim the benefit. The Panel recommends that simple rules be used to determine whether taxpayers qualify for the Family Credit, and that eligibility for the Work Credit flow intuitively from that determination. For the vast majority of taxpayers who qualify for the Family Credit, the question of whether they also qualify for the Work Credit will turn only on the amount of their unused Family Credit and their income.

The Working Families Tax Relief Act of 2004 made eligibility for family tax benefits more uniform by simplifying the test for whether a taxpayer can treat a child or another person as a dependent in order to claim a personal exemption, child tax credit, or EITC for that person. The Panel adopted the approach of the legislation, but recommends additional reforms aimed at further simplifying eligibility tests for the Family and Work Credits.

The following discussion illustrates how a taxpayer would determine whether he or she qualifies for the Family Credit and Work Credit. The Panel recommends an approach that carefully balances the need for simple rules against the need to target the credits appropriately. These rules are designed to allow the IRS to determine each taxpayer's eligibility for the credits, and to be able to calculate the Work Credit if asked to do so by the taxpayer. This design mandates streamlined rules that also would make it easier for taxpayers to calculate the tax credits for themselves.

Amount of the Credits

The Panel's recommendations would eliminate much of the complexity flowing from current-law rules that reduce the value of various tax benefits as a taxpayer's income increases. Under current law, taxpayers must apply a different mechanism under the personal exemption, the child tax credit, and each of a number of other tax provisions to determine what portion, if any, of the tax benefit they can claim. Thus, for example, the amount of personal exemptions and itemized deductions the taxpayer can deduct and the amount of child tax credits the taxpayer can claim decline as the taxpayer's adjusted gross income rises. The rules limiting or reducing the tax benefits are not uniform, however, forcing many taxpayers to do several different complex calculations. By contrast, the Family Credit would not phase out as income rises. This would represent a meaningful simplification for many taxpayers.

Under current law, a taxpayer may be entitled to a tax refund if his child tax credit exceeds his income tax liability (determined before the credit), provided he meets certain other complex tests. These tests are especially burdensome. As discussed earlier in Chapter Five, the options would be much simpler for these taxpayers because the Family Credit would be effectively refundable for low-income workers through the operation of the Work Credit.

The Work Credit, like the EITC, would increase with a taxpayer's earnings up to a ceiling, and would then decrease as the taxpayer's earnings rise further. Like the EITC, this is intended to encourage work while also limiting the credit to low-income taxpayers.

What Family Credits are available?

Family Credits For:	**Would be:**
• A single taxpayer with no child dependent	$1,650
• A single taxpayer with one child, or other related dependent	$2,800
• Married taxpayers filing joint returns	$3,300
• A taxpayer who could be claimed as a dependent by another taxpayer	$1,150
And for each of the following:	**An additional:**
• A child dependent	$1,500
• Other dependent	$ 500

What Work Credit is available?

The Work Credit would approximate the EITC and refundable child tax credit under current law. Taxpayers would determine the amount of their Work Credit by consulting two simple schedules included at the end of this section of the Appendix. The following explains the formulas on which those schedules are based.

The Work Credit would be the amount by which the taxpayer's Family Credit exceeds tax liability before the credit limited to:

- No child dependent: the lesser of 7.65 percent of work income or $412;
- One child dependent: the lesser of 34 percent of work income or $2,120
- Two or more child dependents: the lesser of 40 percent of work income or $3,200.

With an additional credit of:

- up to $1,450 if the taxpayer has one child dependent
  - o phased in at a rate of 34 cents for every dollar of work income (or taxable income, if lower) over $6,235;
- up to $2,600 if the taxpayer has two or more child dependents
  - o phased in at a rate of 40 cents for every dollar of work income (or taxable income, if lower) over $8,000;

The additional credit would phase out at a rate of 12.5 cents for every dollar of the taxpayer's work income (or taxable income, if higher) above $17,000 (or $21,000 if the taxpayer is filing a joint return).

The amount of Work Credit a taxpayer can claim depends on work income. What is a taxpayer's work income?

Work income would include a taxpayer's taxable wages and salaries, self-employment income, and labor income for a statutory employee. If a taxpayer makes an election, non-taxable combat pay would be included in work income. This would allow some active duty military families to qualify for a greater Work Credit than they otherwise would have.

Could a taxpayer have investment income and still qualify for the Work Credit?

The Panel recommends simplifying the eligibility rules by eliminating the investment income test for the Work Credit. Under the current-law EITC, a taxpayer who earns more than $2,800 of investment income in 2006 is ineligible for the credit. This rule discourages low-income workers from saving, because a taxpayer who earns one dollar more than the limit forfeits the entire amount of the EITC.

Under the Panel's options, investment income would be taken into account to determine how much Work Credit the taxpayer could claim. The portion of the Work Credit that is in addition to any excess of the Family Credit over tax liabilities would phase in with the lesser of work income or taxable income, and phase out with the greater of work income or taxable income. Taxpayers would not be required to satisfy a separate investment income test to claim the Work Credit.

Taxpayer Eligibility

A taxpayer must meet certain qualifications to be eligible to claim the Family and Work Credits. These qualifications are similar to the tests that apply to taxpayers claiming standard deductions, personal exemptions, child tax credits, and the EITC under current law, but are simpler and more consistent. The requirements for claiming the Family Credit are the foundation for Work Credit eligibility. Because the Work Credit is intended as a subsidy for low-income working families, a person who qualifies for the Family Credit must satisfy several other tests to claim the Work Credit.

Who could claim a Family Credit?

Almost anyone who files an individual income tax return could claim the Family Credit.

A taxpayer who could be claimed as a dependent or child dependent on someone else's return, however, could claim a Family Credit of only $1,150. The Panel recommends this approach to limit available credits when a person's income does not reflect his or her financial status. This represents a simplification of current law, which denies the dependency exemption, the child tax credit, and the EITC to any taxpayer who can be claimed as a dependent or qualifying child on another's return, and imposes a complex formula to calculate how much of the standard deduction the taxpayer can claim.

Who can claim the Work Credit?

A taxpayer would be eligible for the Work Credit if:

- The taxpayer's Family Credit exceeds tax liability before the credit;
- The taxpayer has one child dependent and income below $28,600 ($32,600 if married); or
- The taxpayer has two or more child dependents and income below $37,800 ($41,800 if married).

The Work Credit would not be available if the taxpayer or the taxpayer's spouse could be claimed as a dependent on someone else's tax return.

Does it matter whether the taxpayer is single or married?

Generally, a family's aggregate Family Credits would be the same regardless of the taxpayer's filing status, but married taxpayers who file as singles may lose a portion of some credits.

The Panel has recommended that a married taxpayer be allowed to choose between filing returns jointly with his or her spouse and filing as a single person, and the Panel's recommendations would reduce the significance of this choice. Moreover, there would be no married-filing-separately status and no head-of-household filing status. This would significantly reduce complexity for many taxpayers.

Instead of having special filing categories, there would be a higher Family Credit available to a person filing as a single taxpayer who has a child or other related dependent (in addition to the credit that could be claimed for the child). A married taxpayer who files as a single taxpayer would generally be unable to claim this higher Family Credit.

In addition, a married taxpayer who files as a single taxpayer would generally be ineligible for the Work Credit.

This limit on the Family and Work Credits for married taxpayers filing as singles would not apply, however, to a taxpayer who lived apart from the taxpayer's spouse for an entire year, and who satisfied certain other conditions that show that the taxpayer and the taxpayer's spouse are no longer a family unit. These rules would be consistent with special rules under current law for separated spouses, but would be somewhat simplified.

The Panel believes this approach would balance the need to simplify the arcane filing status rules and the restrictions on married taxpayers who file separate returns with the need to provide fair and administrable rules for families.

Would a taxpayer have to be a certain age to qualify for the credits?

There would be no age restrictions on taxpayers who claim the Family and Work Credits (although there would be for the taxpayer's dependents, as discussed below). The Panel's recommendations would eliminate the current-law rules that limit the EITC to childless taxpayers between the ages of 25 and 65. The Panel saw no compelling reason to retain this rule in light of other recommendations.

Would the taxpayer need to be a citizen or resident of the United States to claim the credits?	The Family Credit would not apply a citizenship or residency requirement. Like the current law EITC, the Work Credit would be available only to U.S. citizens or individuals who are residents of the United States for the entire year. A taxpayer also would need a Social Security number authorizing work in the United States to claim the Work Credit. In addition, a taxpayer could only qualify for the Work Credit if he lived in the United States for at least half of the year for which the credit is claimed. Special rules would apply to individuals on active duty with the military. The Panel recognizes that these special Work Credit requirements would impose a burden on a small minority of taxpayers, but believes they are necessary to insure the credit is targeted to low-income workers who live in the U.S.
Would a taxpayer's spouse need to be a citizen or resident for the taxpayer to claim the credits?	A taxpayer who is married to a non-resident alien could not file a joint return or claim the Family Credit for his or her spouse. Thus, in general, under rules described above for married taxpayers filing as singles, the taxpayer could only claim the Family Credit for a single taxpayer, and not the higher amount available to a single taxpayer with a child or other related dependent. The taxpayer would, however, be entitled to claim the additional $1,500 Family Credit for any child dependent. The taxpayer would not be able to claim the Work Credit. The restriction on filing a joint return would not apply, however, to a taxpayer who is a citizen or full-year resident of the United States if the spouse elected to be taxed as a full-year U.S. resident. This is consistent with current law, which prohibits a taxpayer who is married to a non-resident alien from filing a joint return or from claiming a dependency exemption for the spouse unless the spouse makes the election to be taxed as a full-year U.S. resident.
Are credits available to U.S. citizens or residents who work abroad?	Family Credits would be available to taxpayers who claim an exemption for income earned abroad. The Work Credit would not be available for these taxpayers.

Credits for Children and Other Dependents—Eligibility

Under the Panel's recommendations, a taxpayer could claim a $1,500 Family Credit for each child who was the taxpayer's "child dependent." A taxpayer could also take such a child into account under the Work Credit if certain other tests are met. A taxpayer would be able to claim a $500 Family Credit for other individuals whom the taxpayer supports but who would not qualify as child dependents.

Who would qualify as a taxpayer's child dependent?	A child dependent would be someone who meets three simple eligibility tests: relationship with the taxpayer, age, and residency.
Who meets the relationship test?	An individual would meet the relationship test if, as under current law, he or she is the taxpayer's child, stepchild, adopted child (including a foster child officially placed with the taxpayer), stepchild, sibling or stepsibling, or descendants of any of these relations.
Who meets the age test?	The age test would be met by an individual who is 18 years old or younger or is permanently disabled. A child who is 19 or 20 years old and a full-time student would also meet the age test. As discussed earlier in Chapter Five, the age requirement would be a change from current law and reflects the Panel's view that credits should be available for children over 18 if they are still dependent on their families.

Who would meet the residency test?

The residency test would be satisfied if a child lived with the taxpayer for more than half of the year, including periods when the child is temporarily away from home. For example, a student who does not live with his parents while attending college could still meet the residency requirement. This approach follows current law. Unlike current law, however, if parents are divorced or legally separated, the noncustodial parent generally would not be able to satisfy the residency test and thus could not claim the couple's children as child dependents. The Panel did not adopt the special rule under current law that allows a custodial parent to release the dependency exemption and child tax credit to a noncustodial parent because it creates unnecessary complexity.

Would a taxpayer be required to show he or she supported a child dependent?

There would be no general support test for child dependents under the Panel's recommendations. If a child is self-supporting (i.e., provides more than half his own support), however, the child may not be claimed as a child dependent. This test would simplify the rules under current law and preserve the ability of financially independent children to claim credits on their own returns.

What if two or more taxpayers claim the same child dependent?

Only one person would be able to claim the child on a tax return. If two or more people entitled to treat a child as a child dependent cannot agree on who will claim the child, the Panel recommends application of the so-called tie-breaker rules of current law. In general, if both a parent and a non-parent claim the child, only the parent would be eligible to take the Family Credit and higher Work Credit for that child. If two parents who do not file joint returns claim the child, only the parent with whom the child lived longest (or if time is equal, the parent who had the highest adjusted gross income) would be eligible. If neither of the taxpayers claiming the child was the child's parent, only the taxpayer with the highest adjusted gross income would be eligible.

If an individual does not meet the tests for being a child dependent, can the taxpayer still claim a Family Credit for that person?

Yes, a $500 Family Credit could be claimed for a dependent who is not a child dependent. But only child dependents would be taken into account for purposes of the Work Credit.

Who would qualify as a taxpayer's dependent?

A dependent would be someone who is a relative of the taxpayer or a member of the taxpayer's household, has gross income below $3,300, is provided with more than half his or her support by the taxpayer, and cannot be claimed as a child dependent by any other taxpayer. The income limit is the approximate amount that, if taxed at the lowest 15 percent marginal rate, would result in a tax liability of $500. The Panel's options would waive the income test for full-time students ages 21 to 23. Thus, for example, if a full-time, 22-year-old student met all of the tests for being a child dependent except that he exceeded the age limit of 20, the student's parents could claim a $500 Family Credit regardless of the student's income.

These requirements are similar to the rules under current law that allow a taxpayer to claim the personal exemption for a qualified relative who is not a qualified child, but do not allow the taxpayer to claim the EITC or child tax credit for that person.

The Panel recognizes that the lower Family Credit for dependents who do not qualify as child dependents introduces additional complexity into the Panel's recommendations. The Panel believes that the balance between fairness and simplicity weighs in favor of allowing a Family Credit when a taxpayer financially supports an individual for whom the taxpayer cannot claim the higher credit. Moreover, the Panel believes that most taxpayers will not need to apply these additional tests.

Would there be any other general requirements to claim a child dependent or dependent?

A taxpayer could not claim an individual as a dependent or a child dependent without providing the individual's name and valid social security number on the federal income tax return. This is generally consistent with the current-law requirement that a taxpayer provide a child's name and taxpayer identification number to claim the dependency exemption and the child tax credit, but is more liberal than the rule for the EITC, which requires the child to have a social security number that is valid for work in the United States.

The preceding discussion describes the rules that the vast majority of taxpayers would have to apply to claim the Family and Work Credits. The Panel would recommend additional special rules for determining whether an individual could be claimed as a taxpayer's child dependent or other dependent, but the application of those rules would be limited.

Could a married individual qualify as a child dependent or dependent?

If an individual is married and files a federal income tax return jointly with his or her spouse, no taxpayer could treat that individual as a dependent or child dependent. This would be consistent with the current-law rule for the personal exemption and the EITC.

Could an individual who is a nonresident alien qualify as a child dependent or dependent?

To qualify as a child dependent or as a dependent, an individual would have to be a resident or citizen of the United States. Thus, a parent of a non-resident alien child could not claim the Family Credit for that child or qualify for the higher Work Credit for that child. This rule is consistent with current law, but provides more uniformity: the rules for the dependency exemption under current law allow taxpayers to claim children who are residents of Canada and Mexico.

Would there be any additional U.S. residency rules to qualify for the higher Work Credit available to taxpayers with child dependents?

Yes. To qualify for the Work Credit, a taxpayer's child dependent would be required to have lived with the taxpayer in the United States for more than half of the year. This is identical to the requirements under the current-law EITC. Although this rule adds complexity by creating an additional eligibility test under the Work Credit, it was retained to ensure the Work Credit would be limited to families that reside within the United States.

The Panel believes that navigating these rules should be as simple as possible for taxpayers and has recommended a structure that gives taxpayers the option of allowing the IRS to compute the Work Credit for them. For those taxpayers who choose to compute the Work Credit themselves, the Panel developed the worksheet and instructions shown in the last section of this Appendix to illustrate the process.

Home Credit

As discussed in Chapter Five, the Panel recommends that the current home mortgage interest deduction be converted into a tax credit of 15 percent of home mortgage interest. The Panel also recommended limiting the credit to interest on a standard principal amount, based on the average price of single-family homes in the United States, adjusted annually to take into account regional variations in housing costs. Each year, taxpayers would apply the current year's mortgage limit. Thus, the amount of home mortgage debt for which the interest credit could be claimed would increase each year if home prices rise.

The Panel recommends basing the average home price on the ceilings that the Federal Housing Administration (FHA) sets for the amount of a home mortgage loan that it will insure. The ceilings are determined using median home prices and are provided on a county-by-county basis to account for regional variations in housing costs. These amounts would be adjusted to reverse a discount the FHA applies and to account for the difference between median and average prices. To determine mortgage loan limits, the amount the FHA reports would be grossed-up to 100 percent of median values and then increased by 125 percent. This is the equivalent of multiplying the FHA amount by 1.315. If the credit were in place today, the limits would be between approximately $227,147 and $411,704. The IRS currently provides guidelines for average sales prices using a similar methodology for other tax purposes. Thus, if an individual living in Los Angeles, California (a high-cost area) had a home mortgage loan of $400,000, all of the interest on that loan could qualify for the credit because the loan principal would be below the $411,704 ceiling for high-cost areas. If the principal amount of the loan was $500,000, interest on the first $411,704 of loan principal would qualify.

Currently, banks and other lending institutions that service home mortgage loans are required to report deductible interest and points to the IRS and borrowers annually on Form 1098. Under the Panel's recommendations, these institutions would determine how much of each borrower's interest payments qualify for the Home Credit using the information available from the FHA and would provide that information to borrowers and the IRS. Borrowers who had only one mortgage on their principal residence could simply use the information provided by the lending institution to claim the Home Credit. Borrowers who did not receive annual information statements from a lending institution, or who received a report on more than one loan, could calculate creditable home mortgage interest themselves, using information provided by the IRS.

As under the current law deduction, the Home Credit would be available for interest on a loan that is used to buy, build or substantially improve an individual's principal

residence, and that is secured by the residence. It would also be available for the refinancing of such a loan (limited to the loan's outstanding principal amount). Current rules determine how a loan is used by tracing the loan proceeds. In light of the recommended limitations on benefits for home mortgage interest, these rules should be simplified and should provide straightforward guidelines to reduce complexity for taxpayers.

To claim the credit for home mortgage interest, an individual would have to be legally liable on the mortgage and actually have paid such interest. This rule is the same as current law. Married couples would face the same interest limitation as single taxpayers. Thus, as under current law, married taxpayers who file as singles would have to divide the limit on their one primary residence among themselves. Together, they would only be entitled to claim credits for a single property, which must be the principal residence of one of them.

As described in Chapter Five, the Panel recommends that the changes to the mortgage interest deduction be phased in over five years. During the transitional period, taxpayers would be allowed to claim either the Home Credit or the mortgage interest deduction on existing mortgages. The current-law $1 million mortgage interest limit would be reduced annually during the five-year transition period. Table A.1 summarizes the transition schedule.

Table A.1. Transition Rules for the Home Credit

Year	Mortgage Interest Limit	Tax Benefit
1	$900,000 of principal	Deduction
2	$700,000 of principal	Deduction
3	$500,000 of principal	Deduction
4	Regional limit of principal	Deduction
5	Regional limit of principal	15 percent Home Credit

Interest on a second home or a home equity loan would not be eligible for transition relief. Interest on new or refinanced mortgages would not qualify for the transitional mortgage interest deduction, but would be eligible for the new Home Credit.

Charity

As described in Chapter Five, the Panel recommends a number of reforms that would improve the deduction for charitable giving. Among these reforms are information reporting for large gifts and better standards for valuing non-cash gifts.

To minimize the recordkeeping burden associated with information reporting, the Panel recommends that information reporting be required only for donors whose total annual contributions to a charity exceed $600, which is consistent with current-law information reporting thresholds for mortgage interest and trade or business

payments. All cash and non-cash contributions of $250 or more would count toward the $600 threshold. The Panel also recommends that small charities that do not receive (1) more than 250 contributions of $600 or more, or (2) total contributions of more than $150,000 be exempted from the information reporting requirements. Taxpayers would not be required separately to substantiate contributions for which the charity reported to the taxpayer and the IRS.

The lack of clear, objective standards for establishing the fair market value of donated property has led to many recent valuation abuses. The Panel recommends new rules requiring that appraisals be prepared by a qualified appraiser in accordance with generally accepted and customary appraisal standards. New guidelines should also specify that fair market value is the price that would be received if the property were sold in the appropriate market. For a taxpayer or charity selling property, this would generally be the price received from selling to a dealer or other private party. Standards for appraisers would be imposed to ensure that appraisers have achieved a minimum level of certification or education, have not been barred from practice, are independent and unrelated to the donor or donee, and do not have an interest in the outcome of an appraisal.

To improve the reporting of valuations of contributed property for which a taxpayer is entitled to receive a fair market value deduction, the Panel recommends that appraisers be required to report the value of the contributed property directly to the IRS, the donor, and the charity. The charity would use the appraiser's valuation as the basis for its information reporting.

The Panel believes that current law penalties applicable to appraisers for aiding and abetting the understatement of tax by taxpayers are inadequate to prevent valuation abuses. Accordingly, the Panel recommends that new penalties be imposed on appraisers who misstate the value of property by more than 50 percent. The penalty would be imposed as a percentage of the valuation overstatement up to a maximum penalty.

Chapter Six: The Simplified Income Tax Plan

Territorial Tax Regime

Under the new territorial regime, income earned abroad by controlled foreign corporations and foreign branches of U.S. corporations would fall into one of two categories: (1) "Foreign Business Income," which would generally be exempt from U.S. taxation, and (2) "Mobile Income," which would be taxed by the United States on a current basis.

Foreign Business Income

Income earned abroad by a controlled foreign corporation (a "foreign affiliate") in the conduct of an active business ("Foreign Business Income") would not be subject to U.S. tax at the business level when repatriated as a dividend. Foreign Business

Income is net income after deductions. The general rule is that any payment that is deductible abroad would be taxed in the United States. Thus, non-dividend payments from foreign affiliates to U.S. corporations (e.g., interest, royalties, payments for intercompany transfers) would be subject to U.S. tax. A hybrid security rule would be required to prevent a payment that is treated as deductible interest abroad from being treated as an exempt dividend in the United States.

The Simplified Income Tax Plan would provide that exempt earnings of foreign affiliates could be redeployed to other foreign affiliates in different foreign jurisdictions without losing the benefit of exemption. There would be no tax on the gains from the sale of assets that generate exempt income and losses from the sales of such assets would be disallowed.

Businesses would not receive foreign tax credits for foreign taxes (including both corporate level taxes and dividend withholding taxes) attributable to Foreign Business Income because this income would not be subject to tax in the United States. As a result, the foreign tax credit system would serve a more limited function than it does under present law.

Income of foreign branches would be treated like income of foreign affiliates under rules that would treat foreign trades or businesses conducted directly by a U.S. corporation as foreign affiliates. These rules would be needed to place branches and foreign affiliates on an equal footing. For example, a rule would be needed to impute royalties to foreign branches. All trades or businesses conducted predominantly within the same country would be treated as a single foreign affiliate for this purpose.

Further rules would be needed to address the taxation of Foreign Business Income earned by a U.S. multinational that owns at least 10 percent of the stock of a foreign corporation that is not controlled by U.S. shareholders (so-called "10/50" companies).

All distributed earnings of foreign affiliates would be subject to the new international tax regime following the effective date, regardless of whether such distributions were paid out of pre-effective date or post-effective date earnings.

Mobile Income

Passive and highly mobile income ("Mobile Income") would be subject to tax when earned. Mobile Income would include foreign personal holding company income (e.g. interest, dividends, rents, and royalties arising from passive assets), certain types of foreign active business income that is not likely to be taxed in any foreign jurisdiction (e.g., certain income from personal services and income from international waters and space), and income from the sale of property purchased from or sold to a related person by a foreign corporation located in a country that is neither the origin nor the destination of that property. Small amounts of Mobile Income (measured using a *de minimis* rule based on a percentage of gross income or total assets) would be ignored for simplicity.

A foreign tax credit would be available to offset foreign tax paid (including withholding taxes) on Mobile Income. The current complex foreign tax credit basket rules would be replaced with a single overall foreign tax credit limitation.

Financial services businesses, such as banks, securities dealers, and insurance companies, earn interest and other types of Mobile Income in the conduct of their active business. Special rules would need to provide that qualifying financial services business income is treated as Foreign Business Income to the extent such income is earned through active business operations abroad. Anti-abuse rules would be needed to prevent passive investment income earned by financial services businesses from being treated as Foreign Business Income.

Expense Allocation

Under the Simplified Income Tax Plan, the active business earnings of foreign affiliates would not be subject to U.S. tax at the business level. Accordingly, business expenses that are attributable to these foreign earnings should not be allowed as a deduction against U.S. taxable income. For example, interest and other expenses incurred by a U.S. business to earn exempt foreign earnings would be allocated to those earnings and therefore disallowed. The question of how to allocate expenses to exempt foreign income is a difficult one. Detailed expense allocation rules similar to current law would be necessary. These rules would inevitably involve some complexity, but could be simpler than current-law expense allocation rules.

Interest expense should only be disallowed to the extent that the U.S. operations of a U.S. multinational are more heavily leveraged than the multinational's foreign operations; that is, interest expense should be disallowed to the extent that the ratio of foreign debt to foreign assets is lower than the worldwide ratio of debt to assets. Therefore, the Panel recommends that interest expense be allocated between U.S. and foreign affiliates under rules similar to those recently enacted as part of the American Jobs Creation Act of 2004.

General and administrative expenses that are not charged out to foreign subsidiaries or otherwise recovered by intercompany fees (such as certain stewardship expenses) would be allocated to gross foreign affiliate income in the same proportion that gross foreign affiliate income of the U.S. multinational bears to overall gross income of the worldwide affiliated group. General and administrative expense allocated to foreign affiliate income would then be further allocated between exempt and non-exempt foreign income, with expenses related to exempt foreign affiliate income disallowed.

The Panel recommends that research and experimentation expenses be allocated between domestic source income and foreign-source Mobile Income only. No research and experimentation expenses would be allocated against exempt foreign-source income because all royalty income associated with those research and experimentation expenses would be taxable at the U.S. rate.

Transfer Pricing Enforcement

In a territorial system, U.S. multinationals would have incentives to use transfer pricing to minimize taxable income generated by domestic operations and maximize lightly-taxed income generated in foreign operations. These pressures also exist under current law, and a large body of rules has evolved to enforce "arm's length" transfer pricing among related parties. Because these pressures are more pronounced in a territorial system, it would be necessary to continue to devote resources to transfer pricing enforcement.

Taxation of Foreign-Source Dividend Income by OECD Countries

Table A.2 provides information regarding the tax treatment of resident corporations on their receipt of direct (non-portfolio) foreign dividends paid out of active business income in OECD countries. Some countries generally exempt such income, while other countries generally tax it with a credit for foreign taxes paid. However, the exact treatment of dividends paid out of active business income varies by country and often is not straightforward. For example, many countries that are classified as "exemption" countries tax some (low-tax) active income currently and exempt other (high-tax) active income. New Zealand and France are examples.

Table A.2. Home Country Tax Treatment of Foreign-Source Dividend Income Received by Resident Corporations	
Exemption	**Foreign Tax Credit**
Australia*	Czech Republic
Austria	Iceland
Belgium	Japan
Canada*	Korea
Denmark	Mexico
Finland	New Zealand
France#	Poland
Germany	United Kingdom
Greece*	United States
Hungary	
Iceland	
Italy#	
Luxembourg	
Netherlands	
Norway	
Portugal*	
Slovak Republic	
Spain	
Sweden	
Switzerland	
Turkey	

Note: In general, tax treatment depends on qualifying criteria (e.g. minimum ownership level, minimum holding period, the source country, the host country tax rate). The table reports the most generous treatment of foreign direct dividends in each case.
* Exemption by treaty arrangement.
# Exemption of 95 percent.
Source: Table compiled from information provided by the OECD Secretariat. Information as of January 2005.

Calculating the Dividend Exclusion Percentage

Under the Panel's proposal, shareholders of U.S. corporations could exclude from income 100 percent of the dividends paid from income of the corporation reported as taxable in the United States. Corporations would report each year on their information reports to shareholders the total dividends paid and the amount which is taxable. For corporations that report all their income in the U.S., 100 percent of dividends paid would be nontaxable to their shareholders. Corporations which earn part of their worldwide income in the U.S. would have to compute the fraction

of worldwide income that is reported as taxable in the U.S. each tax year, and this fraction would be used to calculate the dividend exclusion for dividends paid in the following year. Because of the clean tax base recommended by the Panel, the Panel believes that rules specifying how this percentage is calculated can and should emphasize simplicity over precision. For example, this percentage can be calculated simply by dividing taxable U.S. income each year by worldwide pretax income as reported on the corporation's financial statements for the same year. For simplicity, foreign tax credits on foreign Mobile Income reported as taxable in the U.S. could be ignored in this calculation. Taxpayers who wished to adjust for the difference between accelerated depreciation allowed in the U.S. and book depreciation could be allowed to do so by adding back the difference to U.S. taxable income before calculating the fraction of worldwide income taxable in the U.S., but other adjustments would not be allowed or required.

Disclosure of Foreign Earnings

The Simplified Income Tax Plan would require additional disclosures that would complement the new international tax regime. U.S. businesses with Foreign Business Income would be required to file with their tax return a schedule showing their consolidated worldwide revenues and income before taxes, as reported in their financial statements. The new schedule would disclose the proportion of domestic and foreign revenues and income. In addition, businesses would be required to reconcile the consolidated revenues and income reported on their financial statements with the taxable revenues and income reported on their tax returns.

This disclosure, combined with the exclusion of dividends paid out of domestic earnings, would provide disincentives for corporations to understate the amount of income subject to U.S. tax. A business that understates the amount of income reported on its tax return would increase the amount of tax required to be paid on dividends received by its shareholders. In addition, businesses whose securities are publicly traded would be required by existing disclosure rules to report in their financial statements the proportion of United States and foreign income and revenues computed under tax and accounting rules. This public disclosure would increase the transparency of the business's calculations and provide a better top-down view of a corporation's global operations to shareholders, potential investors, and regulators.

Chapter Seven: The Growth and Investment Tax Plan

As described in Chapter Seven, the Growth and Investment Tax Plan would shift our current tax system towards a consumption tax. Making this shift would represent a substantial change to the U.S. tax system that would present a number of implementation issues. Among these issues are the treatment of financial transactions and financial institutions, transactions between businesses and taxpayers not subject to the cash flow tax (such as individuals and non-profits), and cross-border transactions.

The following sections identify some of the issues considered by the Panel and potential approaches for addressing them. There are additional issues that would need

to be covered in greater detail and require additional rules. Some of these rules would be similar to those that exist under current law.

Distinguishing Between Financial and Non-Financial Business Transactions

One of the central issues in implementing the Growth and Investment Tax Plan would arise in distinguishing between non-financial, or "real" business transactions, whose receipts are generated from business operations, and financial transactions, whose receipts are generated from interest, dividends, or other financial returns. The Growth and Investment Tax Plan excludes financial transactions by non-financial firms from the business tax base, so firms with positive tax liabilities would have an enormous incentive to characterize transactions as financial rather than non-financial. For example, a car dealership would have an incentive to post a low sales price for cars, but to sell cars on credit with a high financing charge. The dealership would benefit by characterizing the interest proceeds from the sale as a financial transaction, making it tax-free.

Another area where there may be an incentive to recharacterize non-financial transactions is the treatment of derivatives. Purchases and sales of commodities generally are cash flows subject to the cash flow tax. Derivatives on commodities, in contrast, are generally thought of as financial in nature, the gains and losses on which generally should not be treated as cash flows subject to the business cash flow tax. However, there may be circumstances in which purchases and sales of these derivatives should be subject to the cash flow tax. For example, a derivative entered into to hedge a non-financial business asset or liability should be treated similarly to the underlying asset as a non-financial business transaction subject to the cash flow tax. Absent special rules, businesses would be able to use combinations of derivatives to create deductions without offsetting income.

Implementation rules would be required to avoid creating incentives for firms to disguise non-financial transactions as financial transactions, and vice versa. For example, transactions that bundle financial and non-financial components could be required to be treated as taxable cash flow. Such implementation rules serve two functions. First, they prevent firms from devoting resources to complex tax planning with the objective of reducing tax liability. While expenditures on such planning may yield private benefits for the firm, they do not have any broader business purpose and they absorb resources that could be deployed elsewhere in more productive manner. Second, tax avoidance reduces the revenue collected from the tax system, which in turn requires higher tax rates to raise a required level of revenue.

Financial Services

As described in Chapter Seven, the taxation of financial services presents difficulties in both consumption and income taxes. Rather than exempting these transactions as is done in most VATs, the Growth and Investment Tax Plan would adopt a special regime for financial institutions that includes both real business and financial cash flows in their business tax base.

There are several alternative approaches that could be used instead of this regime. One alternative approach would be to tax all businesses, not just financial institutions, on the full amount of all transactions between businesses and non-businesses that combine financial and non-financial transactions. This approach would eliminate the necessity of determining whether a business is a financial institution. It would, however, make it necessary to identify those transactions that have both a business and a financial component. Another alternative would be to subject financial institutions to the cash flow tax like other businesses. The disadvantage of this approach would be that, to the extent a transaction includes both real business and financial components, the real business components would be untaxed, which is inconsistent with the general approach of the Growth and Investment Tax Plan. This approach, however, avoids distinguishing between financial and non-financial institutions and transactions that have both real and financial components.

Tax-Free Formations and Mergers and Acquisitions of Businesses

Under current law, there are a number of rules that permit tax-free formations and combinations of businesses. These rules generally provide that no gain or loss is recognized when assets are exchanged for an ownership interest in an entity.

Rules could be crafted to allow for the tax-free treatment of a transfer of assets by an individual to a business and by a business to another business in exchange for an equity interest. These rules could be similar to those under current law, which provide for tax-free treatment for certain transfers of property to a corporation or partnership. In addition, the Growth and Investment Tax Plan could include rules permitting tax-free business combinations similar to the reorganization rules of current law.

The adoption of these rules, however, may create opportunities to transfer losses between businesses. For example, a business could easily transfer assets without tax by contributing them to a subsidiary and selling the stock in a tax-free financial transaction. The rules described in Chapter Seven to address the transferability of negative and positive cash flow may mitigate some of these concerns. It may be necessary, however, to incorporate additional rules similar to current-law judicial doctrines, such as the step transaction doctrine and the business purpose test, which recharacterize or disregard transactions carried out to achieve tax advantages.

Taxation of Employee Stock Options

Employee stock options may present a challenge under the Growth and Investment Tax Plan because they are a form of compensation that is difficult to value. Current tax law has two sets of rules for employee stock options. The first set of rules, which apply to incentive stock options, do not create deductions for the employer and provide employees capital gains tax treatment when they eventually sell the stock that is purchased upon exercise of the options. In contrast, the second set, which apply to nonqualified options that do not have an ascertainable value, create a deduction for the employer when the options are exercised equal to the difference between the market price when exercised and the strike price; employees include the same amount in ordinary income at the exercise date.

Under the Growth and Investment Tax Plan, rules similar to those for incentive stock options could be adopted. Business would not receive a deduction for employee stock options at any point in time; the employee would not recognize any compensation from the option. The effect of this tax treatment would be that options would increase tax collections from business taxation to the extent that employees accept options in lieu of wage compensation. Firms that include employee options in their compensation packages would have a larger tax base, holding other factors equal, than firms that did not use employee stock options. Alternatively, firms could be required to calculate the value of the options at the grant date and would be entitled to a deduction equal to the value of the options when they are granted, with employees recognizing taxable wages at the grant date. Under this approach, the options would have no further consequences for the firm; the transaction would be considered a financial transaction of the firm and capital income for the employee after the grant date.

Small Businesses

The taxation of small businesses, such as sole proprietorships, presents some special issues. Most countries that administer a value-added tax (VAT) provide an exemption for small businesses. However, these countries typically administer an income tax in addition to a VAT. If small businesses were exempted from the Growth and Investment Tax Plan, there would be an incentive for small businesses to pay little or no wages and to retain earnings within the business. Moreover, the U.S. income tax does not provide a small business exemption. The Panel, therefore, concluded that small businesses should be taxable under the Growth and Investment Tax Plan.

One approach to taxing sole proprietorships would be to treat them like other business entities subject to tax on cash flow at the 30 percent rate. A sole proprietorship would be permitted to pay its owner deductible wages and to make distributions of positive cash flow that would be treated as dividends. The difficulty with this approach is that a sole proprietorship would have to file tax returns and maintain separate records even though it is indistinguishable from its owner.

The Panel adopted an alternative approach that would tax positive cash flow from sole proprietorships on individual tax returns and at the graduated individual tax rates. Some have suggested that this approach properly reflects the fact that sole proprietorship income represents a return to labor rather than a return to capital. Cash flow of the sole proprietorship subject to the cash flow tax would not be subject to the 15 percent capital income tax. To the extent that the sole proprietorship receives cash flow that is not subject to the business cash flow tax (e.g., stock gains, dividends, and interest), such cash flow would be subject to the capital income tax when received by the sole proprietorship.

As under our current system, rules would be needed to distinguish between personal activities and business activities. In addition, special issues arise with respect to business assets withdrawn from a sole proprietorship if those assets have been previously expensed. Once withdrawn from the sole proprietorship, the asset future

cash flow attributable to the asset would not be subject to the cash flow tax. Therefore, it may be necessary to treat a withdrawal as a disposition of the asset that results in cash flow equal to the fair market value of the asset.

Use of Businesses to Avoid Tax on Capital Income

One consequence of adding the 15 percent tax on dividends, interest, and capital gains under the Growth and Investment Tax Plan is that individuals may have an incentive to hold financial assets indirectly through a business entity rather than directly. Absent special rules, non-financial businesses could be used to defer tax on returns from financial assets until the business makes distributions to its owners, or permanently if current law rules providing for a step-up in basis to fair market value at death are retained. This potential for tax deferral may contribute to perceptions of unfairness, and may lead to additional tax planning to avoid tax on capital income altogether.

Under current law, there are a number of so-called "anti-deferral" regimes designed to discourage the accumulation of untaxed amounts within a corporation. In some cases, these rules require that the income of a business be imputed to the owners of the business, and in other cases tax is imposed at the business level. One or more of the current anti-deferral regimes could be adopted, or modified, under the Growth and Investment Tax Plan to limit opportunities to defer the capital income tax. For example, to address situations involving individual owners of closely-held businesses, each owner might be required to report his share of the entity's financial income on his U.S. tax return. Similar rules might be adopted to address other situations. Special rules would be required to determine when the anti-deferral rule should apply. Although anti-deferral rules may prevent some tax avoidance, these rules often require factual inquiries and may not be completely effective in preventing deferral of capital income in a realization-based tax.

Additional Issues in the Tax Treatment of Cross-Border Transactions

Under the destination-basis Growth and Investment Tax Plan, purchases from businesses outside the United States would not be allowed as a deduction against sales in calculating taxable business cash flow. The resale by the importing business would give rise to a taxable receipt. The reseller might "gross up" the resale price to cover the tax cost to the importer of the denial of the deduction for the cost of the import. Alternatively, some importers may try to avoid the tax burden.

If the "importer" is not a taxable U.S. business, it would be outside of the tax system and, as a result, border adjustments would be ineffective. This would be a particularly challenging problem with respect to taxing internet sales and other businesses that have a minimal presence in the United States. Appropriate mechanisms would have to be developed to enforce the tax collection responsibilities for consumption in the United States.

Sourcing the Destination: "Domestic" versus "Foreign" Consumption

Determining when and if goods have been "exported" for foreign consumption would be necessary in order to make border adjustments. Rules exist under current law to determine when a sale of goods occurs (i.e., when beneficial ownership and risk of loss have passed to a buyer either within or outside the United States). A set of rules similar to these so-called "passage-of-title" tests could be used to track the intended ultimate destination of sales of goods under the Growth and Investment Tax Plan.

Determining when and if services have been exported is also necessary to make appropriate border adjustments. Rules would need to be developed to ascertain where services are used or consumed. These rules would be similar to those used in countries that operate a VAT. Service businesses include a range of technical and professional service providers, such as law firms, accounting firms, engineering firms, and management consulting firms.

Tax Treaties

Bilateral income tax treaties that facilitate cross-border investment may need to be renegotiated to account for the new business tax system under the Growth and Investment Tax Plan. Bilateral income tax treaties help prevent double taxation and ensure that U.S. individuals and corporations investing in foreign markets and foreign individuals and corporations investing in the United States receive tax treatment in the treaty country that is comparable to the tax treatment received by home country residents. For example, these treaties provide for interest expense to be deducted by an entity carrying on business through a permanent establishment in the other country for purposes of determining income tax liability to that other country.

Some of the benefits the United States currently provides to foreign businesses through its bilateral tax treaties would be less valuable if the Growth and Investment Tax Plan were adopted. For example, the Growth and Investment Tax Plan would not provide interest deductions to permanent establishments of treaty partner businesses. As a result, foreign governments could seek to renegotiate or terminate their tax treaty arrangements with the United States. The Panel suggests that the Growth and Investment Tax Plan retain withholding taxes on dividends and non-portfolio interest consistent with current law, but these taxes could be reduced or eliminated by treaty.

Chapter Eight: Value-Added Tax

VAT Exemptions

In evaluating a proposal to adopt a broad based value-added tax (VAT), the Panel assumed that all domestic consumption would be included in the tax base unless specifically exempted. Exemptions for goods and services could be provided either with or without a credit for "input tax" previously paid on goods or services used to produce the exempt good. When a good or service is "exempt with credit," a supplier of that good or service is allowed to claim input tax credits associated with the exempt

good or service even though no tax is assessed on the exempt sale. If a supplier's input tax credits exceed VAT liability, the supplier would receive a refund from the government. In contrast, when a good or service is "exempt without credit," the good or service supplier would not assess VAT on sale of the exempt good, but could not claim input tax credits associated with that sale.

Substantial administrative complications arise in a VAT when business entities sell both taxable and exempt goods, or assess different VAT rates on different goods. In these cases, administrative rules must be established to allocate input credits between exempt, preferred-rate, and taxable sales. A broad based VAT that taxes virtually all goods and services using a single rate and implements necessary omissions from that base using an exemption with credit minimizes economic distortions and simplifies compliance and administration. For this reason, providing exemptions with credit would generally be preferable to exempting goods or services without credit. Charitable and religious services are a special exception to this general rule.

It is inappropriate to tax exports in a destination-based VAT because exports do not represent domestic consumption. Exports would therefore be exempt with credit under the VAT. Further discussion of this issue appears in Chapter Eight. Other types of goods and services that would be excluded, exempt with credit, exempt without credit, or receive other unique treatment under the VAT studied by the Panel are described in Table A.3.

Table A.3. Domestically Consumed Goods and Services Receiving Distinctive Treatment

Exempt with Credit (Zero-rated)	Exempt without Credit	Other
• Noncommercial government services • Primary and secondary education	• Charitable and religious services • Food produced and consumed on farms	• Residential housing (prepayment method) • Financial services (same as the Growth and Investment Tax Plan treatment)

Government Services

For reasons of administrative simplicity and to preserve economic neutrality between the private sector and the public sector, governments would pay VAT on purchases just like other businesses and individuals. However, like a business selling taxable goods and services, governments would be entitled to claim input tax credits on all inputs used to provide services.

Non-commercial government services provided to the public for a fee would be exempt with credit. Other noncommercial government services and intra-government transfers would be excluded from the base. No VAT would be imposed on taxes or fines, because these charges are not paid in return for a specific good or service.

Commercial services provided by government (state, local, or federal) for a fee would be taxed. For example, VAT would be collected on services such as transportation services provided by a local transit authority or water provided by a government-owned utility. Rules would be needed to distinguish between commercial and noncommercial government activities, and would inevitably entail some substantial complexity.

Education

Most primary and secondary education is provided by state and local governments at public schools, generally free of charge. Applying a VAT to privately provided primary and secondary education would discriminate against private education by making it more expensive relative to public schools. The Panel concluded that introducing the VAT should not change the competitive balance between public and private education. Thus, primary and secondary education would be exempt with credit, regardless of whether provided by government or private institutions. Rules would be needed to prevent non-educational exempt consumption through schools (such as cafeterias set up on school premises to avoid VAT).

Postsecondary education is provided by public and private institutions for a fee. In addition to educating students, postsecondary institutions engage in a broad array of research activities, many of which overlap with activities conducted in the private sector. For these reasons, the Panel determined that it would be appropriate to apply the VAT to postsecondary education, whether provided by public or private institutions.

Charitable and Religious Services

Charitable and religious services provided by non-profit organizations would be exempt without credit. When a charitable or religious organization supplies goods or services free of charge, no VAT would be assessed. However, when a charitable or religious organization supplied new goods or services that compete with other businesses and are offered at market prices, those goods and services would be taxed. For example, memberships that provide access to cultural or recreational institutions would be taxable. Rules would be needed to define the boundary between exempt charitable or religious services and commercial services. These rules could also exempt charitable or religious services provided for a nominal fee. Donations and government grants received by charities would not be considered payments in return for goods or services and therefore also would not be taxed.

Charitable and religious services would be exempted without credit because of the sector's heavy reliance on used goods and donations and the consequent administrative complications and abuses that might arise under a regime providing exemption with credit. Any charitable or religious service provider would remain eligible to claim input tax credits with respect to their VAT liability for any commercial services they provide, just like any other business. The threshold for mandatory VAT collection of $100,000 in annual gross taxable receipts would allow charitable and religious organizations that provide only a small amount of commercial services to remain outside the VAT system entirely, even if their non-taxable operations were quite extensive. For those charitable and religious organizations with receipts from commercial services in excess of the VAT threshold, or that elect to collect VAT, allocation rules would be required to distinguish input credits related to tax-free charitable and religious services from input credits related to commercial services.

Housing

The purchase price of new residential real estate would be taxed. Taxing housing services in this way is more administratively feasible than taxing the imputed value of owner-occupied housing, but excludes pre-existing housing from VAT. Activities related to renovating existing housing (e.g., purchasing building materials or repair and maintenance services) would be taxed. To ensure both that renters and owners receive comparable treatment and that new residential real estate that is subject to a lease would not be double taxed, leases of residential housing would be exempt from VAT, as would the imputed value of owner-occupied housing services. Rules would be needed to define the appropriate VAT treatment if real estate were to be converted from residential to non-residential use or vice versa.

Financial Services

Financial services would be taxed using an approach similar to that proposed for the Growth and Investment Tax Plan.

Modified Family Credit and Work Credit for Partial Replacement VAT

Modified Family Credit

The modified Family Credit described in Chapter Eight would be computed by starting with a base amount for household type and adding additional amounts for the number of children and other dependent members of the household. The base Family Credit amounts are provided in Table A.4.

Table A.4. Family Credit Amounts under Partial Replacement VAT	
Household Type	**Base Credit**
Married Taxpayers Filing Joint Returns	$4,300
Single Taxpayers With Dependent Children	$3,300
Single Taxpayers with no Child Dependent	$2,150
Taxpayers Who Could be Claimed as a Dependent	$1,650

Each family would add to the base credit amount $2,000 for each child and $1,000 for each other dependent. The Family Credit amounts would be adjusted annually for inflation.

Modified Work Credit

The modified Work Credit would be the amount by which the taxpayer's modified Family Credit exceeds tax liability before the credit limited to:

- No child dependent: the lesser of 17.65 percent of work income or $1,832;
- One child dependent: the lesser of 44 percent of work income or $4,870;
- Two or more child dependents: the lesser of 50 percent of work income or $6,650

With an additional credit of:

- up to $1,950 if the taxpayer has one child dependent
    - o phased in at a rate of 44 cents for every dollar of work income (or taxable income, if lower) over $11,100;
- up to $3,100 if the taxpayer has two or more child dependents
    - o phased in at a rate of 50 cents for every dollar of work income (or taxable income, if lower) over $13,300;

The additional credit would phase out at a rate of 12.5 cents for every dollar of the taxpayer's work income (or taxable income, if higher) above $22,000 (or $26,000 if the taxpayer is filing a joint return).

Evolution of VAT Rates in Developed Economies

In addition to reviewing econometric research relating to the money machine argument, the Panel examined the evolution of VAT rates in developed countries. The table below shows the basic VAT rates in OECD countries for the period from 1976 to 2005. The shaded years represent the most recent periods during which the basic VAT rate either did not change or was lowered.

In examining the Table A.5, it is worth noting that more than half of the countries represented are members of the European Union (EU). The European Economic

Table A.5. Standard VAT/GST in OECD Member Countries												
	1976	1980	1984	1988	1990	1992	1994	1996	1998	2000	2003	2005
Australia	-	-	-	-	-	-	-	-	-	10.0	10.0	10.0
Austria	18.0	18.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0
Belgium	18.0	16.0	19.0	19.0	19.0	19.5	20.5	21.0	21.0	21.0	21.0	21.0
Canada	-	-	-	-	-	7.0	7.0	7.0	7.0	7.0	7.0	7.0
Czech Republic	-	-	-	-	-	-	22.0	22.0	22.0	22.0	22.0	19.0
Denmark	15.0	22.0	22.0	22.0	22.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0
Finland	-	-	-	-	-	-	22.0	22.0	22.0	22.0	22.0	22.0
France	20.0	17.6	18.6	18.6	18.6	18.6	18.6	20.6	20.6	20.6	19.6	19.6
Germany	11.0	13.0	14.0	14.0	14.0	14.0	15.0	15.0	16.0	16.0	16.0	16.0
Greece	-	-	-	16.0	18.0	18.0	18.0	18.0	18.0	18.0	18.0	18.0
Hungary	0.0	-	-	25.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0	25.0
Iceland	-	-	-	-	22.0	22.0	24.5	24.5	24.5	24.5	24.5	24.5
Ireland	20.0	25.0	23.0	25.0	23.0	21.0	21.0	21.0	21.0	21.0	21.0	21.0
Italy	12.0	15.0	18.0	19.0	19.0	19.0	19.0	19.0	20.0	20.0	20.0	20.0
Japan	-	-	-	-	-	5.0	3.0	3.0	5.0	5.0	5.0	5.0
Korea	-	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0
Luxembourg	10.0	10.0	12.0	12.0	12.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0
Mexico	-	-	10.0	10.0	10.0	10.0	10.0	15.0	15.0	15.0	15.0	15.0
Netherlands	18.0	18.0	19.0	20.0	18.5	17.5	17.5	17.5	17.5	17.5	19.0	19.0
New Zealand	-	-	-	-	-	-	12.5	12.5	12.5	12.5	12.5	12.5
Norway	-	-	-	-	-	-	22.0	23.0	23.0	23.0	24.0	24.0
Poland	-	-	-	-	-	-	-	-	22.0	22.0	22.0	22.0
Portugal	-	-	-	17.0	17.0	16.0	16.0	17.0	17.0	17.0	19.0	19.0
Slovak Republic	-	-	-	-	-	-	25.0	23.0	23.0	23.0	20.0	19.0
Spain	-	-	-	12.0	12.0	13.0	16.0	16.0	16.0	16.0	16.0	16.0
Sweden	17.65	23.46	23.46	23.46	23.46	25.0	25.0	25.0	25.0	25.0	25.0	25.0
Switzerland	-	-	-	-	-	-	6.5	6.5	6.5	7.5	7.6	7.6
Turkey	-	-	-	-	-	-	15.0	15.0	15.0	17.0	18.0	18.0
United Kingdom	8.0	15.0	15.0	15.0	15.0	17.5	17.5	17.5	17.5	17.5	17.5	17.5
Unweighted average	14.0	16.9	17.2	17.5	17.7	16.9	17.4	17.6	17.9	17.8	17.8	17.7

Note: Shaded years represent most recent periods during which the VAT rate either did not change or was lowered.
Source: OECD Secretariat. Rates as of January 2005.

Community, the predecessor to today's EU, required member countries to impose a VAT in the late 1960s. Thus, Belgium, Denmark, France, Germany (then West Germany), Ireland, Italy, Luxembourg, the Netherlands, and the United Kingdom all adopted VATs between 1967 and 1973. Similarly, Greece, Portugal, and Spain adopted VATs in the late-1980s in preparation for EU membership.

Chapter Nine: National Retail Sales Tax

Tax-Inclusive Rates

As explained in Box 9.1, it is equally valid to think of tax rates in tax-inclusive or tax-exclusive terms. The most appropriate way to compare a national retail sales tax rate to the state sales taxes paid by most Americans is to consider the tax-exclusive rate. On the other hand, it is appropriate to compare the retail sales tax rate with current income tax rates by utilizing the tax-inclusive rate. Table A.6 provides the tax-inclusive rates that correspond to the tax-exclusive rate estimates provided in Table 9.1.

Table A.6. Retail Sales Tax Rate Estimates Reported as Tax-Inclusive Rates

Evasion Rate / Base	Extended Base	Partial Replacement VAT Base	Median State Sales Tax Base
Low Evasion (15%)	25%	28%	39 %
Higher Evasion (30%)	33%	37%	47%

Source: Department of the Treasury, Office of Tax Analysis.

Uniform Cash Grant Program

The Treasury Department calculated the uniform cash grant program as the retail sales tax (inclusive) rate times the poverty guideline amount defined by the Department of Health and Human Services, providing double the single person amount for married couples. The projected poverty guideline amounts in 2006 are $9,820 for a single person and $3,360 for each additional person in the household. With this cash grant program, assuming 15 percent evasion for personal consumption spending, the revenue-neutral rate would be approximately 25 percent on a tax-inclusive basis (34 percent on a tax-exclusive basis). The rebate amounts in 2006 would therefore be $2,494 ($4,988 for married couples) plus $853 for each dependent.

Targeted Cash Grant Program

The Treasury Department developed a targeted cash grant proposal with a phase-in range and a phase-out range. The proposal required providing an annual cash subsidy of as much as $7,068 for married couples ($3,534 for singles), plus $2,570 for each dependent. Like the EITC, the program would phase in over a range. The program would begin to phase out when family income exceeds ten times the maximum

available rebate and be completely phased out when income reached 20 times the maximum available rebate. For example, a married couple with no children would receive a higher rebate as income increased up to an income level of $17,670. This couple's rebate would begin to phase out once income exceeded $70,680 and phase out completely once income exceeded $141,360. By comparison, a married couple with two children would receive a higher rebate as income increased up to an income level of $30,520. This family's rebate would begin to phase out once income exceeded $122,080 and phase out completely once income exceeded $244,160. Families that qualify under current law for the EITC would continue to receive those amounts as an additional cash subsidy.

Hypothetical Taxpayer Analysis

Standard distributional estimates, revenue estimates, and hypothetical taxpayer calculations performed by the Treasury Department for any tax proposal assume that the Administration's economic forecast, including the price level, is unchanged over the ten-year budget period. A retail sales tax would create a "wedge" between the prices producers receive for their goods and the amount that they would have left to pay wages and other forms of labor compensation and to pay the suppliers of capital (interest and profits). Since by standard assumption the price level cannot rise, this wedge must cause wages and payments to capital to fall. The reduction in wages reduces the payroll tax base, and therefore payroll taxes paid. This reduction in payroll taxes must be accounted for in hypothetical taxpayer examples for proposals, such as a retail sales tax or a value-added tax, that produce a wedge between producer and consumer prices.

An Example of a State Sales Tax Base: Florida

Existing state sales tax bases are narrower than the broad tax bases evaluated by the Panel, and the breadth of these tax bases may be illustrative of potential base erosion. For example, it is estimated that Florida has the 11th broadest tax base among states that impose retail sales taxes. In relative terms, Florida has a limited number of exemptions from its sales tax. Nevertheless, Florida's retail sales tax imposes sales tax on only a small number of services and has at least 90 exemption categories. For example, neither financial nor medical services are taxed. All sales to the U.S. government, a state or any county, municipality, or political subdivision of a state, and nonprofit religious, charitable, scientific or educational institutions are exempt. Moreover, churches and the federal government are exempt from the requirement to collect and remit sales tax.

Florida also exempts a wide variety of goods, including Bibles, hymnals, prayer books and other religious publications; church service and ceremonial raiment and equipment; food and drink for human consumption that is classified as "general grocery items," but not when sold by restaurants, cafeterias, concession stands, or other similar places of business; water (except certain mineral or carbonated water);

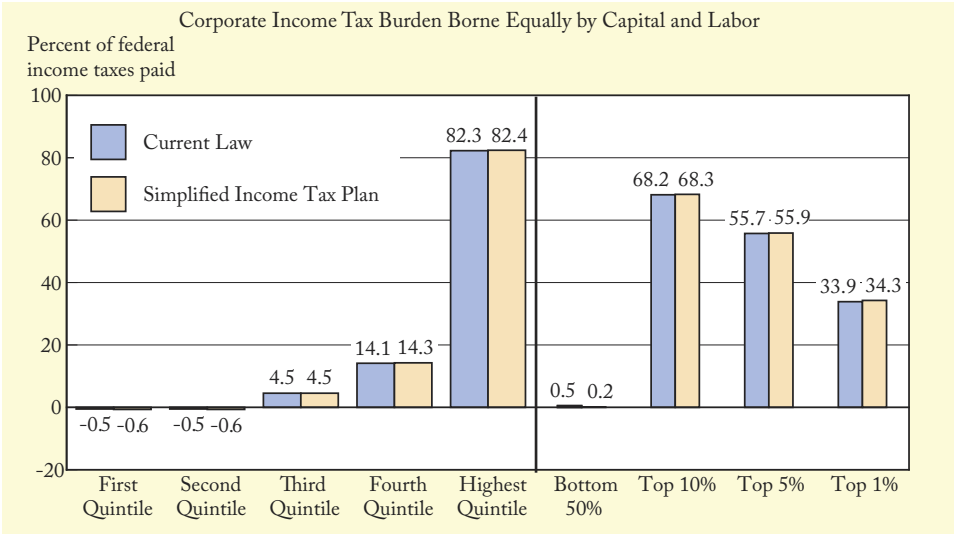
any food or beverage that is donated to a food bank by a retailer that sells food products; hospital meals and rooms; prescription medication and other products and supplies dispensed at retail by a licensed pharmacist on a physician's order; hypodermic needles; test kits used to treat or diagnose human disease; artificial eyes and limbs; hearing aids, crutches and prosthetics; sales or rentals of guide dogs for the blind and sales of food or other items for such dogs; certain prepared meals sold by a nonprofit organization to handicapped, elderly, or indigent people; rentals of more than six months' duration; school books and lunches sold at institutions of higher learning; firefighting and rescue service equipment and supplies purchased by volunteer fire departments; admissions to athletic or other events sponsored by schools; solar energy systems, fertilizers, insecticides, seedlings, and cuttings; sales of U.S. and Florida flags; purchases of office supplies made by the Florida Retired Educators Association; and the sale of a racing dog by its owner if the owner is also the breeder of the animal.

Additional Distribution Tables

Alternative Distribution of the Corporate Income Tax

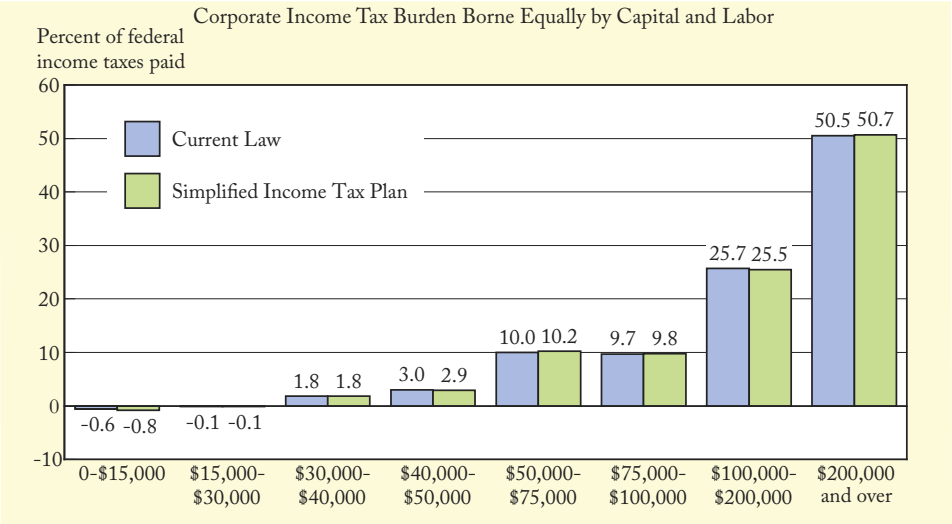
As explained in Chapter Three, for the purpose of distributional analysis, the Treasury Department assumes that the burden of the corporate income tax is borne entirely by owners of capital. The alternative distribution figures presented below show the distribution of the income tax burden under current law and each of the plans assuming that half of the burden of the corporate income tax is distributed to labor, while the other half is distributed to owners of capital. However, the change in corporate tax burden associated with the options is distributed to just owners of capital. This reflects the assumption that over the budget window owners of capital are the group that bears the burden of this tax. Over time, however, some (or all) of the burden of corporate taxes is likely to be shifted to workers and consumers.

Figure A.1. Alternative Distribution of Federal Income Tax Burden Under Current Law and the Simplified Income Tax Plan by Income Percentile (2006 Law)



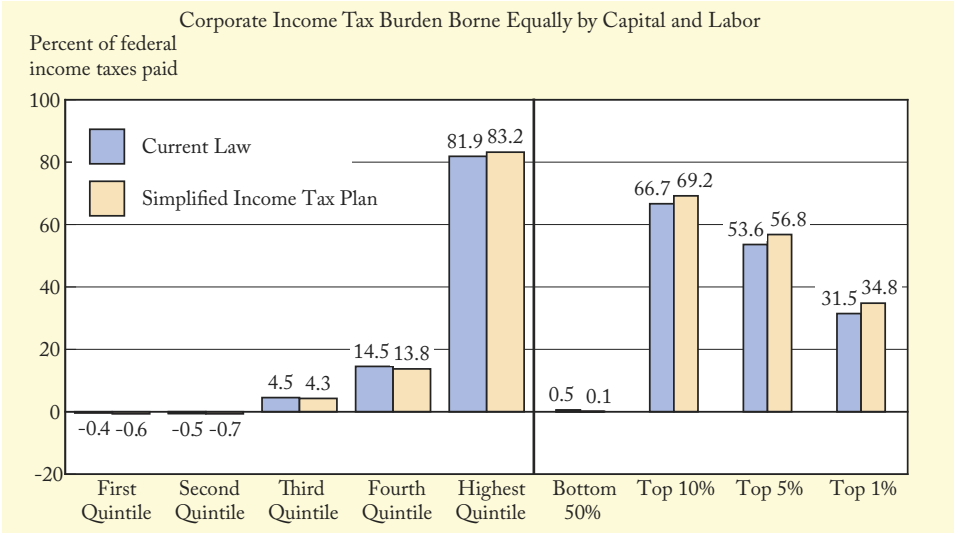
Note: Estimates assume the current corporate income tax burden is borne equally by labor and capital, but changes to the corporate income tax under the proposal are assumed to be borne by capital only. The standard assumption is that the corporate income tax is borne by capital generally. Estimates of 2006 law at 2006 cash income levels. Quintiles begin at cash income of; Second $12,910; Third $27,461; Fourth $45,345; Highest $84,124; Top 10% $123,076; Top 5% $169,521; Top 1% $407,907; Bottom 50% below $36,738.
Source: Department of the Treasury, Office of Tax Analysis.

Figure A.2. Alternative Distribution of Federal Income Tax Burden Under Current Law and the Simplified Income Tax Plan by Income Level (2006 Law)



Note: Estimates assume the current corporate income tax burden is borne equally by labor and capital, but changes to the corporate income tax under the proposal are assumed to be borne by capital only. The standard assumption is that the corporate income tax is borne by capital generally. Estimates of 2006 law at 2006 cash income levels.
Source: Department of the Treasury, Office of Tax Analysis.

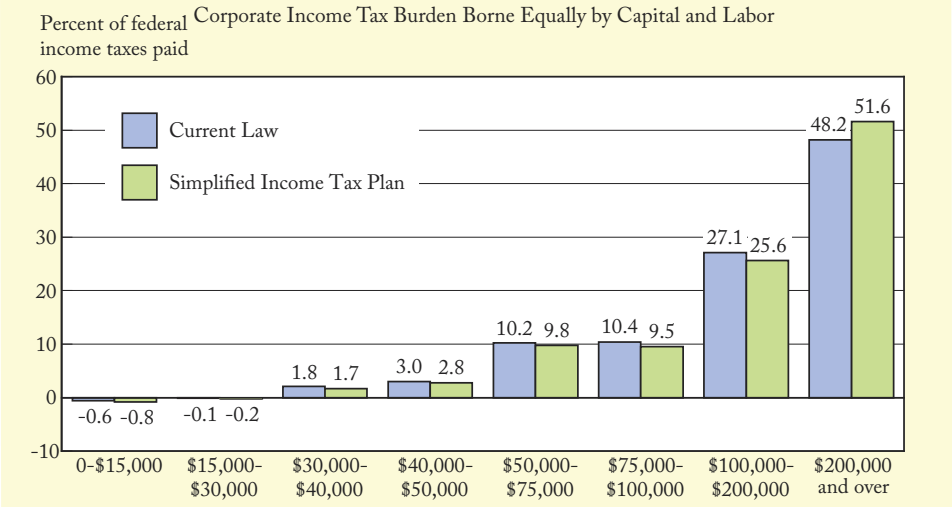
Figure A.3. Alternative Distribution of Federal Income Tax Burden Under Current Law and the Simplified Income Tax Plan by Income Percentile (2015 Law)



Note: Estimates assume the current corporate income tax burden is borne equally by labor and capital, but changes to the corporate income tax under the proposal are assumed to be borne by capital only. The standard assumption is that the corporate income tax is borne by capital generally. Estimates of 2015 law at 2006 cash income levels. Quintiles begin at cash income of; Second $12,910; Third $27,461; Fourth $45,345; Highest $84,124; Top 10% $123,076; Top 5% $169,521; Top 1% $407,907; Bottom 50% below $36,738.

Source: Department of the Treasury, Office of Tax Analysis.

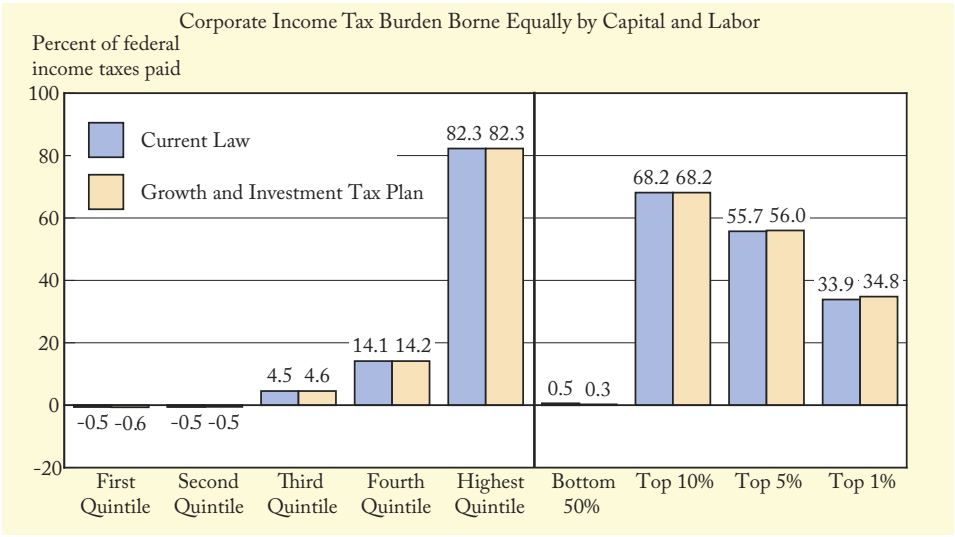
Figure A.4. Alternative Distribution of Federal Income Tax Burden Under Current Law and the Simplified Income Tax Plan by Income Level (2015 Law)



Note: Estimates assume the current corporate income tax burden is borne equally by labor and capital, but changes to the corporate income tax under the proposal are assumed to be borne by capital only. The standard assumption is that the corporate income tax is borne by capital generally. Estimates of 2015 law at 2006 cash income levels.

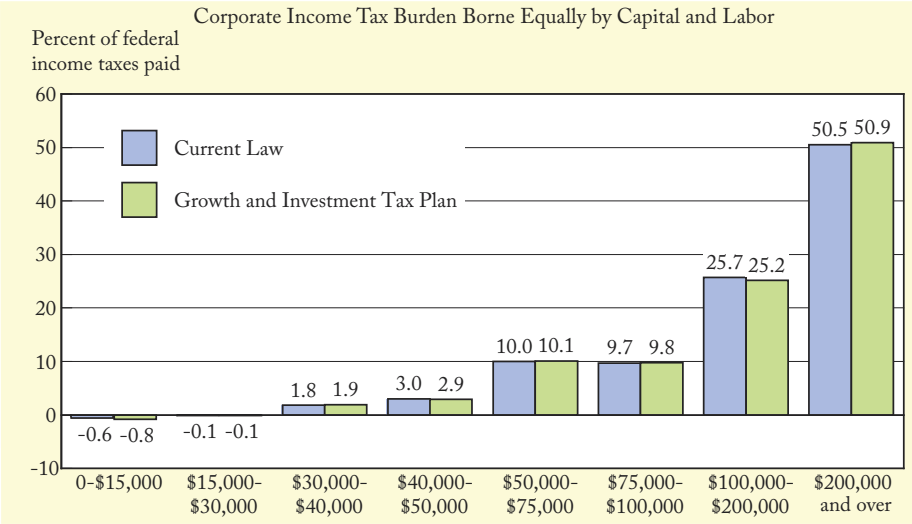
Source: Department of the Treasury, Office of Tax Analysis.

Figure A.5. Alternative Distribution of Federal Income Tax Burden Under Current Law and the Growth and Investment Tax Plan by Income Percentile (2006 Law)



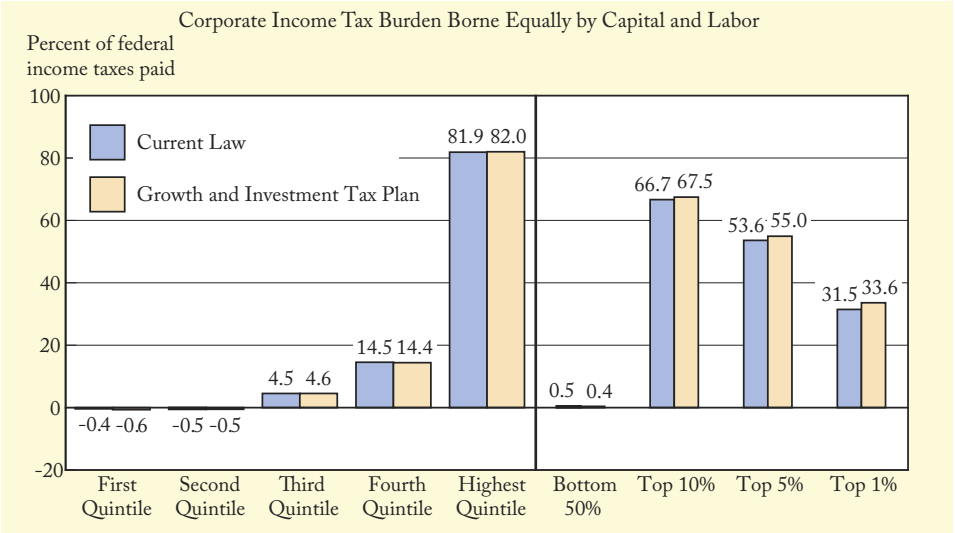
Note: Estimates assume the current corporate income tax burden is borne equally by labor and capital, but changes to the corporate income tax under the proposal are assumed to be borne by capital only. The standard assumption is that the corporate income tax is borne by capital generally. Estimates of 2006 law at 2006 cash income levels. Quintiles begin at cash income of; Second $12,910; Third $27,461; Fourth $45,345; Highest $84,124; Top 10% $123,076; Top 5% $169,521; Top 1% $407,907; Bottom 50% below $36,738.
Source: Department of the Treasury, Office of Tax Analysis.

Figure A.6. Alternative Distribution of Federal Income Tax Burden Under Current Law and the Growth and Investment Tax Plan by Income Level (2006 Law)



Note: Estimates assume the current corporate income tax burden is borne equally by labor and capital, but changes to the corporate income tax under the proposal are assumed to be borne by capital only. The standard assumption is that the corporate income tax is borne by capital generally. Estimates of 2006 law at 2006 cash income levels.
Source: Department of the Treasury, Office of Tax Analysis.

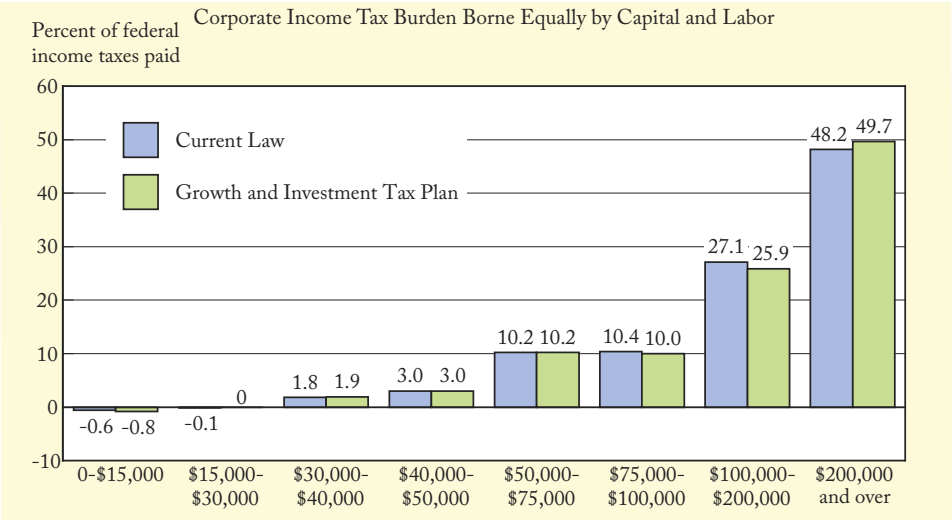
Figure A.7. Alternative Distribution of Federal Income Tax Burden Under Current Law and the Growth and Investment Tax Plan by Income Percentile (2015 Law)



Note: Estimates assume the current corporate income tax burden is borne equally by labor and capital, but changes to the corporate income tax under the proposal are assumed to be borne by capital only. The standard assumption is that the corporate income tax is borne by capital generally. Estimates of 2015 law at 2006 cash income levels. Quintiles begin at cash income of; Second $12,910; Third $27,461; Fourth $45,345; Highest $84,124; Top 10% $123,076; Top 5% $169,521; Top 1% $407,907; Bottom 50% below $36,738.

Source: Department of the Treasury, Office of Tax Analysis.

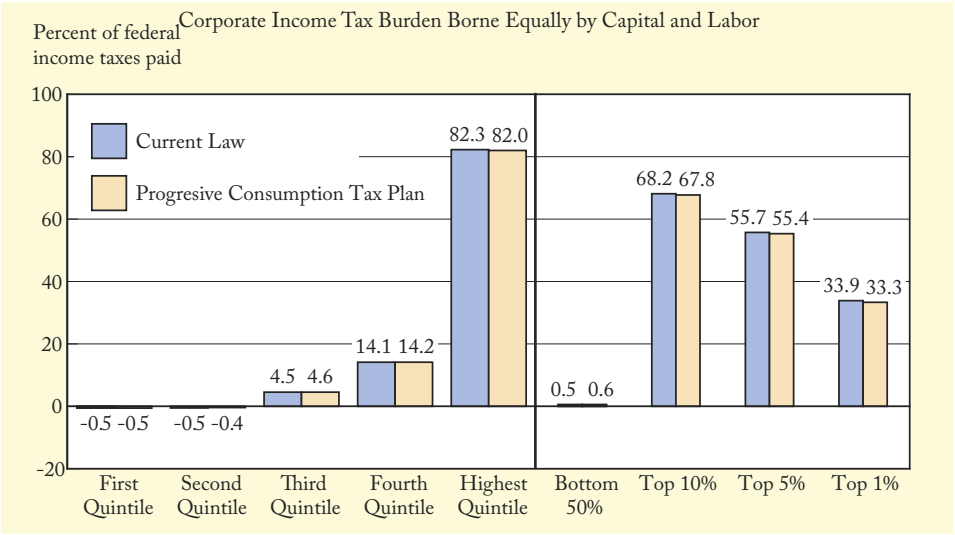
Figure A.8. Alternative Distribution of Federal Income Tax Burden Under Current Law and the Growth and Investment Tax Plan by Income Level (2015 Law)



Note: Estimates assume the current corporate income tax burden is borne equally by labor and capital, but changes to the corporate income tax under the proposal are assumed to be borne by capital only. The standard assumption is that the corporate income tax is borne by capital generally. Estimates of 2015 law at 2006 cash income levels.

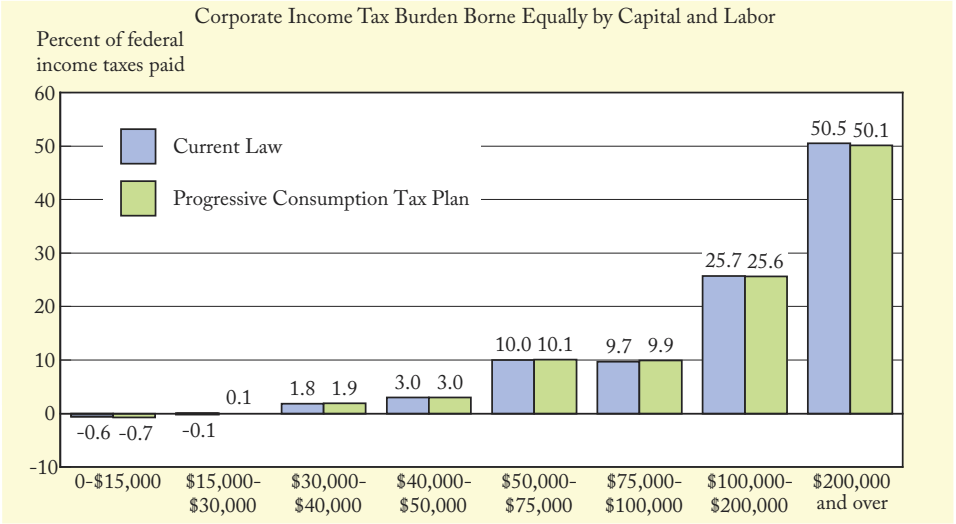
Source: Department of the Treasury, Office of Tax Analysis.

Figure A.9. Alternative Distribution of Federal Income Tax Burden Under Current Law and the Progressive Consumption Tax Plan by Income Percentile (2006 Law)



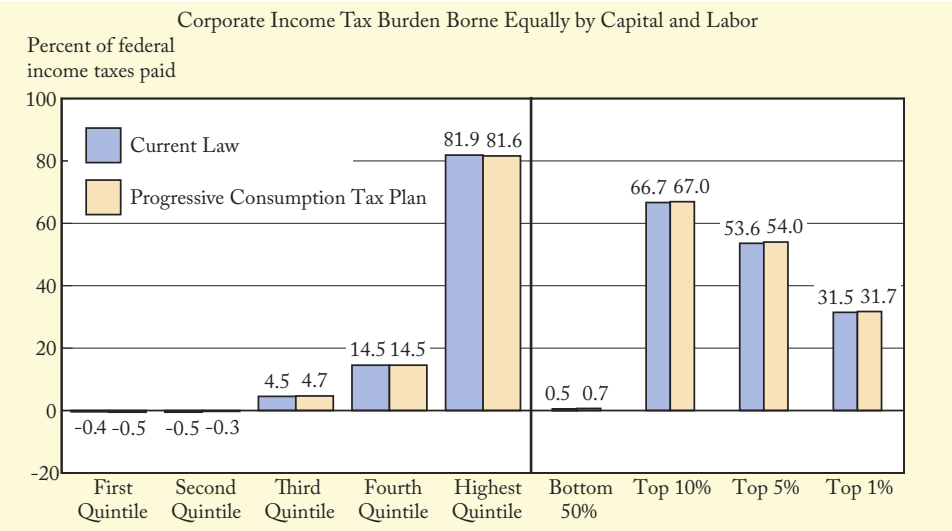
Note: Estimates assume the current corporate income tax burden is borne equally by labor and capital, but changes to the corporate income tax under the proposal are assumed to be borne by capital only. The standard assumption is that the corporate income tax is borne by capital generally. Estimates of 2006 law at 2006 cash income levels. Quintiles begin at cash income of; Second $12,910; Third $27,461; Fourth $45,345; Highest $84,124; Top 10% $123,076; Top 5% $169,521; Top 1% $407,907; Bottom 50% below $36,738.
Source: Department of the Treasury, Office of Tax Analysis.

Figure A.10. Alternative Distribution of Federal Income Tax Burden Under Current Law and the Progressive Consumption Tax Plan by Income Level (2006 Law)



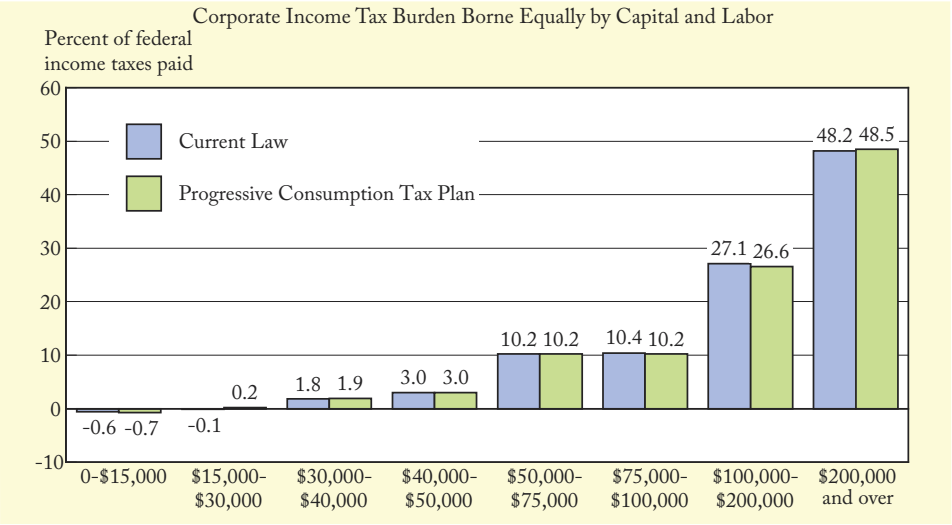
Note: Estimates assume the current corporate income tax burden is borne equally by labor and capital, but changes to the corporate income tax under the proposal are assumed to be borne by capital only. The standard assumption is that the corporate income tax is borne by capital generally. Estimates of 2006 law at 2006 cash income levels.
Source: Department of the Treasury, Office of Tax Analysis.

Figure A.11. Alternative Distribution of Federal Income Tax Burden Under Current Law and the Progressive Consumption Tax Plan by Income Percentile (2015 Law)



Note: Estimates assume the current corporate income tax burden is borne equally by labor and capital, but changes to the corporate income tax under the proposal are assumed to be borne by capital only. The standard assumption is that the corporate income tax is borne by capital generally. Estimates of 2015 law at 2006 cash income levels. Quintiles begin at cash income of; Second $12,910; Third $27,461; Fourth $45,345; Highest $84,124; Top 10% $123,076; Top 5% $169,521; Top 1% $407,907; Bottom 50% below $36,738.
Source: Department of the Treasury, Office of Tax Analysis.

Figure A.12. Alternative Distribution of Federal Income Tax Burden Under Current Law and the Progressive Consumption Tax Plan by Income Level (2015 Law)



Note: Estimates assume the current corporate income tax burden is borne equally by labor and capital, but changes to the corporate income tax under the proposal are assumed to be borne by capital only. The standard assumption is that the corporate income tax is borne by capital generally. Estimates of 2015 law at 2006 cash income levels.
Source: Department of the Treasury, Office of Tax Analysis.

Distributional Analysis Over the Ten-Year Budget Period

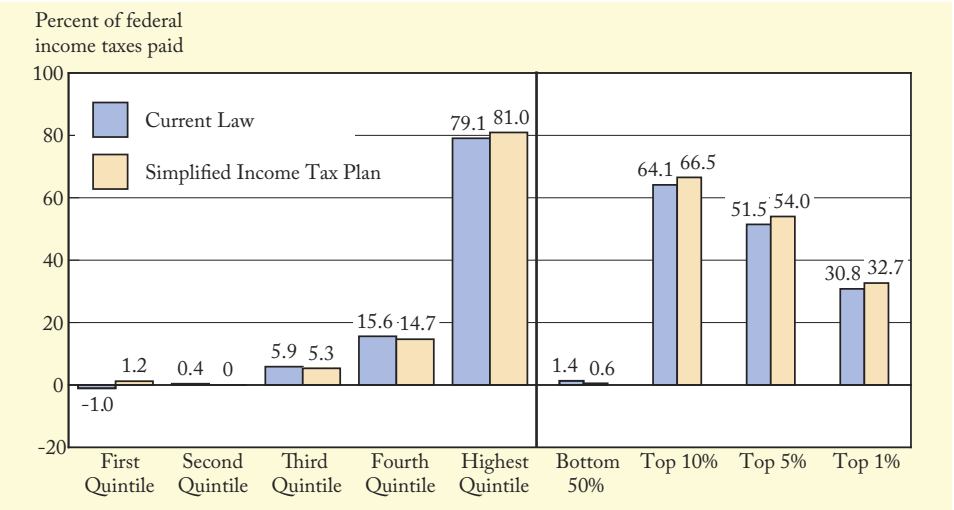
The Treasury Department provided the Panel with distributional analysis of the Simplified Income Tax Plan, the Progressive Consumption Tax Plan, and the Growth and Investment Tax Plan over the ten-year budget period. The technical explanation of the estimates that follows was provided by the Treasury Department at the request of the Panel.

The analysis uses a model that traces the income and taxes paid in each year for a sample of "tax families" constructed from income tax returns. A tax family is defined as the non-dependent primary taxpayer, the taxpayer's spouse, and their dependents for income tax purposes. The analysis begins with the distribution of the individual income and corporate income tax to "tax families" in each year. Individual income tax liabilities are distributed to payers (which includes dependent filers) and corporate income tax liabilities to capital income generally. Tax liabilities are aggregated at the family level. The cash income of all family members is also aggregated at the family level.

Family-level income and tax liabilities in each year are then divided by an equivalence scale. The equivalence scale is based on family size and adjusts for economies of scale as family size increases. Each family's "equivalenced" income and tax liabilities are then attributed to each member of the family in that year.

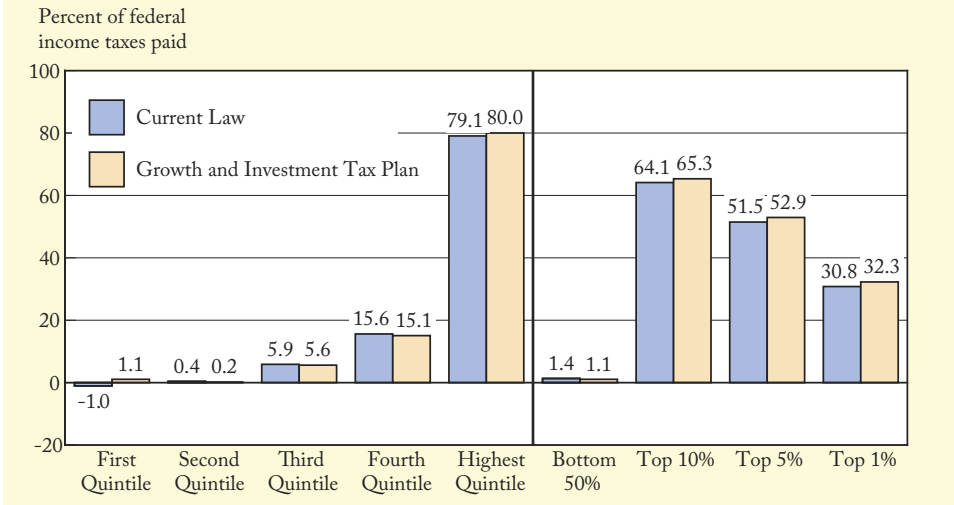
The present values of year-by-year "equivalenced" income and tax liabilities are then computed for each individual present in the first year of the ten-year budget period. The discount rate used is the sum of the forecast inflation rate (as measured by the CPI-U) and an assumed four percent real rate of return. These present values are converted to real level annuities over the ten-year budget period with the same present value. The real level annuity values of income are used to place individuals into income quintiles, and tax shares are computed from the real level annuity values for taxes and income.

Figure A.13. Alternative Distribution of Federal Income Tax Burden Under Current Law and the Simplified Tax Income Plan by Income Percentile (Over Budget Period)



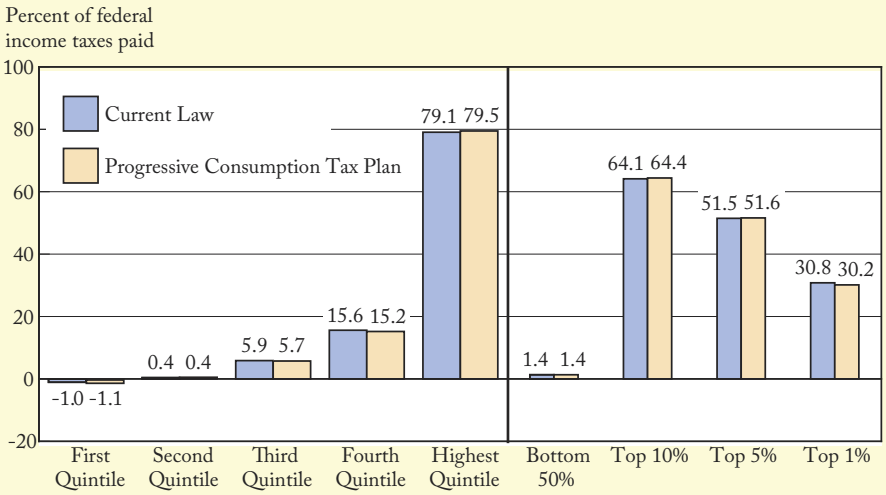
Note: See explanation in text.
Source: Department of the Treasury, Office of Tax Analysis.

Figure A.14. Alternative Distribution of Federal Income Tax Burden Under Current Law and the Growth and Investment Tax Plan by Income Percentile (Over Budget Period)



Note: See explanation in text.
Source: Department of the Treasury, Office of Tax Analysis.

Figure A.15. Alternative Distribution of Federal Income Tax Burden Under Current Law and the Progressive Consumption Tax Plan by Income Percentile (Over Budget Period)



Note: See explanation in text.
Source: Department of the Treasury, Office of Tax Analysis.

Additional Tax Forms

As discussed in Chapters Six and Seven, the tax returns that would be used under both the Simplified Income Tax Plan or the Growth and Investment Tax Plan would fit on a single page. These tax returns could even fit on the front and back of a postcard. Figures A.16 and A.17 show how these forms would appear if printed on a postcard instead of a regular sheet of paper. Figure A.18 shows the Work Credit worksheet and instructions.

Figure A.16. Form 1040-Simple

Postcard - Front

1040-SIMPLE U.S. Individual Income Tax Return 200X (99)

For the year Jan. 1–Dec. 31, 200X, or other tax year beginning , 200X, ending , 20 — OMB No. 1545-XXXX

LABEL HERE

Your first name and initial	Last name	Your social security number
If married, spouse's first name and initial	Last name	Spouse's social security number
Home address (number and street, city, town or post office, state, and ZIP code). If you have a P.O. box or a foreign address, see page xx.		▲ Important! ▲ You **must** enter your SSN(s) above.

1	Wages, salaries, tips, etc. Attach Form(s) W-2			+	1
2	Business income or (loss). Attach Schedule C, C-EZ, E, or F			+	2
3	Taxable interest and dividends			+	3
4	Gain or (loss) on stock. Attach Schedule D			+	4
5	Other gains or (losses). Attach Form 4797			+	5
6	Taxable distributions (retirement and savings)			+	6
7	Social security benefits			+	7
8	Other income. List type and amount ▶			+	8
9	Add lines 1 through 8		Total income =		9
10	Charitable contributions	10			
11	Multiply line 9 by 1% (.01)	11		–	
12	Subtract line 11 from line 10. If zero or less, enter -0-	12			
13	Social security benefits deduction (see page xx)	13		+	
14	Health insurance deduction	14		+	
15	Add lines 12 through 14			–	15
16	Subtract line 15 from line 9. If zero or less, enter -0-		Taxable income =		16

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page xx. Cat. No. 00000X **1040-SIMPLE** (200X)

Postcard - Back

17	Figure your tax (see page xx)		Tax =		17
18	Home credit (see page xx)			–	18
19	Subtract line 18 from line 17. If zero or less, enter -0-				19
20	Family credit. Attach Schedule A if required			–	20
21	Subtract line 20 from line 19. If zero or less, enter -0-				21
22	Self-employment tax			+	22
23	Other taxes and foreign tax credit. Attach Schedule O			+	23
24	Add lines 21 through 23. If zero or less, enter -0-		Total tax =		24
25	Federal income tax withheld	25			
26	Work credit	26		+	
27	Savers credit. Attach Form XXXX	27		+	
28	Estimated tax and other payments	28		+	
29	Add lines 25 through 28		Total payments =		29
30	If line 29 is more than line 24, subtract line 24 from line 29. If you want to use direct deposit, attach Form XXXX		Amount overpaid =		30
31	Amount of line 30 you want applied to your 200Y estimated tax				31
32	If line 24 is more than line 29, subtract line 29 from line 24		Amount you owe =		32

Sign Here Married? See page xx. Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature	Date	Your occupation	If married but not filing with spouse, check here . . . ▶ ☐
Spouse's signature. If filing with spouse, **both** must sign.	Date	Spouse's occupation	Daytime phone number ( )

Paid Preparer's Use Only

Preparer's signature	Date	Check if self-employed ☐	Preparer's SSN or PTIN
Firm's name (or yours if self-employed), address, and ZIP code		EIN	
		Phone no.	( )

1040-SIMPLE (200X)

Figure A.17. Form 1

Postcard - Front

Form **1** — **U.S. Individual Tax Return** — **200X** (99)

For the year Jan. 1–Dec. 31, 200X, or other tax year beginning , 200X, ending , 20 — OMB No. 1545-XXXX

Label (See instructions on page xx.) **Use the IRS label.** Otherwise, please print or type.

LABEL HERE

Your first name and initial	Last name
If married, spouse's first name and initial	Last name
Home address (number and street). If you have a P.O. box, see page xx.	Apt. no.
City, town or post office, state, and ZIP code. If you have a foreign address, see page xx.	

Your social security number : :

Spouse's social security number : :

▲ **Important!** ▲ You **must** enter your SSN(s) above.

Taxable Amount

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

1	Wages, salaries, tips, etc. Attach Form(s) W-2			1
2	Business cash flow. Attach Schedule 1			2
3	Taxable interest and dividends			3
4	Gains or (losses)			4
5	Taxable distributions (retirement and savings)			5
6	Social security benefits			6
7	Other income. List type and amount ▶			7
8	**Total cash flow.** Add lines 1 through 7 ▶			8
9	Charitable contributions	9		
10	Multiply line 8 by 1% (.01)	10		
11	Subtract line 10 from line 9. If zero or less, enter -0-	11		
12	Social security benefits deduction	12		
13	Health insurance deduction	13		
14	Add lines 11 through 13			14
15	**Taxable amount.** Subtract line 14 from line 8. If zero or less, enter -0-			15

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page xx. Cat. No. 00000X Form **1** (200X)

Postcard - Back

Form 1 (200X) Page **2**

Tax and Credits

16	Tax (see page xx)			16
17	Home credit (see page xx)			17
18	Subtract line 17 from line 16. If zero or less, enter -0-			18
19	Family credit. Attach Schedule A if required			19
20	Subtract line 19 from line 18. If zero or less, enter -0-			20
21	Self-employment tax			21
22	Other taxes. Attach Schedule O			22
23	**Total tax.** Add lines 20 through 22			23

Payments

24	Federal tax withheld	24		
25	Work credit	25		
26	Estimated tax and other payments	26		
27	**Total payments.** Add lines 24 through 26			27

Refund or Amount You Owe

28	**Amount overpaid.** If line 27 is more than line 23, subtract line 23 from line 27. If you want to use direct deposit, attach Form XXXX			28
29	Amount of line 28 you want applied to your 200Y estimated tax			29
30	**Amount you owe.** If line 23 is more than line 27, subtract line 27 from line 23			30

Sign Here Married? See page xx. Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature	Date	Your occupation	**If married but not filing with spouse, check here** . . . ▶ ☐
Spouse's signature. If filing with spouse, **both** must sign.	Date	Spouse's occupation	Daytime phone number ( )

Paid Preparer's Use Only

Preparer's signature ▶	Date	Check if self-employed ☐	Preparer's SSN or PTIN
Firm's name (or yours if self-employed), address, and ZIP code ▶		EIN :	
		Phone no. ( )	

Form **1** (200X)

Figure A.18. Work Credit Worksheet and Instructions

Line 26—Work Credit

Step 1 How To Figure the Credit

1. Do you want the IRS to figure the credit for you?
   - ☐ **Yes.** Just check the box and enter your tax-exempt interest and dividends at the bottom of Schedule A if you meet the conditions listed on Schedule A.
   - ☐ **No.** Go to Step 2.

Step 2 Can You Take the Credit?

1. Can you or your spouse be claimed as a dependent on someone else's 200X return?
   - ☐ **Yes.** STOP You cannot take this credit.
   - ☐ **No.** Continue
2. Do you and your spouse have a social security number that allows you to work or is valid for the work credit (see page xx)?
   - ☐ **Yes.** Continue
   - ☐ **No.** STOP You cannot take this credit.
3. Did you and your spouse live in the United States for more than half of 200X? Members of the military, see page xx before you answer.
   - ☐ **Yes.** Continue
   - ☐ **No.** STOP You cannot take this credit.
4. Were you married at the end of 200X and are electing **not** to file your 200X return with your spouse? If you are separated from your spouse, see page xx.
   - ☐ **Yes.** STOP You cannot take this credit.
   - ☐ **No.** Continue
5. Were you a nonresident alien for any part of 200X?
   - ☐ **Yes.** See *Nonresident aliens* on page xx.
   - ☐ **No.** Continue
6. Are you filing Form 2555 or 2555-EZ (relating to foreign earned income)?
   - ☐ **Yes.** STOP You cannot take this credit.
   - ☐ **No.** Go to question 7.
7. Do any of the following apply to you?
   - The amount on your Schedule A, line 4, is more than the amount on your Schedule A, line 5.
   - You lived with 2 or more child dependents in the United States for more than half of 200X and the amount on 1040-SIMPLE, line 16, is less than $37,800 ($41,800 if married).
   - You lived with 1 child dependent in the United States for more than half of 200X and the amount on 1040-SIMPLE, line 16, is less than $28,600 ($32,600 if married).

   ☐ **Yes.** Go to Step 3. ☐ **No.** STOP You cannot take this credit.

Step 3 Work Income

1. Figure work income:

   1040-SIMPLE, line 1 _____

   Add: + _____
   - All of your nontaxable combat pay if you elect to include it in work income. See *Combat pay, Nontaxable* on page xx.
   - Your business income or (loss) from 1040-SIMPLE, line 2. But if line 2 includes an amount from Schedule E or you were a statutory employee, see *Schedule E filers* or *Statutory employees*, whichever applies, on page xx.
   - Any amounts from Schedule SE, lines 15 and 17, if you elected to use either optional method to figure your net earnings from self-employment.

   Work Income = ☐
2. Do any of the following apply to you?
   - The amount on your Schedule A, line 4, is more than the amount on your Schedule A, line 5.
   - You lived with 2 or more child dependents in the United States for more than half of 200X and your work income is less than $37,800 ($41,800 if married).
   - You lived with 1 child dependent in the United States for more than half of 200X and your work income is less than $28,600 ($32,600 if married).

   ☐ **Yes.** Use the worksheet on page xx to figure your credit. ☐ **No.** STOP You cannot take this credit.

Work Credit Worksheet—Line 26 *Keep for Your Records*

TIP ***The IRS can figure your work credit for you. Just check the box and enter your tax-exempt interest and dividends at the bottom of Schedule A if you qualify.***

Otherwise, be sure you answered the questions on page XX to see if you can take this credit before completing this worksheet.

Part 1
All Filers

1 Is the amount on Schedule A, line 4, more than the amount on Schedule A, line 5?

☐ **Yes.** Subtract Schedule A, line 5, from Schedule A, line 4, and enter the result.
☐ **No.** Skip lines 1 through 3 and enter -0- on line 4.

1 ____

2 Enter your work income from Step 3 on page XX. 2 ____

3 Look up the amount on line 2 in the blue table on page XX to find the credit. Enter the credit here. 3 ____

4 Enter the smaller of line 1 or line 3. 4 ____

Next. If you have at least one child dependent who lived with you in the United States for more than half of 200X, go to Part 2. Otherwise, enter the amount from line 4 on line 11.

Part 2
Filers With At Least One Child Dependent

5 Look up the amount on line 2 in the orange table on pages XX through XX to find the credit. Enter the credit here. 5 ____

6 Enter your taxable income from 1040-SIMPLE, line 16. 6 ____

7 Enter your tax-exempt interest and dividends. 7 ____

8 Add lines 6 and 7. 8 ____

9 Look up the amount on line 8 in the orange table on pages XX through XX to find the credit. Enter the credit here. 9 ____

10 Enter the smaller of line 5 or line 9. 10 ____

Then, add the amounts on lines 4 and 10 and enter the result on line 11.

Part 3
Work Credit

11 **This is your work credit.** 11 ____

Enter this amount on 1040-SIMPLE, line 26.

1040-SIMPLE

CAUTION *If you take the work credit even though you are not eligible, you may not be allowed to take the credit for up to 10 years. See* Form 8862, Who must file, *on page XX. You may also have to pay penalties.*

Definitions and Special Rules

(listed in alphabetical order)

Combat pay, Nontaxable. If you were a member of the U.S. Armed Forces who served in a combat zone, certain pay is excluded from your income. See *Combat Zone Exclusion* in Pub. 3. You can elect to include this pay in your work income when figuring the work credit. The amount of your nontaxable combat pay should be shown in Form(s) W-2, box 12, with code Q. If you are filing a return with your spouse and both you and your spouse received nontaxable combat pay, you can each make your own election.

CAUTION *Electing to include nontaxable combat pay may increase or decrease your work credit. Figure the credit with and without your nontaxable combat pay before making the election.*

Form 8862, Who must file. Generally, you must file Form 8862 if your earned income credit (EIC) or your work credit for a year after 1996 was reduced or disallowed for any reason other than a math or clerical error. But do not file Form 8862 or take the work credit for the:

- 2 years after the most recent tax year for which there was a final determination that your EIC or work credit was reduced or disallowed due to reckless or intentional disregard of the EIC or work credit rules, or
- 10 years after the most recent tax year for which there was a final determination that your EIC or work credit was reduced or disallowed due to fraud.

Members of the military. If you were on extended active duty outside the United States, your home is considered to be in the United States during that duty period. Extended active duty is military duty ordered for an indefinite period or for a period of more than 90 days. Once you begin serving extended active duty, you are considered to be on extended active duty even if you serve fewer than 90 days.

Nonresident aliens. If you are filing your return with your spouse, go to Step 2, question 6, on page xx. Otherwise, stop; you cannot take the work credit.

Schedule E filers. Do not include any income or (loss) from Schedule E in your work income. However, if you received a Schedule K-1, include in work income any amounts from Schedule K-1 (Form 1065), box 14, code A, and Schedule K-1 (Form 1065-B), box 9. Reduce these Schedule K-1 amounts by any partnership section 179 expense deduction claimed, unreimbursed partnership expenses claimed, and depletion claimed on oil and gas properties.

Social security number (SSN). For the work credit, a valid SSN is a number issued by the Social Security Administration unless "Not Valid for Employment" is printed on the social security card and the number was issued solely to apply for or receive a federally funded benefit.

To find out how to get an SSN, see page xx. If you will not have an SSN by April 15, 200X, see *What If You Cannot File on Time?* on page xx.

Statutory employees. If you received a Form W-2 and the "Statutory employee" box in box 13 of that form was checked, include in your work income the amount from box 13 of your Form W-2 instead of your net profit or (loss) from the Schedule C or C-EZ that you filed as a statutory employee and that is included on 1040-SIMPLE, line 2.

Use this table for line 3 of your worksheet

For All Work Credit Filers

1. To find your credit, read down the "At least – But less than" columns and find the line that includes your work income from Step 3 on page XX.

2. Then, go to the column that includes the number of child dependents who lived with you in the United States for more than half of 200X. Enter the credit from that column on line 3 of your worksheet.

Example. You have one child dependent who lived with you in the United States for more than half of 200X. Your work income is $2,455. You would enter $833 on line 3 of your worksheet.

If your work income is—		And you have—		
		No child dependents	One child dependent	Two or more child dependents
At least	But less than	Enter on line 3—		
2,300	2,400	180	799	940
2,400	2,500	187	833	980

If your work income is—		And you have—		
		No child dependents	One child dependent	Two or more child dependents
At least	But less than	Enter on line 3—		
1	100	4	17	20
100	200	11	51	60
200	300	19	85	100
300	400	27	119	140
400	500	34	153	180
500	600	42	187	220
600	700	50	221	260
700	800	57	255	300
800	900	65	289	340
900	1,000	73	323	380
1,000	1,100	80	357	420
1,100	1,200	88	391	460
1,200	1,300	96	425	500
1,300	1,400	103	459	540
1,400	1,500	111	493	580
1,500	1,600	119	527	620
1,600	1,700	126	561	660
1,700	1,800	134	595	700
1,800	1,900	142	629	740
1,900	2,000	149	663	780
2,000	2,100	157	697	820
2,100	2,200	164	731	860
2,200	2,300	172	765	900
2,300	2,400	180	799	940
2,400	2,500	187	833	980
2,500	2,600	195	867	1,020
2,600	2,700	203	901	1,060
2,700	2,800	210	935	1,100
2,800	2,900	218	969	1,140
2,900	3,000	226	1,003	1,180
3,000	3,100	233	1,037	1,220
3,100	3,200	241	1,071	1,260
3,200	3,300	249	1,105	1,300
3,300	3,400	256	1,139	1,340
3,400	3,500	264	1,173	1,380
3,500	3,600	272	1,207	1,420
3,600	3,700	279	1,241	1,460
3,700	3,800	287	1,275	1,500
3,800	3,900	295	1,309	1,540
3,900	4,000	302	1,343	1,580
4,000	4,100	310	1,377	1,620
4,100	4,200	317	1,411	1,660
4,200	4,300	325	1,445	1,700
4,300	4,400	333	1,479	1,740
4,400	4,500	340	1,513	1,780
4,500	4,600	348	1,547	1,820
4,600	4,700	356	1,581	1,860
4,700	4,800	363	1,615	1,900
4,800	4,900	371	1,649	1,940
4,900	5,000	379	1,683	1,980
5,000	5,100	386	1,717	2,020
5,100	5,200	394	1,751	2,060
5,200	5,300	402	1,785	2,100
5,300	5,400	409	1,819	2,140
5,400	5,500	411	1,853	2,180
5,500	5,600	411	1,887	2,220
5,600	5,700	411	1,921	2,260
5,700	5,800	411	1,955	2,300
5,800	5,900	411	1,989	2,340
5,900	6,000	411	2,023	2,380
6,000	6,100	411	2,057	2,420
6,100	6,200	411	2,091	2,460
6,200	6,300	411	2,120	2,500
6,300	6,400	411	2,120	2,540
6,400	6,500	411	2,120	2,580
6,500	6,600	411	2,120	2,620
6,600	6,700	411	2,120	2,660
6,700	6,800	411	2,120	2,700
6,800	6,900	411	2,120	2,740
6,900	7,000	411	2,120	2,780
7,000	7,100	411	2,120	2,820
7,100	7,200	411	2,120	2,860
7,200	7,300	411	2,120	2,900
7,300	7,400	411	2,120	2,940
7,400	7,500	411	2,120	2,980
7,500	7,600	411	2,120	3,020
7,600	7,700	411	2,120	3,060
7,700	7,800	411	2,120	3,100
7,800	7,900	411	2,120	3,140
7,900	8,000	411	2,120	3,180
8,000	- - - -	411	2,120	3,200

Use this table for lines 5 and 9 of your worksheet

For Work Credit Filers With At Least One Child Dependent

1. To find your credit, read down the "At least – But less than" columns and find the line that includes the amount you were told to look up from your work credit worksheet.

2. Then, go to the column that includes the number of child dependents who lived with you in the United States for more than half of 200X. Enter the credit from that column on your worksheet.

If the amount you are looking up is—		Single And you have—		Married And you have—		If the amount you are looking up is—		Single And you have—		Married And you have—		If the amount you are looking up is—		Single And you have—		Married And you have—	
		One child dependent	Two or more child dependents	One child dependent	Two or more child dependents			One child dependent	Two or more child dependents	One child dependent	Two or more child dependents			One child dependent	Two or more child dependents	One child dependent	Two or more child dependents
At least	But less than	Enter on your worksheet—				At least	But less than	Enter on your worksheet—				At least	But less than	Enter on your worksheet—			
1	6,200	0	0	0	0	11,100	11,200	1,450	1,260	1,450	1,260	16,100	16,200	1,450	2,600	1,450	2,600
6,200	6,300	5	0	5	0	11,200	11,300	1,450	1,300	1,450	1,300	16,200	16,300	1,450	2,600	1,450	2,600
6,300	6,400	39	0	39	0	11,300	11,400	1,450	1,340	1,450	1,340	16,300	16,400	1,450	2,600	1,450	2,600
6,400	6,500	73	0	73	0	11,400	11,500	1,450	1,380	1,450	1,380	16,400	16,500	1,450	2,600	1,450	2,600
6,500	6,600	107	0	107	0	11,500	11,600	1,450	1,420	1,450	1,420	16,500	16,600	1,450	2,600	1,450	2,600
6,600	6,700	141	0	141	0	11,600	11,700	1,450	1,460	1,450	1,460	16,600	16,700	1,450	2,600	1,450	2,600
6,700	6,800	175	0	175	0	11,700	11,800	1,450	1,500	1,450	1,500	16,700	16,800	1,450	2,600	1,450	2,600
6,800	6,900	209	0	209	0	11,800	11,900	1,450	1,540	1,450	1,540	16,800	16,900	1,450	2,600	1,450	2,600
6,900	7,000	243	0	243	0	11,900	12,000	1,450	1,580	1,450	1,580	16,900	17,000	1,450	2,600	1,450	2,600
7,000	7,100	277	0	277	0	12,000	12,100	1,450	1,620	1,450	1,620	17,000	17,100	1,444	2,594	1,450	2,600
7,100	7,200	311	0	311	0	12,100	12,200	1,450	1,660	1,450	1,660	17,100	17,200	1,431	2,581	1,450	2,600
7,200	7,300	345	0	345	0	12,200	12,300	1,450	1,700	1,450	1,700	17,200	17,300	1,419	2,569	1,450	2,600
7,300	7,400	379	0	379	0	12,300	12,400	1,450	1,740	1,450	1,740	17,300	17,400	1,406	2,556	1,450	2,600
7,400	7,500	413	0	413	0	12,400	12,500	1,450	1,780	1,450	1,780	17,400	17,500	1,394	2,544	1,450	2,600
7,500	7,600	447	0	447	0	12,500	12,600	1,450	1,820	1,450	1,820	17,500	17,600	1,381	2,531	1,450	2,600
7,600	7,700	481	0	481	0	12,600	12,700	1,450	1,860	1,450	1,860	17,600	17,700	1,369	2,519	1,450	2,600
7,700	7,800	515	0	515	0	12,700	12,800	1,450	1,900	1,450	1,900	17,700	17,800	1,356	2,506	1,450	2,600
7,800	7,900	549	0	549	0	12,800	12,900	1,450	1,940	1,450	1,940	17,800	17,900	1,344	2,494	1,450	2,600
7,900	8,000	583	0	583	0	12,900	13,000	1,450	1,980	1,450	1,980	17,900	18,000	1,331	2,481	1,450	2,600
8,000	8,100	617	20	617	20	13,000	13,100	1,450	2,020	1,450	2,020	18,000	18,100	1,319	2,469	1,450	2,600
8,100	8,200	651	60	651	60	13,100	13,200	1,450	2,060	1,450	2,060	18,100	18,200	1,306	2,456	1,450	2,600
8,200	8,300	685	100	685	100	13,200	13,300	1,450	2,100	1,450	2,100	18,200	18,300	1,294	2,444	1,450	2,600
8,300	8,400	719	140	719	140	13,300	13,400	1,450	2,140	1,450	2,140	18,300	18,400	1,281	2,431	1,450	2,600
8,400	8,500	753	180	753	180	13,400	13,500	1,450	2,180	1,450	2,180	18,400	18,500	1,269	2,419	1,450	2,600
8,500	8,600	787	220	787	220	13,500	13,600	1,450	2,220	1,450	2,220	18,500	18,600	1,256	2,406	1,450	2,600
8,600	8,700	821	260	821	260	13,600	13,700	1,450	2,260	1,450	2,260	18,600	18,700	1,244	2,394	1,450	2,600
8,700	8,800	855	300	855	300	13,700	13,800	1,450	2,300	1,450	2,300	18,700	18,800	1,231	2,381	1,450	2,600
8,800	8,900	889	340	889	340	13,800	13,900	1,450	2,340	1,450	2,340	18,800	18,900	1,219	2,369	1,450	2,600
8,900	9,000	923	380	923	380	13,900	14,000	1,450	2,380	1,450	2,380	18,900	19,000	1,206	2,356	1,450	2,600
9,000	9,100	957	420	957	420	14,000	14,100	1,450	2,420	1,450	2,420	19,000	19,100	1,194	2,344	1,450	2,600
9,100	9,200	991	460	991	460	14,100	14,200	1,450	2,460	1,450	2,460	19,100	19,200	1,181	2,331	1,450	2,600
9,200	9,300	1,025	500	1,025	500	14,200	14,300	1,450	2,500	1,450	2,500	19,200	19,300	1,169	2,319	1,450	2,600
9,300	9,400	1,059	540	1,059	540	14,300	14,400	1,450	2,540	1,450	2,540	19,300	19,400	1,156	2,306	1,450	2,600
9,400	9,500	1,093	580	1,093	580	14,400	14,500	1,450	2,580	1,450	2,580	19,400	19,500	1,144	2,294	1,450	2,600
9,500	9,600	1,127	620	1,127	620	14,500	14,600	1,450	2,600	1,450	2,600	19,500	19,600	1,131	2,281	1,450	2,600
9,600	9,700	1,161	660	1,161	660	14,600	14,700	1,450	2,600	1,450	2,600	19,600	19,700	1,119	2,269	1,450	2,600
9,700	9,800	1,195	700	1,195	700	14,700	14,800	1,450	2,600	1,450	2,600	19,700	19,800	1,106	2,256	1,450	2,600
9,800	9,900	1,229	740	1,229	740	14,800	14,900	1,450	2,600	1,450	2,600	19,800	19,900	1,094	2,244	1,450	2,600
9,900	10,000	1,263	780	1,263	780	14,900	15,000	1,450	2,600	1,450	2,600	19,900	20,000	1,081	2,231	1,450	2,600
10,000	10,100	1,297	820	1,297	820	15,000	15,100	1,450	2,600	1,450	2,600	20,000	20,100	1,069	2,219	1,450	2,600
10,100	10,200	1,331	860	1,331	860	15,100	15,200	1,450	2,600	1,450	2,600	20,100	20,200	1,056	2,206	1,450	2,600
10,200	10,300	1,365	900	1,365	900	15,200	15,300	1,450	2,600	1,450	2,600	20,200	20,300	1,044	2,194	1,450	2,600
10,300	10,400	1,399	940	1,399	940	15,300	15,400	1,450	2,600	1,450	2,600	20,300	20,400	1,031	2,181	1,450	2,600
10,400	10,500	1,433	980	1,433	980	15,400	15,500	1,450	2,600	1,450	2,600	20,400	20,500	1,019	2,169	1,450	2,600
10,500	10,600	1,450	1,020	1,450	1,020	15,500	15,600	1,450	2,600	1,450	2,600	20,500	20,600	1,006	2,156	1,450	2,600
10,600	10,700	1,450	1,060	1,450	1,060	15,600	15,700	1,450	2,600	1,450	2,600	20,600	20,700	994	2,144	1,450	2,600
10,700	10,800	1,450	1,100	1,450	1,100	15,700	15,800	1,450	2,600	1,450	2,600	20,700	20,800	981	2,131	1,450	2,600
10,800	10,900	1,450	1,140	1,450	1,140	15,800	15,900	1,450	2,600	1,450	2,600	20,800	20,900	969	2,119	1,450	2,600
10,900	11,000	1,450	1,180	1,450	1,180	15,900	16,000	1,450	2,600	1,450	2,600	20,900	21,000	956	2,106	1,450	2,600
11,000	11,100	1,450	1,220	1,450	1,220	16,000	16,100	1,450	2,600	1,450	2,600	21,000	21,100	944	2,094	1,444	2,594

(continued on next page)

Use this table for lines 5 and 9 of your worksheet *(Continued)*

If the amount you are looking up is—		Single And you have—		Married And you have—		If the amount you are looking up is—		Single And you have—		Married And you have—		If the amount you are looking up is—		Single And you have—		Married And you have—	
		One child dependent	Two or more child dependents	One child dependent	Two or more child dependents			One child dependent	Two or more child dependents	One child dependent	Two or more child dependents			One child dependent	Two or more child dependents	One child dependent	Two or more child dependents
At least	But less than	Enter on your worksheet—				At least	But less than	Enter on your worksheet—				At least	But less than	Enter on your worksheet—			
37,600	37,700	0	19	0	519	39,100	39,200	0	0	0	331	40,600	40,700	0	0	0	144
37,700	37,800	0	6	0	506	39,200	39,300	0	0	0	319	40,700	40,800	0	0	0	131
37,800	37,900	0	0	0	494	39,300	39,400	0	0	0	306	40,800	40,900	0	0	0	119
37,900	38,000	0	0	0	481	39,400	39,500	0	0	0	294	40,900	41,000	0	0	0	106
38,000	38,100	0	0	0	469	39,500	39,600	0	0	0	281	41,000	41,100	0	0	0	94
38,100	38,200	0	0	0	456	39,600	39,700	0	0	0	269	41,100	41,200	0	0	0	81
38,200	38,300	0	0	0	444	39,700	39,800	0	0	0	256	41,200	41,300	0	0	0	69
38,300	38,400	0	0	0	431	39,800	39,900	0	0	0	244	41,300	41,400	0	0	0	56
38,400	38,500	0	0	0	419	39,900	40,000	0	0	0	231	41,400	41,500	0	0	0	44
38,500	38,600	0	0	0	406	40,000	40,100	0	0	0	219	41,500	41,600	0	0	0	31
38,600	38,700	0	0	0	394	40,100	40,200	0	0	0	206	41,600	41,700	0	0	0	19
38,700	38,800	0	0	0	381	40,200	40,300	0	0	0	194	41,700	41,800	0	0	0	6
38,800	38,900	0	0	0	369	40,300	40,400	0	0	0	181	41,800	- - - -	0	0	0	0
38,900	39,000	0	0	0	356	40,400	40,500	0	0	0	169						
39,000	39,100	0	0	0	344	40,500	40,600	0	0	0	156						