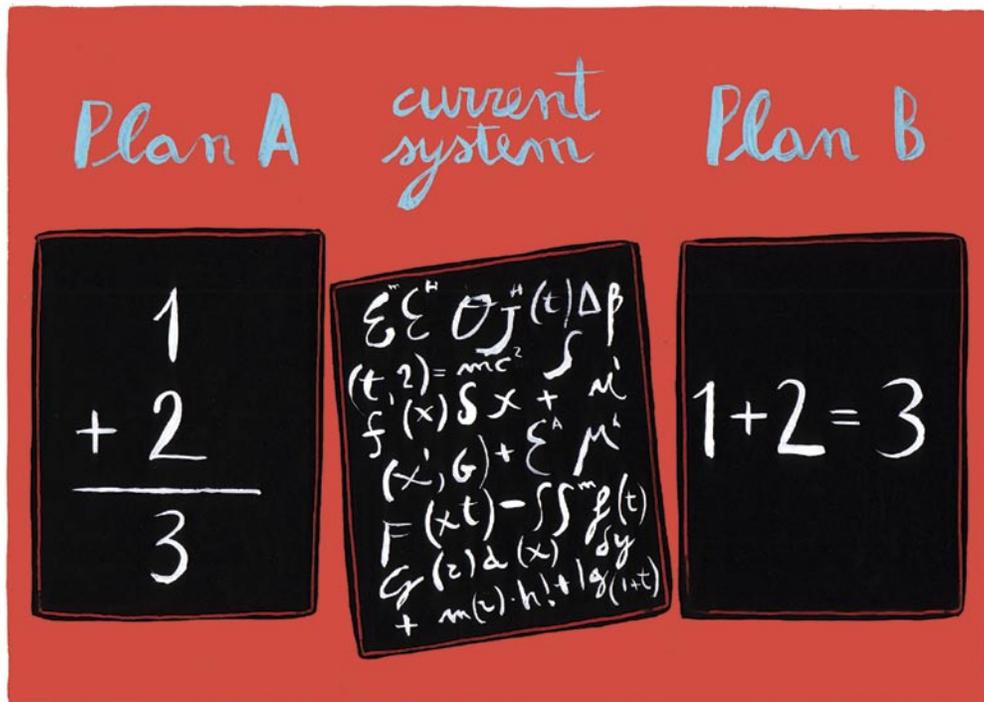


# Chapter Five

## *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 all 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.

<b>Table 5.1. Summary of Tax Reform Plans for Households</b>		
<b>Provisions</b>	<b>Simplified Income Tax Plan</b>	<b>Growth and Investment Tax Plan</b>
<b>Households and Families</b>		
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 couple, \$2,800 credit for unmarried with child, \$1,650 credit for singles, \$1,150 credit for dependent taxpayer; 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: \$3,570; with two or more children, \$5,800	
Marriage penalty	Reduced. All tax brackets, Family Credits, and taxation of Social Security benefits for couples are double those of individuals	
<b>Other Major Credits and Deductions</b>		
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).	
Education	Taxpayers can claim Family Credit for some full-time students; simplified savings plans	
State and local taxes	Not deductible	
<b>Individual Savings and Retirement</b>		
Defined contribution plans	Consolidated into Save at Work plans that have simple rules; 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	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 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.

<b>Table 5.2. Summary of Tax Reform Plans for Businesses</b>		
<b>Provisions</b>	<b>Simplified Income Tax Plan</b>	<b>Growth and Investment Tax Plan</b>
<b>Small Business</b>		
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	Immediate expensing (exception for land and buildings under the Simplified Income Tax Plan)	
<b>Large Business</b>		
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	No change	Not taxable (except for financial institutions)
International tax system	Territorial tax system	Destination-basis (border tax adjustments)
Corporate AMT	Repealed	

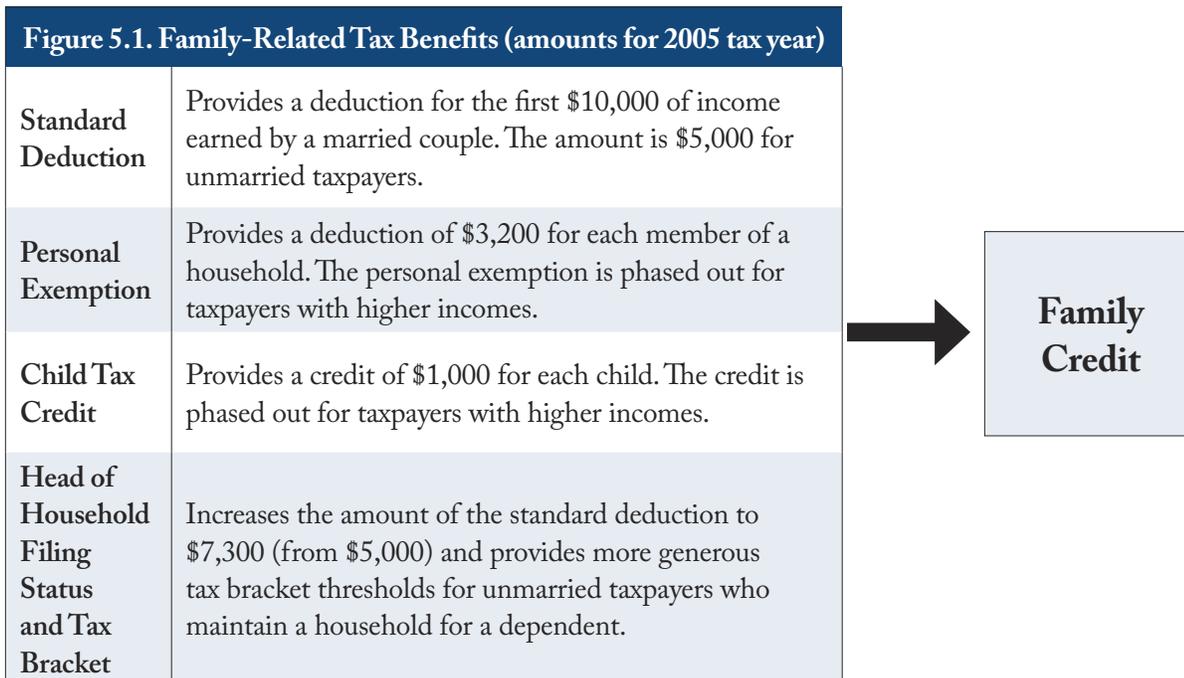
## COMMON ELEMENTS

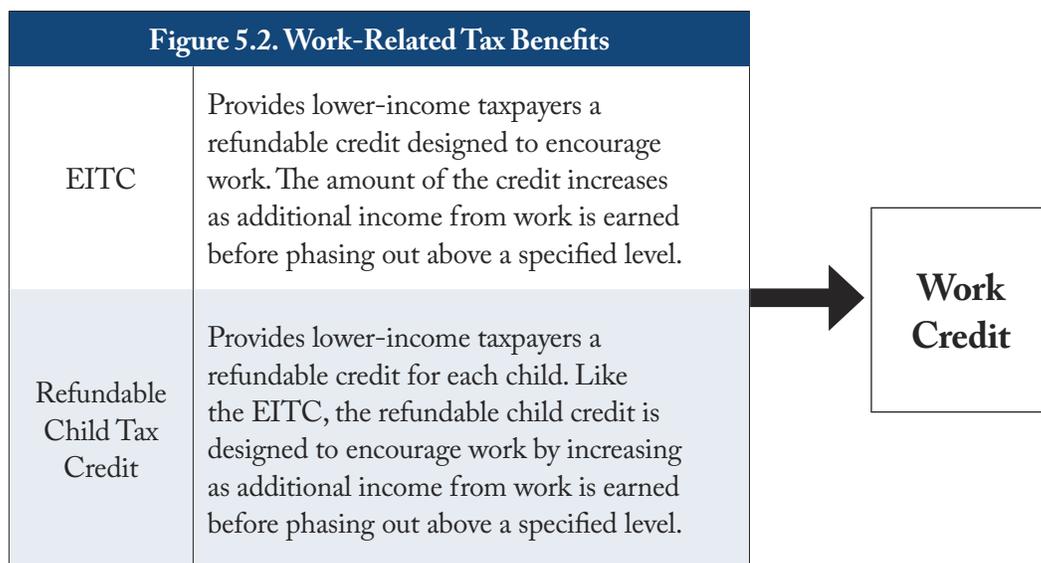
The following common elements serve as the starting point in both of the Panel's reform options. They represent simple and straightforward ideas for reforming the tax code.

### 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.





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 limited to 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.

<b>Household Type</b>	<b>Base Credit</b>
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) <input checked="" type="checkbox"/> if child lived with you in the United States for more than half of 200X
				<input type="checkbox"/>

**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 + **2**   
 Enter the result

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

**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.

**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: <ul style="list-style-type: none"> <li>• You and your spouse have a social security number that allows you to work.</li> <li>• You and your spouse lived in the United States for more than half of 200X.</li> <li>• You were a U.S. citizen or resident alien for all of 200X or you are filing your return with your spouse.</li> </ul>	<b>just check here.</b> <input type="checkbox"/> <b>and enter your tax-exempt interest and dividends</b> <input style="width: 50px;" type="text"/> Then leave line 26 blank.

Printed on recycled paper 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 earnings of 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.~~

### 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.~~

### 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.~~

### *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 Based on Income?**

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 these newly-designed tax benefits in addition to the Family Credit.

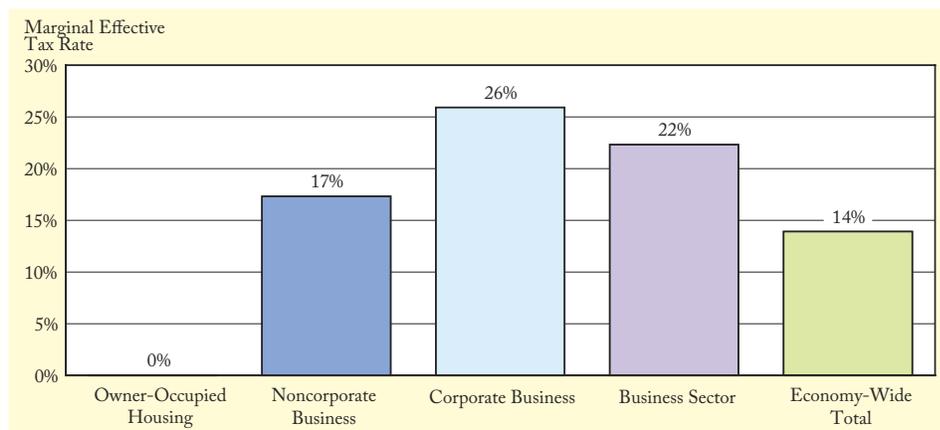


### Provisions Affecting Home Ownership

#### *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**

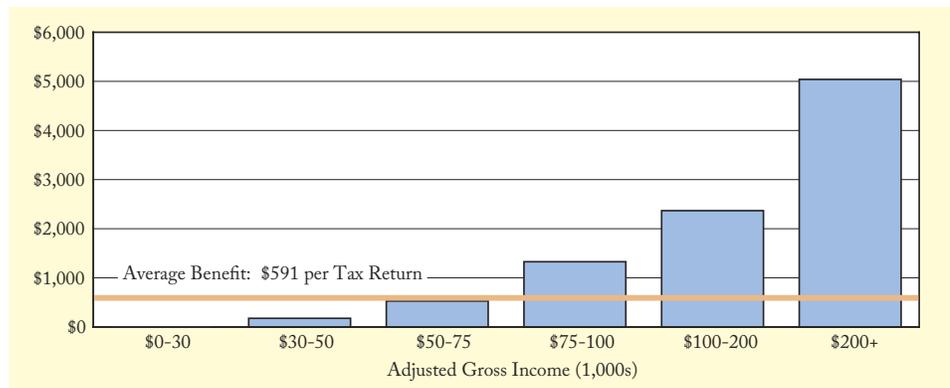


As Figure 5.5 illustrates, the economy-wide tax rate on housing investment is close to zero, compared with a tax rate of approximately 22 percent on business investment. This may result in too little business investment, meaning businesses purchase less new equipment and fewer new technologies than they 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 for 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 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).

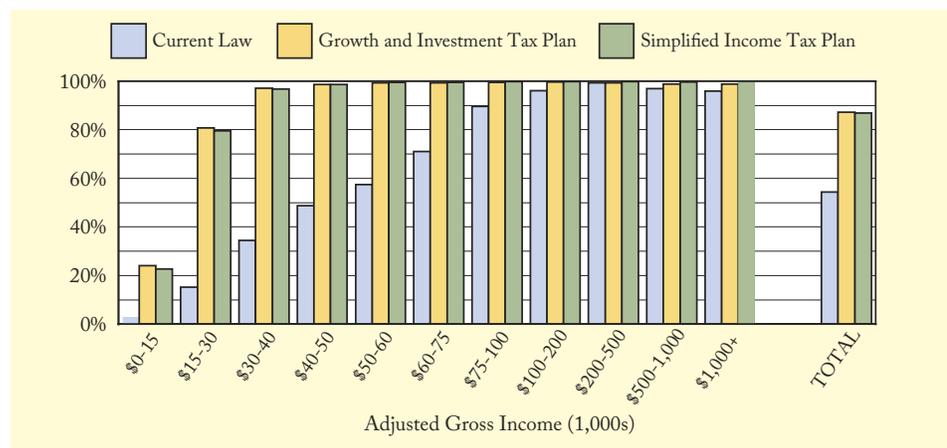
The Home Credit would encourage home ownership, not big homes. More Americans would be able to take advantage of tax benefits for owning a home, while the current subsidy for luxury and vacation homes would be curtailed. In addition, the Home Credit would reduce the incentive to take on more debt by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

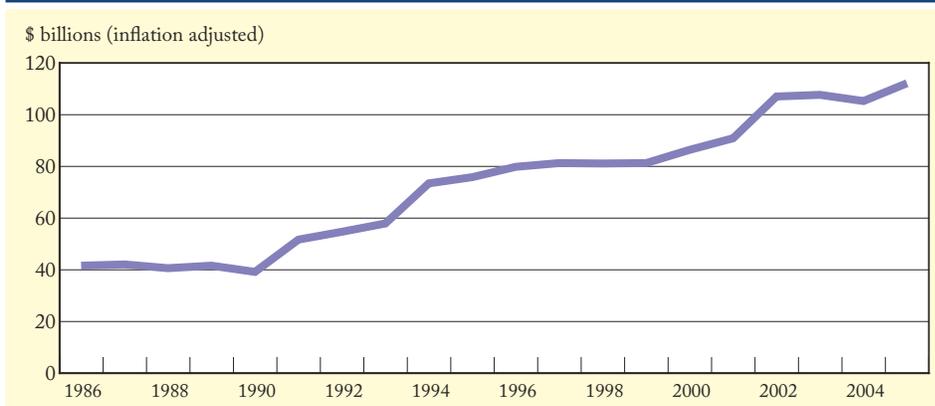
**Incentives for Health Insurance Coverage**

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.

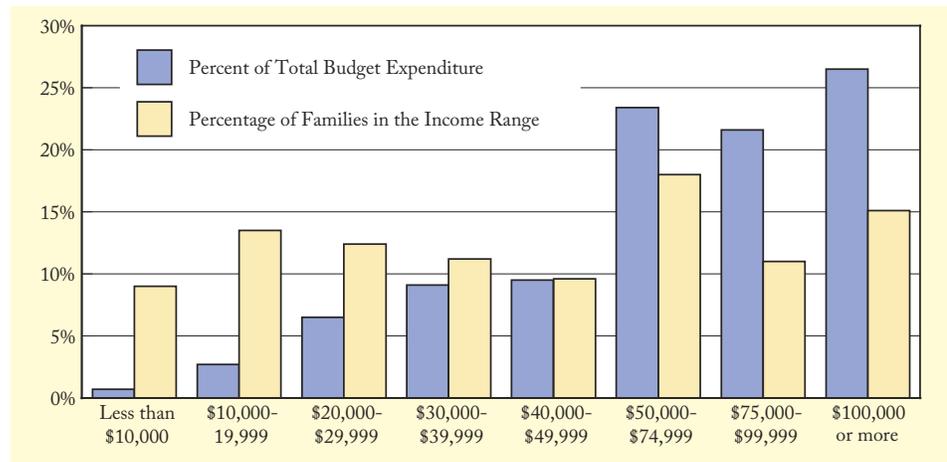
As with housing-related tax subsidies, tax benefits related to health care tend to benefit higher-income households more than lower-income households. This is true

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.

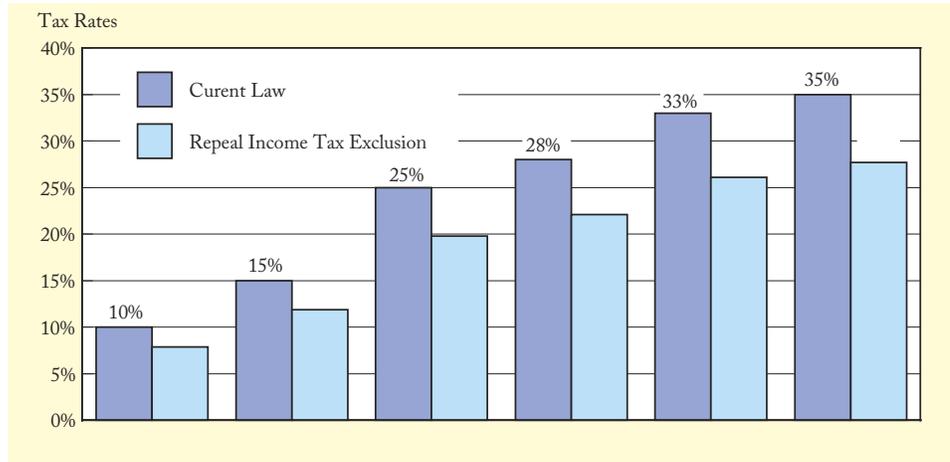
The Panel also recognizes that a strong system of employer-provided health insurance provides many benefits and may lead to a greater percentage of the population with health insurance. In addition, employer-sponsored group coverage reduces transaction costs and may lower premiums for some by pooling 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 Benefits on Individual Income Tax Rates**



Source: Department of the Treasury

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. For example, if taxpayers who receive Social Security choose to continue working, a portion of their Social Security income becomes taxable. 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. Taxpayers above the income threshold would include between 50 and 85 percent of their benefits in their taxable income depending on their income level. 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. Enter the amount from 1040-SIMPLE, line 7, on 1040-SIMPLE, line 13.
  - No. Enter the amount from 1040-SIMPLE, line 7 . . . . . 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 all marginal tax rate brackets, the Family Credit for married couples, and the Social Security benefits deduction thresholds 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 Federal Federal Savings Bonds (not for education) Corporate	Tax-Free Regular Rates Regular Rates Regular Rates	Never Yearly Time of Sale Yearly
Savings Account or Certificate of Deposit	Regular Rates	Yearly
Corporate Stock Capital Gains Dividends	Capital Gains Rate Dividend Rate	Time of Sale Year Received
Small Business <sup>1</sup>	Regular Rates	Yearly
Housing	Tax-Free up to \$500,000 <sup>2</sup>	Time of Sale
Annuities and Whole Life Insurance	Regular Rates	Year Received

<sup>1</sup> Most small businesses are not corporations and their earnings are taxed on owners' returns. <sup>2</sup> 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.

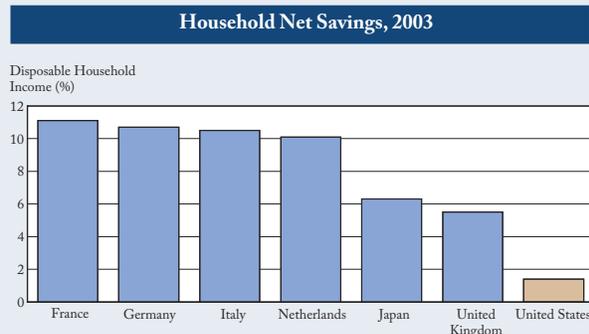
Although choosing the right tax-preferred retirement savings vehicle is complex, the tax-preferred treatment of savings for education is even more confusing. In recent years, accounts known as Coverdell education savings accounts and Section 529 plans have been added to the tax code. Choosing between 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.



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, the simplified employer-sponsored accounts 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.

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

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. Effective Marginal Tax Rates on Capital Income of Corporations by Asset Type**

Asset Type	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.

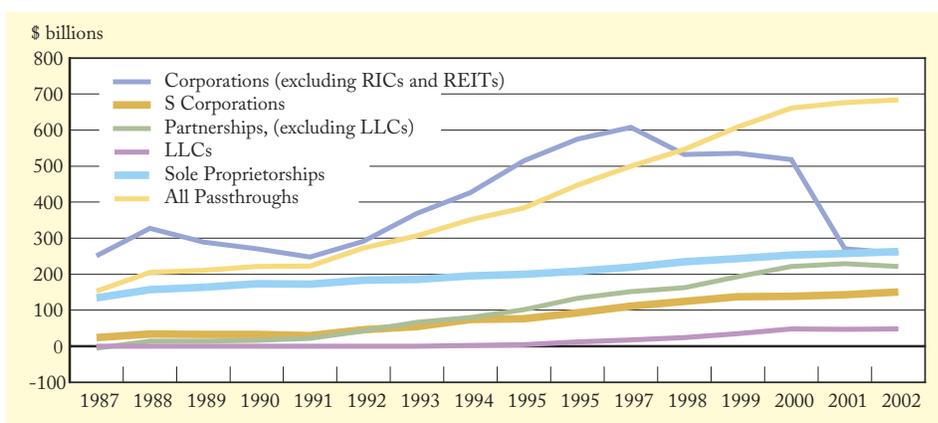
The Growth and Investment Tax Plan would take a more dramatic approach to business investment. This option would replace the system of depreciation allowances with a system that combines complete expensing of business investment and the equal treatment of debt and equity business financing. Giving businesses 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 Entities (1987-2002)**

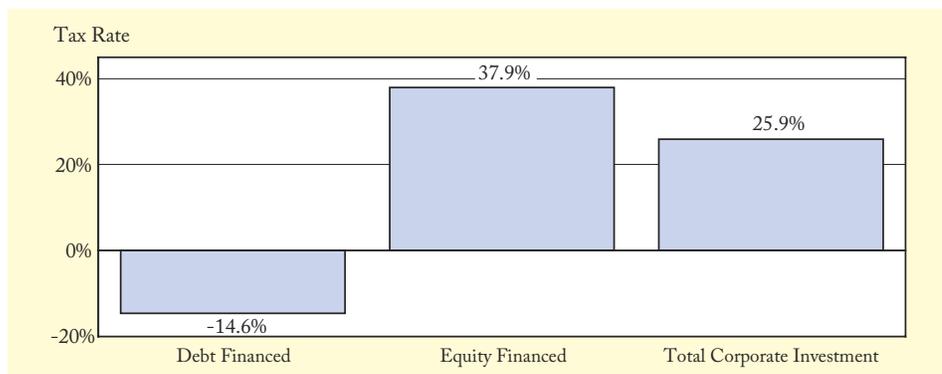


Source: Internal Revenue Service, Office of Research, Analysis, and Statistics.

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 40 percent – a 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.

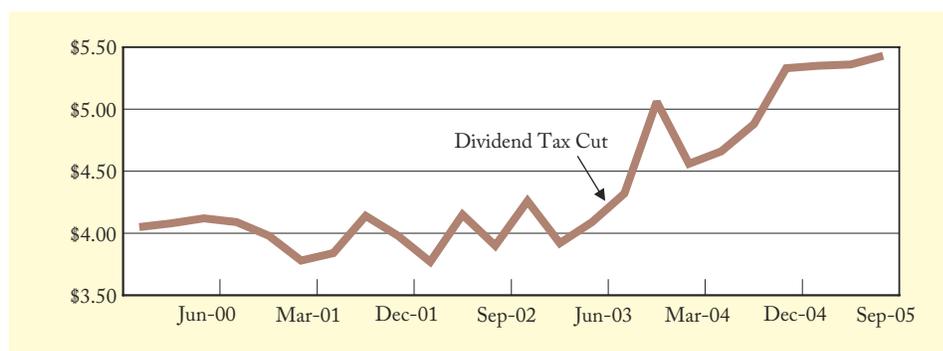
The tax bias against corporate equity encourages firms to rely on debt more than they would if the tax system imposed no such bias. The use of higher debt levels by corporations, known as “leveraging,” may increase the risk of bankruptcy and financial distress during temporary industry or economy-wide 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.

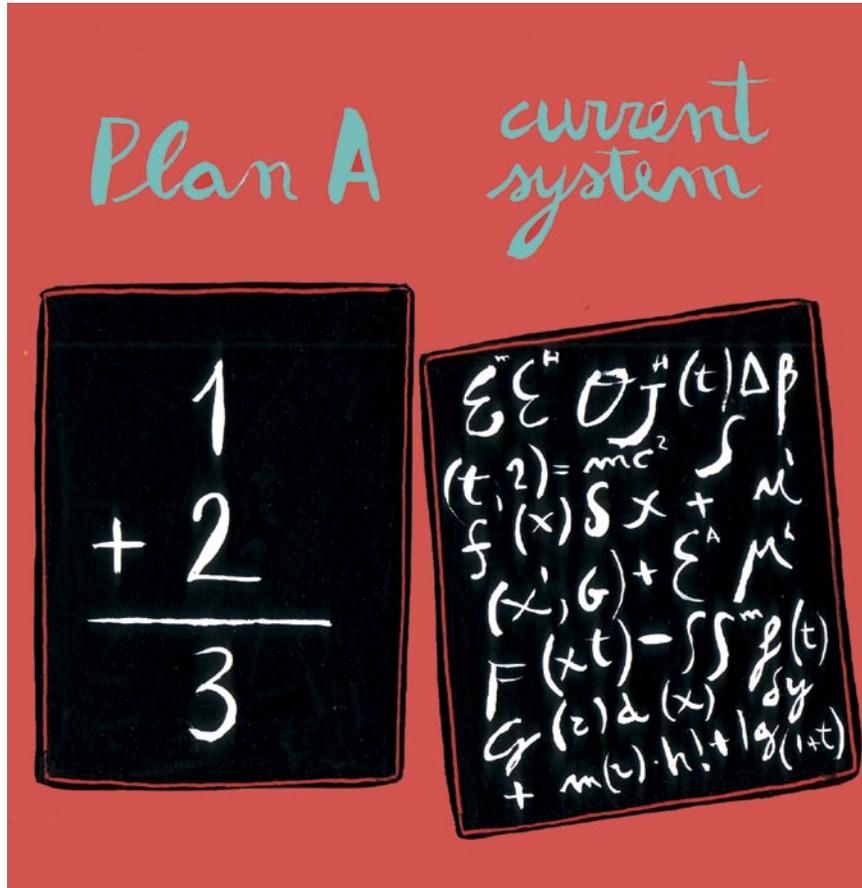
The Panel recommends the repeal of the corporate AMT, an inefficient tax that imposes enormous compliance costs on corporations relative to the amount of tax revenue it actually generates. Both of the Panel's options for reform would provide a clean tax base that is free of special breaks targeted to 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 the next chapter 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.

<b>Table 6.1. Simplified Income Tax Plan for Households</b>	
<b>Provisions</b>	<b>Simplified Income Tax Plan</b>
<b>Households and Families</b>	
Tax Rates	Four tax brackets: 15%, 25%, 30%, 33%
AMT	Repealed
Personal exemption	Replaced with Family Credit available to all taxpayers: \$3,300 credit for married couple, \$2,800 credit for unmarried with child, \$1,650 credit for singles, \$1,150 credit for dependent taxpayer; 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: \$3,570; with two or more children, \$5,800
Marriage penalty	Reduced. All tax brackets, Family Credits, and taxation of Social Security benefits for couples are double those of individuals
<b>Other Major Credits and Deductions</b>	
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).
Education	Taxpayers can claim Family Credit for some full-time students; simplified savings plans
State and local taxes	Not deductible
<b>Individual Savings and Retirement</b>	
Defined contribution plans	Consolidated into Save at Work plans that have simple rules; 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 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. How the Tax Code Would Change for Businesses**

Provisions	Simplified Income Tax Plan
<b>Small Business</b>	
Rates	Taxed at individual rates (top rate has been lowered to 33%)
Recordkeeping	Simplified cash-basis accounting
Investment	Expensing (exception for land and buildings under the Simplified Income Tax Plan)
<b>Large Business</b>	
Rates	31.5%
Investment	Simplified accelerated depreciation
Interest paid	No change
Interest received	No change
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 amount based on family 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.

<b>Tax Rate</b>	<b>Married</b>	<b>Unmarried</b>
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

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

<b>1040-SIMPLE</b>		<b>U.S. Individual Income Tax Return</b>		<b>200X</b>	(99)
For the year Jan. 1-Dec. 31, 200X, or other tax year beginning _____, 200X, ending _____, 20		OMB No. 1545-XXXX			
L A B E L  H E R E	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.	
				<b>1</b>	
1 Wages, salaries, tips, etc. Attach Form(s) W-2				<b>2</b>	
2 Business income or (loss). Attach Schedule C, C-EZ, E, or F		+		<b>3</b>	
3 Taxable interest and dividends		+		<b>4</b>	
4 Gain or (loss) on stock. Attach Schedule D		+		<b>5</b>	
5 Other gains or (losses). Attach Form 4797		+		<b>6</b>	
6 Taxable distributions (retirement and savings)		+		<b>7</b>	
7 Social security benefits		+		<b>8</b>	
8 Other income. List type and amount ▶		+		<b>9</b>	
<b>9 Add lines 1 through 8</b>		<b>Total income =</b>		<b>9</b>	
10 Charitable contributions		<b>10</b>			
11 Multiply line 9 by 1% (.01)		-		<b>11</b>	
12 Subtract line 11 from line 10. If zero or less, enter -0-		-		<b>12</b>	
13 Social security benefits deduction (see page xx)		+		<b>13</b>	
14 Health insurance deduction		+		<b>14</b>	
<b>15 Add lines 12 through 14</b>				<b>15</b>	
16 Subtract line 15 from line 9. If zero or less, enter -0-		-		<b>16</b>	
<b>16 Taxable income =</b>				<b>16</b>	
17 Figure your tax (see page xx)		<b>Tax =</b>		<b>17</b>	
18 Home credit (see page xx)		-		<b>18</b>	
19 Subtract line 18 from line 17. If zero or less, enter -0-		-		<b>19</b>	
20 Family credit from Schedule A, line 6, on back		-		<b>20</b>	
21 Subtract line 20 from line 19. If zero or less, enter -0-		-		<b>21</b>	
22 Self-employment tax		+		<b>22</b>	
23 Other taxes and foreign tax credit. Attach Schedule O		+		<b>23</b>	
<b>24 Add lines 21 through 23. If zero or less, enter -0-</b>		<b>Total tax =</b>		<b>24</b>	
25 Federal income tax withheld		<b>25</b>			
26 Work credit		+		<b>26</b>	
27 Savers credit. Attach Form XXXX		+		<b>27</b>	
28 Estimated tax and other payments		+		<b>28</b>	
<b>29 Add lines 25 through 28</b>		<b>Total payments =</b>		<b>29</b>	
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		<b>Amount overpaid =</b>		<b>30</b>	
31 Amount of line 30 you want applied to your 200Y estimated tax		<b>31</b>			
32 If line 24 is more than line 29, subtract line 29 from line 24		<b>Amount you owe =</b>		<b>32</b>	
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.					
Sign Here		Your signature		Date	Your occupation
Married? See page xx. Keep a copy for your records.		Spouse's signature. If filing with spouse, both must sign.		Date	Spouse's occupation
				If married but not filing with spouse, check here <input type="checkbox"/> Daytime phone number ( )	
Paid Preparer's Use Only		Preparer's signature		Date	Check if self-employed <input type="checkbox"/>
		Firm's name (or yours if self-employed), address, and ZIP code		EIN	Preparer's SSN or PTIN
				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.

<b>Table 6.4. Example of Variation in Small Employer Retirement Plans</b>		
	<b>401(k) Plan</b>	<b>SIMPLE IRA Plan</b>
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	<i>Either</i> 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.

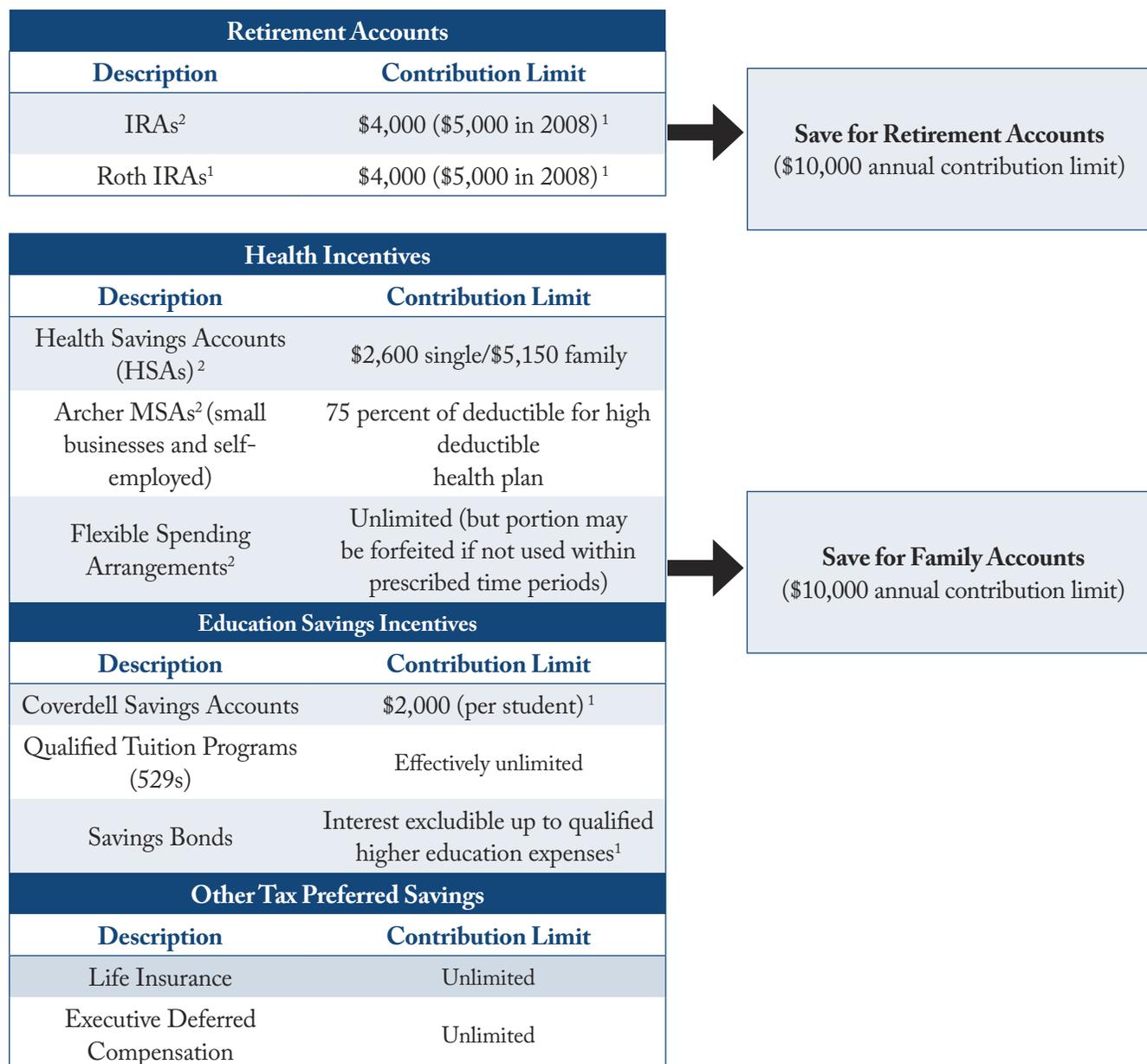
All Americans, regardless of income, age, family structure, or marital status, could have a Save for Family account. Contributions would be made on an after-tax basis, and like current-law Roth IRAs, earnings would grow tax-free. Existing education and health savings plans could be converted to Save 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**



<sup>1</sup> Contribution limit may phase out based on income.

<sup>2</sup> 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. 1545-0000 <b>200X</b> 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 <input type="checkbox"/> Yes <input type="checkbox"/> No					
G If you started or acquired this business during 200X, check here <input type="checkbox"/>					
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). <input type="checkbox"/> All investment is at risk. <input type="checkbox"/> 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. XXXXXX 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 thresholds.

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.

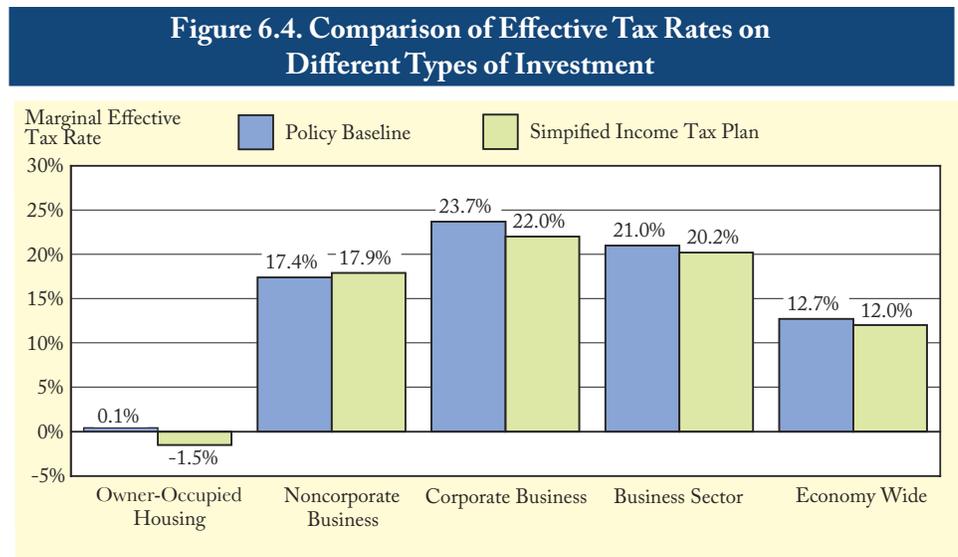
Currently, there are only about 150,000 active U.S. businesses that have more than \$10 million in receipts. Requiring all large entities, including partnerships, to abide by the same business tax rules would provide fewer opportunities for tax shelters and less exploitation of loopholes. For example, 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, and is often received by tax-exempt parties. 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.



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.

	<b>Category I</b>	<b>Category II</b>	<b>Category III</b>	<b>Category IV</b>
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 is a hybrid of 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.

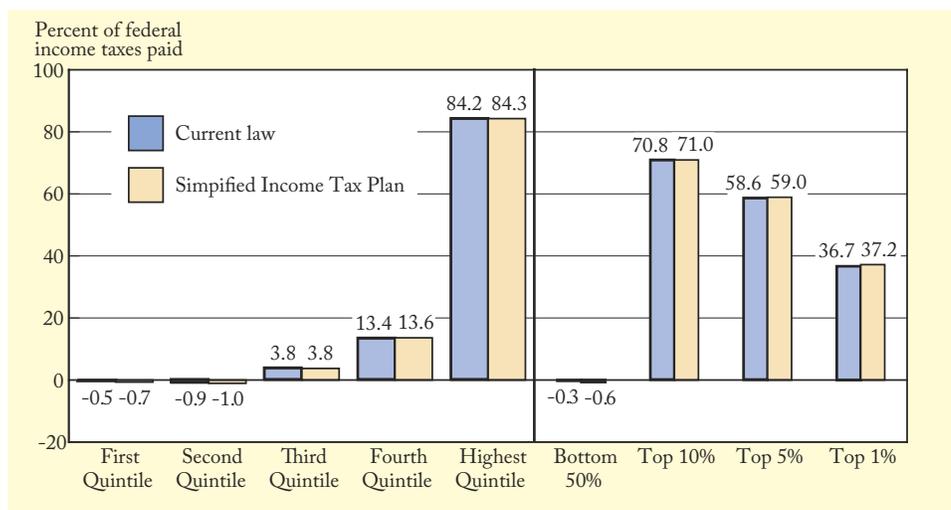
To prevent this tax-motivated ploy, the Simplified Income Tax Plan would provide a comprehensive rule that treats a business as a resident of the U.S. (and subject to U.S. tax) if the United States is the business's place of legal residency or if the United States is the business's place of "primary 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.

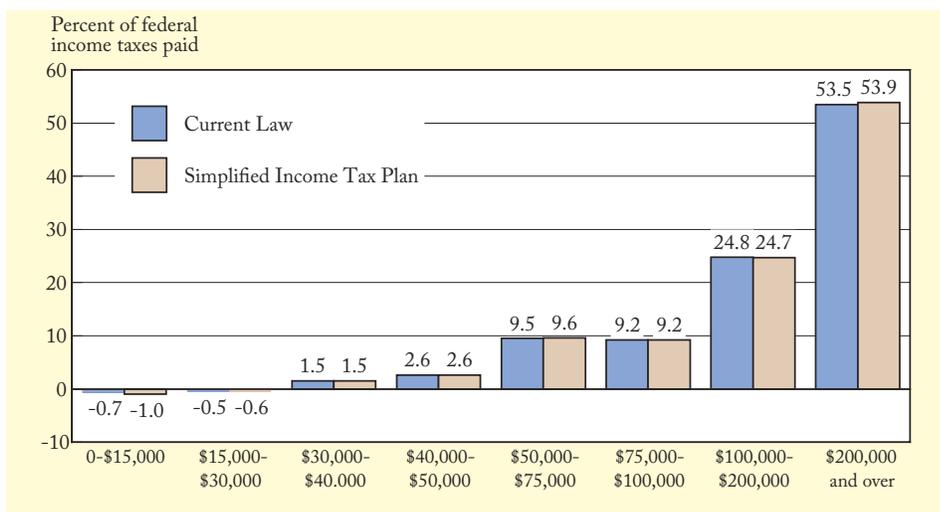
**Figure 6.5. Distribution of Federal Income Tax Burden Under Current Law and the Simplified Income Tax by Income Percentile (2006 Law)**



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.

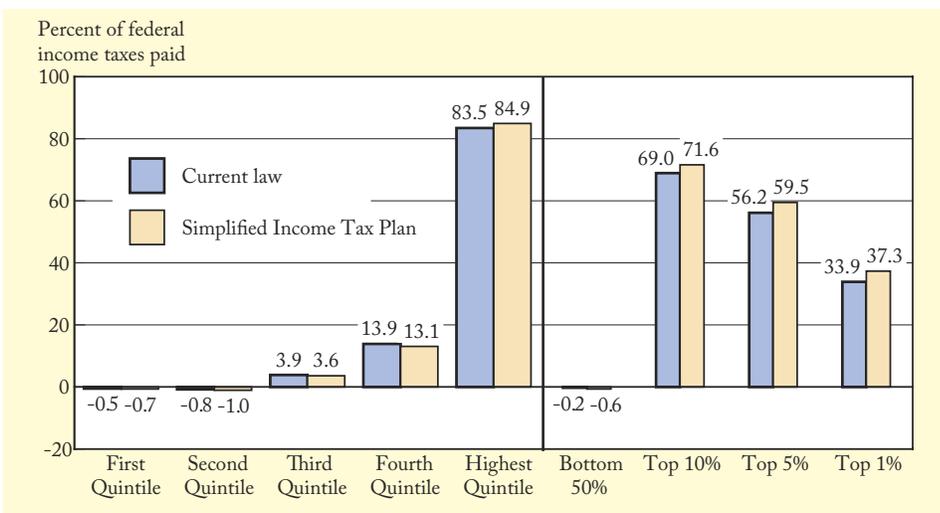
**Figure 6.6. Distribution of Federal Income Tax Burden Under Current Law and the Simplified Income Tax Plan by Income Level (2006 Law)**



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

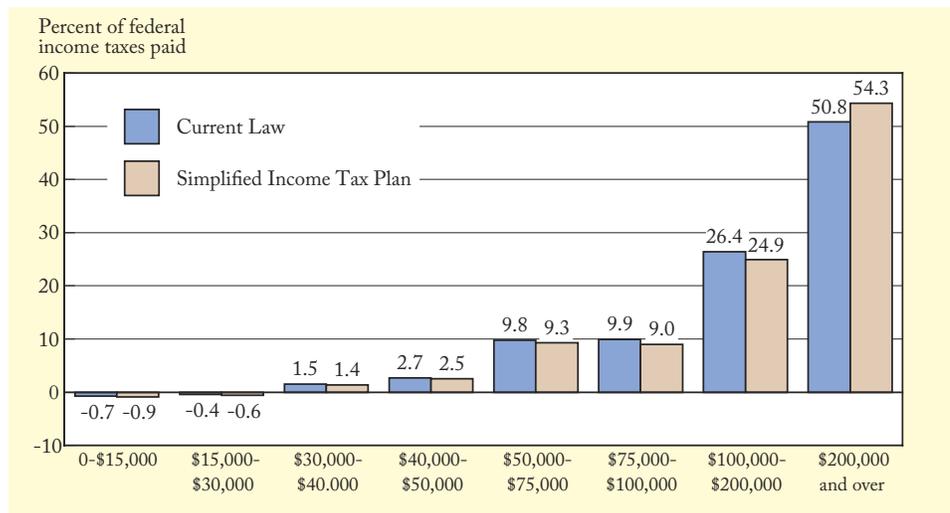
To provide additional information about the effect of the Simplified Income Tax Plan, the Panel asked the Treasury Department to provide a distribution of the Simplified Income Tax Plan for 2015, the last year of the budget window. Figures 6.7 and 6.8 compare the effect of the Simplified Income Tax Plan 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 Income Tax Plan by Income Percentile (2015 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 6.8. Distribution of Federal Income Tax Burden Under Current Law and the Simplified Income Tax by Income Level (2015 Law)**

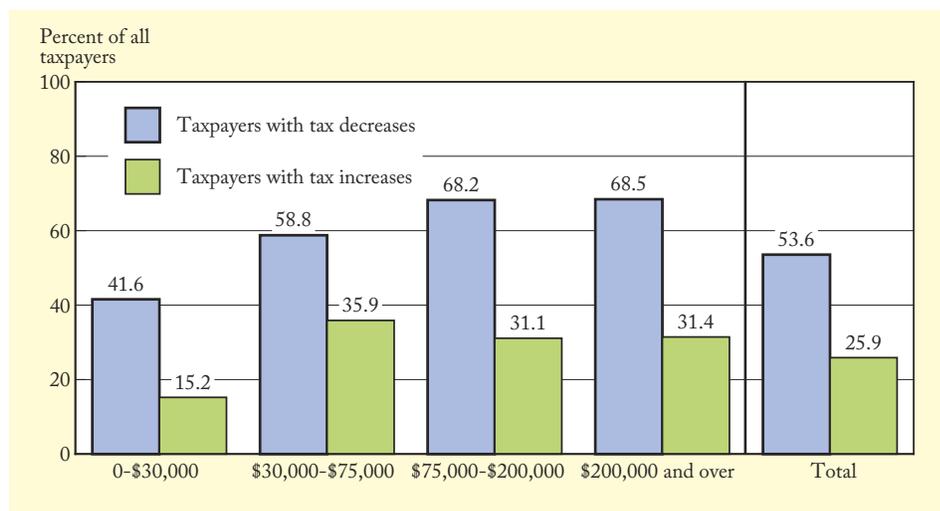


Note: Estimates of 2006 law at 2006 cash income levels.  
 Source: Department of the Treasury, Office of Tax Analysis.

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)**

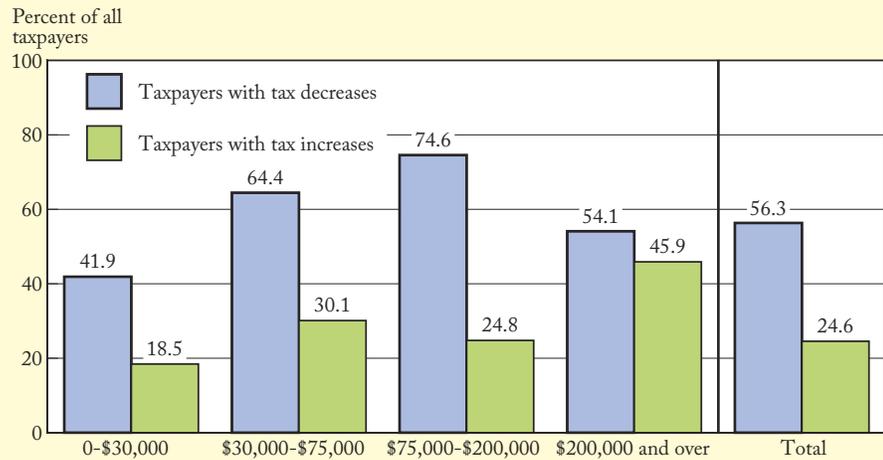


Note: Estimates of 2006 law at 2006 cash income levels. Figure does not show the percentage of taxpayers who have neither an increase nor a decrease in tax liability.

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**

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	
<b>Single Taxpayers Younger Than 65</b>													
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%
<b>Heads of Household Younger Than 65</b>													
(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%
<b>Married Filing Jointly Younger Than 65</b>													
(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%
<b>Single Taxpayers (and Surviving Spouses) Age 65 and Over*</b>													
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%
<b>Married Filing Jointly Age 65 and Over**</b>													
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 95<sup>th</sup> 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 25<sup>th</sup> 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, 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 this is no longer the case – 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					
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					
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**

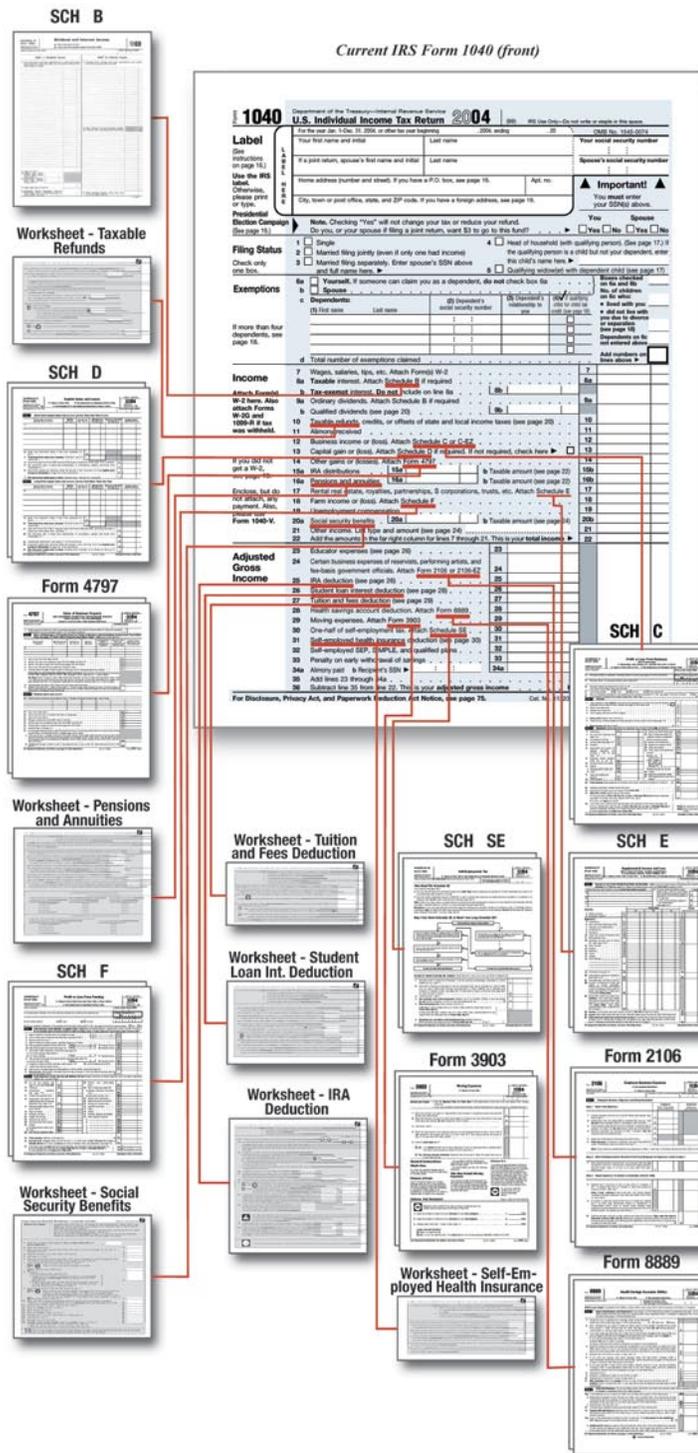
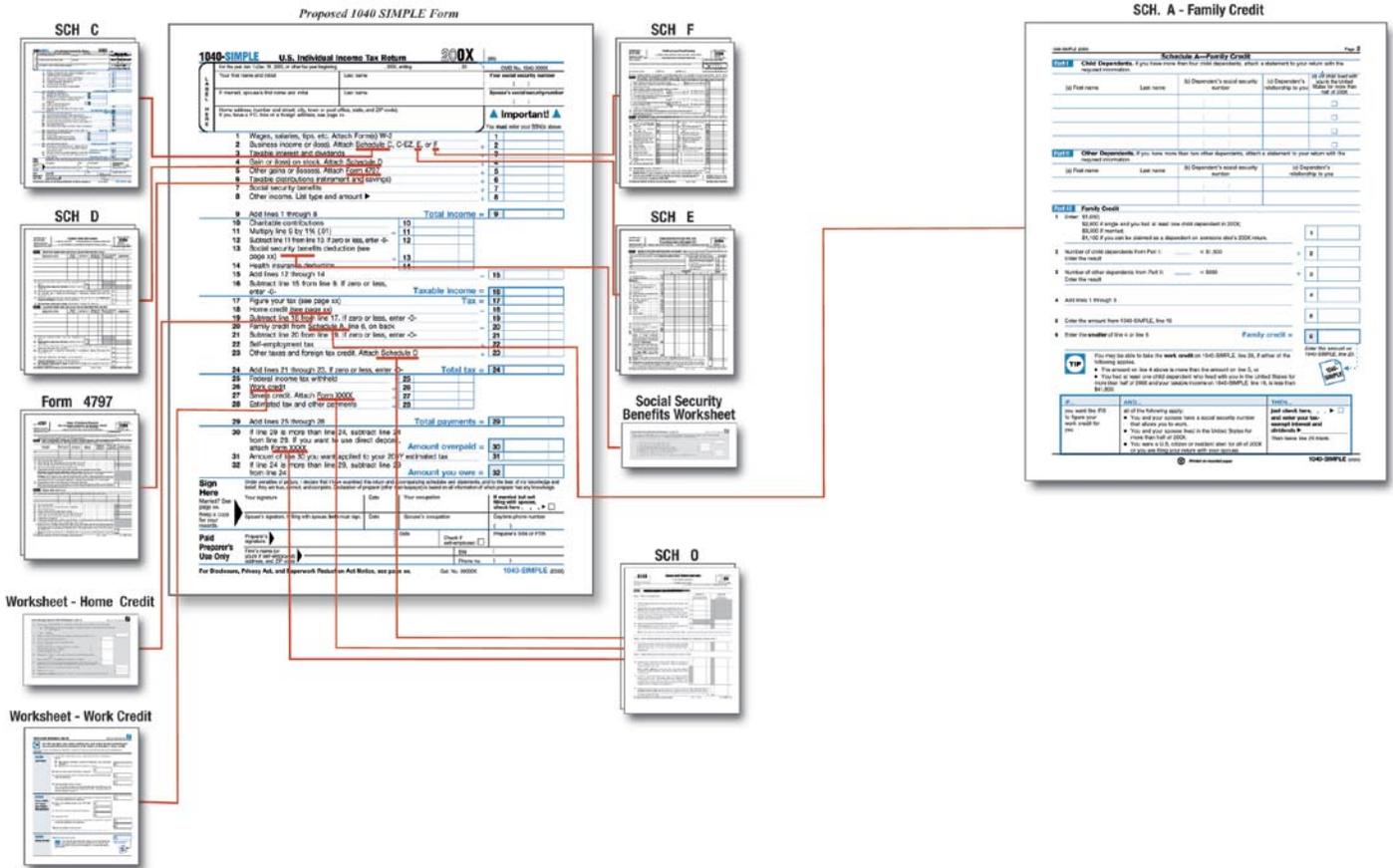




Figure 6.12. Form 1040 SIMPLE with Related Schedules, Forms, and Worksheets



## **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 AMT patch was extended and indexed, the Panel would not have been required to account for that additional amount of tax revenue and could have used that revenue to lower tax rates under the Simplified Income Tax Plan by 5 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 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 1.4 percent to 2.3 percent over the long run.

