TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH

The Treasury Department Report to the President

Volume 1 Overview

Office of the Secretary
Department of the Treasury

November 1984

THE SECRETARY OF THE TREASURY
WASHINGTON D.C. 20220

November 27, 1984

Dear Mr. President:

I am pleased to submit the Treasury Department's Report on Fundamental Tax Simplification and Reform that you requested in your State of the Union address in January. It contains proposals for a broad-based income tax that would allow us to lower marginal tax rates for individuals by an average of 20 percent and the corporate rate from 46 percent to 33 percent. The proposals would make the tax system simpler, fairer, and more economically efficient.

The present U.S. income tax is complex, it is inequitable, and it interferes with economic choices of households and businesses. It is also widely perceived to be unfair. Because this perception undermines taxpayer morale, it may be as important as the actual defects of the system.

In your State of the Union address, you said:

> "To talk of meeting the present situation by increasing taxes is a Band-Aid solution which does nothing to cure an illness that has been coming on for half a century, to say nothing of the fact that it poses a real threat to economic recovery....
>
> There is a better way: Let us go forward with an historic reform for fairness, simplicity and incentives for growth. I am asking Secretary Don Regan for a plan for action to simplify the entire tax code so all taxpayers, big and small, are treated more fairly.... I have asked that specific recommendations, consistent with those objectives, be presented to me by December 1984."

Further we believe we have followed your mandate of May 1984 to design a sweeping and comprehensive reform of the entire tax code. The Treasury Department study focused on four options: a pure flat tax, a modified flat tax, a tax on income that is consumed, and a general sales tax, including a value-added tax and retail sales taxes.

The objectives of our study included: lower marginal tax rates; reduced interference with private economic decisions; simplicity; revenues equal to those of the existing tax system; fairness for families; equal treatment of all sources and uses of income; an unchanged distribution of tax burdens across income classes; and encouragement to economic growth.

We believe that our proposals for a modified flat tax best reconcile these competing objectives. They include some features that are similar to those in flat tax proposals that have been offered by members of Congress, but our proposals are much more comprehensive.

The adoption of these reforms should have far reaching and positive effects on the U.S. economy. Rate reductions of the magnitude we propose will open wide the doors of opportunity to those who are willing to work, to save and invest, and to innovate. With investment decisions being determined by economic consequences, rather than by the tax system, capital will be allocated more efficiently across industries, and growth will accelerate.

If tax reform is not adopted, the complexities, inequities, and distortions of the present system will increase and continue to hinder our nation's progress. Moreover, taxpayer morale will continue to deteriorate, and the so-called tax gap will grow.

The proposals presented in this Report form an integrated package. In some cases neutrality between competing industries can be achieved only if the special preferences benefitting each industry are eliminated. In other cases, changes are mutually dependent and must occur together to avoid inequities, distortions, and extraordinarily complex administrative rules and increased compliance costs to taxpayers. Most importantly, any change in the package inevitably means that the proposed rate structure must be redesigned in order to keep tax burdens constant -- in total and across income classes. Each credit, deduction or deferral of tax that is retained in current law means that tax rates higher than those proposed in the Report will be necessary to attain the same level of revenues. Moreover, if any special tax benefits are left intact, it will be more difficult to resist appeals by others for special treatment.

These proposals are bold, and they will be controversial. Those who benefit from the current tax preferences that distort the use of our nation's resources, that complicate paying taxes for all of us, and that create inequities and undermine taxpayer morale will complain loudly and seek support from every quarter. But a far greater number of Americans will benefit from the suggested rate reduction and simplification. The achievement of fundamental tax reform -- and the manifest benefits it would entail -- will require extraordinary leadership.

I am fully convinced that these proposals constitute the substance of tax simplification and reform that this nation so badly needs. I look forward to working with you and others to secure their enactment.

Respectfully,

Donald T. Regan

Donald T. Regan

The President
The White House
Washington, D.C. 20500

Summary of Proposals

Introduction

The present U.S. tax system desperately needs simplification and reform. It is too complicated, it is unfair, and it retards savings, investment, and economic growth.

Under the current progressive tax system, all taxpayers face higher marginal tax rates in order to make up for the revenue lost by numerous special preferences, exceptions, and tax shelters used by a relatively small number of taxpayers.

As a result, the tax system is complex and inequitable. It reduces economic incentives, hampers economic growth, and is perceived to be so unfair that taxpayer morale and voluntary compliance have been seriously undermined.

As requested by President Reagan in his 1984 State of the Union Address, the Treasury Department has completed a thorough review of the U.S. tax system. This summary outlines the Department's proposals for a fundamental reform and simplification of the income tax system which would raise approximately the same amount of revenues as current law with lower tax rates imposed on a broader tax base.

The Treasury Department is proposing a new income tax system which is broad-based, simple, and fair. It reflects the enormous public input generated by a series of public hearings held throughout the country.

The Treasury Department's recommendation reflects the broad political consensus of the American people that the present system is too complicated and favors special interests at the expense of the general public. While much more comprehensive and far-reaching than other proposals, it resembles several plans for tax reform advanced by members of Congress, especially the Kemp-Kasten and Bradley-Gephardt plans. This bipartisan congressional consensus augurs well for quick action by the Congress.

Tax Simplification and Reform for Individuals

The Treasury Department proposals combine lower tax rates, increased personal exemptions, and zero bracket amounts with the repeal or modification of a number of existing deductions, exclusions and credits. The proposal does not generally change the distribution of individual tax burden across income classes, though it does reduce tax burdens more than proportionally for taxpayers with the lowest incomes.

Rate Structure

The Treasury Department proposal replaces the present 14 brackets of tax rates ranging from 11 to 50 percent with a simple three-bracket system with tax rates set at 15, 25 and 35 percent. (See Tables S-1 and S-2.)

Fairness for Families

In order to provide greater fairness for families, the Treasury Department proposal will increase the personal exemption for all taxpayers and their dependents to $2,000 and increase the zero bracket amounts to $2,800 for singles, $3,800 for joint returns, and $3,500 for heads of households.

These adjustments will virtually eliminate from taxation families with incomes below the poverty level. The individual tax brackets, the personal exemption, and the zero bracket amount would continue to be indexed.

Impact on Individuals

Under the proposal, 78 percent of all taxpayers will experience either no tax change or a tax decrease, and 22 percent will face higher taxes. Of those facing a tax increase, more than half will experience a tax increase of less than one percent of income.

On average, marginal tax rates will be reduced by about 20 percent and individual tax liabilities will be reduced by an average of 8.5 percent. Because of the increased tax-free threshold, the average tax reductions are greater at the bottom of the income scale. Tax liabilities of families with incomes below $10,000 will be reduced by an average of 32.5 percent, and the reduction in taxes for families with incomes of $10,000 to $15,000 will be 16.6 percent.

Broadening the Base

In order to broaden the base, simplify the tax system, and eliminate special preferences and abuses, the Treasury Department proposals would modify or repeal a number of itemized deductions, exclusions, and special tax credits.

These changes generally involve special preferences which are not used by the majority of individual taxpayers and include various fringe benefits, wage replacement payments, preferred uses of income, business deductions for personal expenses such as entertainment, and other areas of abuse.

For most taxpayers who do itemize deductions, the marginal rate reductions and the increased personal exemption will offset the benefits lost from the various proposed reforms. However, those taxpayers who consistently make above-average use of deductions and exclusions to shelter their income in order to avoid paying a fair share of the tax burden will face an increase in taxes.

The Treasury Department proposal retains the existing itemized deductions above certain floors for medical expenses and for casualty losses.

The home mortgage interest deduction is retained for a taxpayer's principal residence. Certain other interest deductions, including consumer interest and interest on second homes, are allowed up to $5,000 in excess of investment income.

The itemized deduction for charitable contributions is retained, but allowed only for charitable contributions in excess of two percent of adjusted gross income.

The deduction for contributions to an Individual Retirement Account is retained and increased from $2,000 to $2,500 per employee. The current $250 spousal IRA limit would be increased to $2,500 for spouses working in the home.

The Social Security benefit exclusion, which generally excludes from taxation Social Security benefits, would be retained.

The existing child care credit would be replaced with a child care deduction.

The earned income tax credit would be retained and indexed for inflation.

A new, single credit for the elderly, blind and disabled would be provided, and the current exclusions for workers' compensation, and for black lung and certain veterans' disability payments would be folded into the credit.

The two-earner deduction, no longer necessary under the revised rate brackets, would be repealed.

The current exclusions for employer-provided pension and profit-sharing plans are retained as are the treatment of certain hard-to-value fringe benefits specifically addressed in the Deficit Reduction Act of 1984.

The exclusion of health insurance benefits would be retained, but capped at $70 per month for singles and $175 per month for a family. This change would affect only about 30 percent of all employees with such plans.

The special exclusion of group-term life insurance and the special treatment of cafeteria plans would be repealed, as would the exclusion of other employer-provided fringe benefits, such as educational benefits, legal services, and dependent care.

The tax-exempt threshold for unemployment compensation, currently set at $18,000 for a joint return, would be repealed. It is not fair that those receiving unemployment compensation pay no tax, while those with equal incomes who work pay tax. With the personal exemption and zero bracket amount increased to $11,800 for a family of four, the impact of this change on low and moderate income taxpayers would be minimal.

Itemized deductions for all state and local taxes would be repealed. These deductions are claimed on only a minority of tax returns, and disproportionately benefit higher income individuals in high-tax states and localities.

The use of business deductions for personal expenses would be curtailed. Deductions for entertainment would be denied, and deductions for business meals would be limited.

Income Distribution

The Treasury Department proposals are designed to be basically neutral from a distributional point of view. The table below shows that the distribution of individual income tax burdens does not differ significantly from that under current law.

	Percent of Total Income Taxes Paid	
Income Class (000)	Current Law	Treasury Proposal
$ 0-10	0.5%	0.3%
10-15	1.8	1.6
15-20	3.3	3.1
20-30	10.3	10.2
30-50	24.3	24.1
50-100	32.8	33.1
100-200	12.3	12.6
200+	14.9	15.0

Average Tax Rates

The proposed tax reforms will reduce individual tax liabilities for all income classes by an average of 8.5 percent. However, those at the bottom of the income scale will receive substantial tax reductions, and those with incomes up to $50,000 will experience above-average reductions in tax liability, as the following table shows.

Average Tax Rate by Income Class

Income Class (000)	Current Law	Treasury Proposal	Change
$ 0-10	1.4%	0.9%	-32.5%
10-15	3.2	2.7	-16.6
15-20	4.6	4.0	-12.1
20-30	6.2	5.7	- 9.1
30-50	7.8	7.0	- 9.3
50-100	9.4	8.7	- 7.4
100-200	13.2	12.3	- 6.4
200+	20.9	19.3	- 8.0

Marginal Tax Rates

The Treasury proposal would reduce marginal tax rates by an average of nearly 20 percent. Although marginal tax rates are reduced by a larger percent for those at the top, these income groups will experience smaller than average tax reductions, as shown in the preceding table. Marginal tax rates fall furthest at the top of the income distribution because that is where the tax base is increased by the largest fraction.

Marginal Tax Rate by Income Class

Income Class (000)	Current Law	Treasury Proposal	Change
$ 0-10	4.2%	3.7%	-11.9%
10-15	9.4	8.5	- 9.6
15-20	12.4	11.0	-11.3
20-30	16.0	14.0	-12.5
30-50	20.9	16.5	-21.1
50-100	27.6	22.1	-19.9
100-200	37.5	30.5	-18.7
200+	46.1	33.2	-28.0

Tax Simplification

The Treasury proposal repeals or consolidates about 65 provisions in the tax Code. It eliminates the need for at least 16 tax forms and 10 lines from the 1040 form.

The proposed changes will reduce the number of individual taxpayers who itemize their deductions from 36 percent to fewer than 25 percent of all individual taxpayers.

In addition, the Internal Revenue Service is proceeding to develop a return-free tax system. Under such a system, the IRS would, at the election of the taxpayer, compute the tax liability of most taxpayers based on withholding and information reports. Institution of a return-free tax system could eliminate the actual filing of tax returns for half or more than half of all taxpayers.

Reform of Capital and Business Income

The taxation of capital and business income in the United States is deeply flawed. It lacks internal consistency, and it is ill-suited to periods when inflation rates have varied and been unpredictable. It contains subsidies to particular forms of investment that distort choices in the use of the nation's scarce capital resources. It provides opportunities for tax shelters that allow wealthy individuals to pay little tax, undermine confidence in the tax system, and further distort economic choices. Equity investment in the corporate sector is placed at a particular disadvantage by the double taxation of dividends. Resulting high marginal tax rates discourage saving, investment, invention, and innovation. Moreover, high marginal rates encourage efforts to obtain additional special tax benefits which, if successful, further erode the tax base and necessitate higher rates in a never-ending cycle.

The Treasury Department's tax reforms would rationalize the taxation of income from business and capital. An overriding objective is to subject real economic income from all sources to the same tax treatment.

Implementation of the reforms proposed by the Treasury Department would cause improved reallocations of economic resources. The lower tax rates made possible by base-broadening and the more realistic rules for the measurement of income and calculation of tax liabilities will increase the attractiveness of industries that suffer under the weight of the current unfair and distortionary tax regime. Both established industries and new "high-tech" industries will benefit from tax reform. But the ultimate beneficiaries will be the American public. No longer will the nation's scarce economic resources--its land, its labor, its capital, and its inventive genius--be allocated by the tax system, instead of by market forces. The result will be more productive investment, greater opportunities for employment, more useful output, and faster economic growth.

Lower Corporate Tax Rates

The Treasury Department's proposals would allow the corporate tax rate to be reduced to 33 percent. All corporations would be subject to this single rate, which is 2 percentage points below the proposed top individual rate.

Capital Gains

Capital gains on assets held for at least a prescribed period have long benefitted from preferential tax treatment. Partial exclusion of capital gains has been justified by the need to avoid taxing fictitious gains that merely reflect inflation.

The Treasury Department approach to the inflation problem is more direct--and therefore more equitable and more neutral. Under it the basis (original cost) of assets used in calculating gains would be adjusted for inflation, so that only real gains would be subject to tax. With this inflation adjustment and a rate structure with only a few wide income brackets in place, there would be little need for preferential tax treatment of realized capital gains. Investment in capital assets will continue to enjoy the substantial benefits of deferral of tax until gains are realized. At even moderate rates of inflation, the taxation of real gains as ordinary income at the proposed rates is more generous than the taxation of nominal gains at the current preferential rates. The reduced rates proposed in this report would alleviate any problems of lock-in and bunching.

Capital Consumption Allowances

The investment tax credit (ITC) and the accelerated cost recovery system (ACRS) were introduced to stimulate investment and prevent capital consumption allowances from being eroded by inflation. Since the present tax system does not adjust the basis of depreciable assets for inflation, these provisions were required to prevent confiscatory taxation of income from capital.

At the lower rates of inflation prevailing today, the ITC and ACRS allow investment in depreciable assets to be recovered far more rapidly than under a neutral system of income taxation. As a result, the tax system favors industries that invest heavily in depreciable assets such as equipment over others such as high technology industries, service industries, and the trade sector that invests more heavily in inventories.

Because the advantages of the ITC and ACRS are "front-loaded," these provisions are of relatively little value to new and rapidly growing firms or to ailing industries, neither of which can fully utilize their benefits. New firms are penalized and there are incentives for tax-motivated mergers. The result is reduced competitiveness and less incentive for innovation. The front-loading of tax benefits also leads to the proliferation of tax shelters, many of which are abusive and create severe administrative burdens for the Internal Revenue Service.

To assure that capital consumption allowances will be more nearly appropriate, regardless of the rate of inflation, the Treasury Department proposes that the investment tax credit be repealed, that the basis of depreciable assets be indexed for inflation, and that depreciation allowances for tax purposes be set to approximate economic depreciation.

Relief for Double Taxation of Dividends

Under present law equity income originating in the corporate sector is taxed twice--first as corporate profits and then as dividends. This double taxation of dividends discourages saving and discriminates against investment in the corporate sector. The Treasury Department proposes that the United States do what many other developed countries do, continue to levy the corporate income tax on earnings that are retained, but provide partial relief from double taxation of dividends. The proposal allows corporations to deduct a portion of the dividends paid out of previously-taxed earnings.

Subsidies for Specific Industries

Certain industries benefit from special tax preferences that have no place in a comprehensive income tax. These include the energy and financial sectors. Moreover, the exclusion of interest on bonds issued by state and local governments for private purposes detracts from the fairness of the tax system, as well as distorting capital flows.

Energy

To be consistent with the goal of increased reliance on free-market forces underlying both this Administration's energy policy and these proposals for fundamental tax reform, the Treasury Department proposes that expensing of intangible drilling costs and percentage depletion should be replaced by cost depletion. The proposed rules are identical to proposed changes in the general rules for income measurement for all multi-period production, which require cost capitalization in order to match deductions with taxable receipts.

Consistent with our objective to make the tax system neutral, the Treasury Department proposes to accelerate the phase-out of the Windall Profits Tax to 1988.

Financial Institutions

The Treasury proposal repeals the preferential tax treatment available to most types of financial institutions. Besides being unfair and distortionary, relative to the taxation of the rest of the economy, these tax preferences create distortions within the financial sector that are inconsistent with the Administration's efforts to deregulate financial markets. Equity and neutrality demand that all financial institutions be taxed uniformly, on all of their net income. These special preferences are especially inappropriate in a world in which the corporate tax rate is lowered and both individuals and other corporations are taxed more nearly on their economic income.
These special preferences are especially inappropriate in a world in which the corporate tax rate is lowered and both individuals and other corporations are taxed more nearly on their economic income.

State and Local Government Bonds

Interest on debt issued by state and local governments for public purposes, such as schools, roads and sewers ("public purpose municipal bonds"), has long been exempt from tax. State and local governments have recently expanded the use of tax-exempt bonds in ways that do not have any "public" purpose. Proceeds from tax-exempt bonds have been used for economic development (via industrial development bonds or IDBs), for low-interest mortgages on owner-occupied housing, for student loans, and for private hospital and educational facilities. In addition, state and local governments have routinely invested proceeds of tax-exempt bonds in higher-yielding taxable securities to earn arbitrage profits.

The Treasury Department proposal would subject to tax the future issuance of all "private purpose" tax-exempt bonds and tighten the restrictions on arbitrage.

The elimination of private purpose bonds should be of financial benefit to state and local governments. Reducing the volume of tax-exempt bonds will improve the market for public purpose bonds, thus reducing interest costs to governments.

Curtailment of Tax Shelters

As a result of the growth in tax shelter activity, there has been a significant erosion in the base of the Federal income tax, particularly among taxpayers with the highest incomes. Estimates from the 1983 Treasury individual tax model indicate that partnership losses may shelter as much as $35 billion of all individual income from taxation. Roughly 82 percent of this total, or $28.6 billion in partnership losses were reported by taxpayers with gross incomes (before losses) of $100,000 or more, and 60 percent, or $21.0 billion, were reported by taxpayers with incomes in excess of $250,000. By comparison, these groups reported 9 percent and 4 percent, respectively, of all gross income before losses reported by individuals.

Several of the Treasury Department's proposals--for example, lower tax rates, taxation of real capital gains as ordinary income, capital consumption allowances that approximate economic depreciation, indexing of net interest expense, matching expenses and receipts from multiperiod production, and tax treatment of certain large partnerships as corporations--will greatly reduce the attractiveness of tax shelters. Yet opportunities for tax shelters will remain, and several proposals are being made to further reduce these opportunities.

Table S-1

Comparison of Tax Rates Under Current Law and Proposal for 1986

Single Returns			Head of Household Returns			Joint Returns		
Taxable income	Marginal tax rate: Current Law 1/	Marginal tax rate: Proposal	Taxable income	Marginal tax rate: Current Law 1/	Marginal tax rate: Proposal	Taxable income	Marginal tax rate: Current Law 1/	Marginal tax rate: Proposal
	(percent)			(percent)			(percent)	
Less than $ 2,800	0-11	0	Less than $ 3,500	0-11	0	Less than $ 3,800	0-11	0
$2,800 to 19,300	11-23	15	$3,500 to 25,000	11-24	15	$3,800 to 31,800	11-25	15
$19,300 to 38,100	23-38	25	$25,000 to 48,000	24-35	25	$31,800 to 63,800	25-38	25
$38,100 or more	38-50	35	$48,000 or more	35-50	35	$63,800 or more	38-50	35

Office of the Secretary of the Treasury
Office of Tax Policy

1/ Estimated.

Table S-2

Comparison of Tax Rates Under Current Law and Proposal for 1986

Single Returns			Head of Household Returns			Joint Returns		
Taxable income	Marginal tax rate: Current Law 1/	Marginal tax rate: Proposal	Taxable income	Marginal tax rate: Current Law 1/	Marginal tax rate: Proposal	Taxable income	Marginal tax rate: Current Law 1/	Marginal tax rate: Proposal
Less than $2,510	0		Less than $2,510	0		Less than $3,710	0	
2,510 - 3,710	11	0	2,510 - 4,800	11	0	3,710 - 6,000	11	0
3,710 - 4,800	12		4,800 - 7,090	12		6,000 - 8,290	12	
4,800 - 7,090	14		7,090 - 9,490	14		8,290 - 12,990	14	
7,090 - 9,280	15		9,490 - 12,880	17		12,990 - 17,460	16	
9,280 - 11,790	16	15	12,880 - 16,370	18	15	17,460 - 22,040	18	15
11,790 - 14,080	18		16,370 - 19,860	20		22,040 - 26,850	22	
14,080 - 16,370	20		19,860 - 25,650	24		26,850 - 32,630	25	
16,370 - 19,860	23		25,650 - 31,430	28		32,630 - 38,410	28	
19,860 - 25,650	26	25	31,430 - 37,210	32	25	38,410 - 49,980	33	25
25,650 - 31,430	30		37,210 - 48,780	35		49,980 - 65,480	38	
31,430 - 37,210	34		48,780 - 66,130	42		65,480 - 93,420	42	
37,210 - 45,290	38		66,130 - 89,270	45		93,420 - 119,390	45	
45,290 - 60,350	42	35	89,270 - 118,190	48	35	119,390 - 117,230	49	35
60,350 - 89,270	48		118,190 or more	50		177,230 or more	50	
89,270 or more	50							

Office of the Secretary of the Treasury
Office of Tax Analysis

November 26, 1984

1/ Estimated.

Comparison of Current Law and Treasury Proposal Highlights

	1986 Current Law	Treasury Proposal
INDIVIDUAL TAX RATES	14 rate brackets from 11 to 50%	3 rate brackets 15, 25 & 35%
EXEMPTIONS		
Self, spouse	$1,090	$2,000
Dependents	$1,090	$2,000
ZERO BRACKET AMOUNT		
Single	$2,510	$2,800
Joint	$3,710	$3,800
Heads of Household	$2,510	$3,500
INDEXED RATE BRACKETS, EXEMPTIONS AND ZBA	Yes	Yes
PERSONAL DEDUCTIONS		
Mortgage Interest	Yes	Yes, for principal residences
Other personal interest	Yes	Limited to $5,000 over investment income
Medical expenses	Yes (above 5% of AGI)	Yes (above 5% of AGI)
Charitable contributions	Yes	Yes (above 2% of AGI) but no deduction for unrealized gains on contributed property.
State and local income tax	Yes	No
Other State and local taxes	Yes	No, unless incurred in income-producing activity.
Two-earner deduction	Yes	No
OTHER INDIVIDUAL ITEMS		
Earned Income Credit	Yes	Yes, indexed
Child Care Credit	Yes	Deduction
Unemployment Compensation	Taxed if AGI over $12,000 ($18,000 if married)	Taxed
Workers' Compensation	Not taxed	Taxed, but eligible for special credit for elderly and disabled
Entertainment expenses	Deducted	No
Business Meals and Travel Expenses	Deducted	Capped
Income shifting to children and via trusts	Permissible	Curtailed

RETIREMENT SAVINGS		
IRA	$2,000	$2,500
Spousal IRA	$ 250	$2,500
Corporate pensions	Tax deferred	Tax deferred
Social Security	Generally not taxed	Generally not taxed
FRINGE BENEFITS		
Health insurance	Excluded	Capped Exclusion
Group life and legal insurance	Excluded	Taxed
CAPITAL AND BUSINESS INCOME		
Corporate Tax Rates	Graduated, up to 46%	33% flat rate
Dividend relief	$100/200 exclusion	Exclusion repealed; 50% dividend-paid deduction
Depreciation	ACRS	Economic depreciation, indexed
Investment Tax Credit	6% - 10%	Repealed
Capital gains	60% excluded	Indexed, taxed as ordinary income
Interest income/expense	Fully taxed/deducted	Indexed, partially excludable/nondeductible
Rehabilitation and energy credits	Yes	No
Inventory accounting		
LIFO conformity required	Yes	No
FIFO	Not Indexed	Indexed
Uniform production Cost rules	No	Yes
Bad debt reserve deduction	Yes	No
Installment sales	Deferral	No deferral if receivables pledged
OIL INDUSTRY		
Percentage depletion	Yes	No; Indexed cost depletion
Expensing of intangible drilling costs	Yes	No
Windfall profits tax	Yes	Accelerate phase-out
FINANCIAL INSTITUTIONS		
Special bad debt deduction	Yes	No
Deduction for interest to carry tax-exempts	Yes	No
Exemption of credit unions	Yes	No
Deferral for life insurance investment income and annuity income	Yes	No
MUNICIPAL BONDS		
Public purpose	Tax-exempt	Tax-exempt
Private purpose	Tax-exempt	Taxed

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Chapter 1

THE NEED FOR TAX REFORM: BACK TO BASICS

The present income tax is badly in need of fundamental simplification and reform. It is too complicated, it is unfair, and it interferes with economic choices and retards saving, investment and growth.

In a real sense, the U.S. income tax has grown without any conscious design or overall planning since it was enacted in 1913. It was originally imposed at low rates and applied to fewer than 400,000 individuals with very high incomes. The need to finance World War II and expanded non-defense expenditures turned the individual income tax into a levy paid by most Americans. Tax rates were increased during World War II, and at their peak individual income tax rates reached 94 percent. The original income tax had serious flaws, and while some of these have been corrected over time, others have grown worse. With over 90 million individual tax returns now being filed, it is important to address these problems.

It is one thing to decide to tax "income," and quite another to decide how to define taxable income. If inadequate attention is devoted to establishing a uniform and consistent definition of income, some sources and uses of income will escape tax, and others will be taxed twice, as in the United States. The result may or may not be a simple tax system, but it is certain that the tax system will contain inequities and interfere with the economic behavior of taxpayers.

The U.S. income tax is not used simply to raise revenue. Instead, it is used to subsidize a long list of economic activities through exclusions from income subject to tax, adjustments to income, business deductions unrelated to actual expenses, deferral of tax liability, deductions for personal consumption expenditures, tax credits, and preferential tax rates. In some cases, deviations from a comprehensive definition of income originated in incomplete understanding of the concept of income or in outmoded ideas about the proper fiscal relationship between the Federal Government and state and local governments. But whatever its origin, in many cases bad public policy has become accepted -- virtually enshrined -- as appropriate.

For seven decades, the Treasury Department has fought to protect Federal revenues and the fairness and economic neutrality of the tax system from those seeking to create and exploit gaps and inconsistencies in the definition of taxable income. As loopholes have been discovered or created, exploited, and then plugged, techniques of tax avoidance have become increasingly sophisticated and the complexity of the income tax has grown, in a never-ending cycle.

The resulting tax system is both unfair and needlessly complex. Moreover, it interferes with economic behavior and, thus, prevents markets from allocating economic resources to their most productive uses. Perhaps worse, the complexity and inequity of the tax system undermine taxpayer morale -- a valuable, yet fragile, national asset and a prerequisite for a tax system based on voluntary compliance.

During the past year, the Treasury Department has undertaken a thorough review of the U.S. tax system. The object has been to determine how to reduce the complexities, inequities, and economic distortions in the tax system and make it more conducive to economic growth. Although the present report was prepared internally by the Treasury Department, it draws heavily on a vast national storehouse of knowledge about the tax system and its effects on the economy. The report also reflects information, views, and concerns which the Treasury Department received from taxpayers in the course of public hearings, meetings, and discussions, and in correspondence and in more formal written statements.

The Federal Income Tax in 1954

To understand better the need for tax reform, it is useful to compare our present income tax system with the one that prevailed in the late 1950s, after enactment of the 1954 Internal Revenue Code. Though the 1954 income tax system exhibited some serious problems, it was relatively simple, it was more nearly neutral toward many economic decisions, and most citizens probably thought it was reasonably fair.

Today the American economy is far more complex than it was 30 years ago. The financial affairs of the typical American family are far more complicated than in previous generations. Ownership of both financial and nonfinancial assets is more widespread and varied. Families have a greater quantity and variety of income, both taxed and untaxed. Business transactions are more complicated, financial intermediation is more highly developed, and taxpayers are more sophisticated and better advised. We also know more about the adverse effects of taxation than 30 years ago. Therefore, it would not be desirable -- nor would it be possible -- simply to reinstate an earlier tax law that was not designed to deal with the more complex economy of the 1980s. But a useful perspective on the current need for tax reform and simplification can be gained by considering how the tax law -- and its impact on taxpayers -- has changed over the past three decades.

One important defect of the 1954 income tax was a schedule of marginal rates that reached 91 percent for a small number of taxpayers. Besides creating severe disincentives for saving, investment, and work effort, the confiscatory rates may have spawned many of the vexing tax avoidance schemes that now riddle the income tax. But the advantages of the earlier income tax were also manifest. Virtually all taxpayers below the top 10 percent of the income distribution paid tax at an essentially uniform marginal rate of about

20 percent. Only at the very top of the income distribution did rates become steeply progressive. The income tax was still being used primarily to raise public revenues, and not to guide households and private business enterprises into a multitude of activities -- some of dubious value -- through preferential tax treatment. With notable exceptions, the income tax was levied on a base that included most income. The erosion of that base by a multitude of exclusions, adjustments, deductions, and credits not required to measure income accurately had not reached its present stage.

Compared to today, the 1954 income tax was simpler, more neutral, and fairer, in many respects. Perhaps as importantly, it was probably seen to be fair by most taxpayers, and the perception of fairness helped maintain the voluntary compliance so crucial to the American system of taxation.

The Decline in Simplicity

In 1954 the income tax was simpler for most taxpayers, in part because incomes were lower and the financial affairs of most families were simpler. There was little need for most taxpayers to work through a variety of complicated forms -- and even more complicated instructions -- to determine eligibility for a particular tax benefit. Only 25 percent of taxpayers itemized deductions in 1955, compared to 35 percent in 1982. Thus, fewer taxpayers found it necessary to save receipts verifying a multitude of expenditures accorded tax-preferred status. There was also little need to engage the services of a tax professional to file an individual income tax return. Tax planning -- the rearrangement of one's economic affairs to minimize taxes -- was the concern of only a few. Most taxpayers did not even feel the need to consider the tax consequences of major decisions, much less everyday transactions.

Today the proliferation and expansion of exclusions, adjustments to income, deductions, and credits create a major burden of paperwork and make part-time bookkeepers of many Americans. At present, about 100 different Federal tax forms are used by individuals. Many decisions -- for example, whether and how to make a charitable contribution, whether to participate in insurance plans offered by an employer, and whether to contribute to a political party -- all have tax consequences. Ordinary citizens are confronted with the alternatives of using a professional tax preparer, becoming knowledgeable in arcane tax law, running afoul of the tax administration, or possibly passing up available tax benefits. Today, over 40 percent of all individual income tax returns -- and some 60 percent of all long forms (form 1040s) -- are prepared by paid professionals. So-called tax shelters, once known only to the wealthy, are now attracting increasing numbers of middle-income Americans, many of whom do not have access to sophisticated tax advice and are misled by the misrepresentations of unscrupulous promoters of illegal shelters, often with disastrous effects. Legislative response to the tax shelter problem over the last 15 years has involved a patchwork of solutions that has generally increased the complexity of the tax system without correcting the underlying causes of tax shelters.

Erosion of the Tax Base

In 1954, the income tax did favor certain economic activities over others. For example, even then, tax experts criticized the fact that income from oil and gas properties, interest on state and local securities, and appreciation on capital assets were accorded preferential tax treatment. These "*loopholes*," *as they were called*, created inequities and distorted the use of the Nation's resources. By comparison, most interest, dividend, and labor income was taxed in full, and few forms of personal expenditure were tax deductible. The most important itemized deductions were for state and local taxes, charitable contributions, interest payments, and medical expenses; some of these had valid or easily understood justifications.

The last three decades have seen enormous erosion of the tax base. Compensation has increasingly taken the form of tax-free fringe benefits and legally taxable "perks" that many taxpayers improperly treat as tax-exempt. Interest on bonds issued by state and local governments has long been tax exempt, but recently these governments have increasingly used tax-exempt bonds to finance private investments. The investment tax credit greatly reduces the effective tax rate on income generated by business equipment, and accelerated depreciation and the deduction for interest expense combine to eliminate most taxes on income from debt-financed investments in real estate. In extreme cases these and other features of the tax law create losses for tax purposes that can be used to shelter other income. Exclusions, itemized deductions, and the deduction value of credits offset about 34 percent of personal income in 1982, as opposed to only 18 percent in 1954.

Economic Distortions

The lack of a comprehensive income tax base has two obvious and important adverse effects on the ability of the marketplace to allocate capital and labor to their most productive uses. First, the smaller the tax base, the higher tax rates must be to raise a given amount of revenue. High tax rates discourage saving and investment, stifle work effort, retard invention and innovation, encourage unproductive investment in tax shelters, and needlessly reduce the Nation's standard of living and growth rate.

Second, tax-preferred activities are favored relative to others, and tax law, rather than the market, becomes the primary force in determining how economic resources are used. Over the years, the tax system has come to exert a pervasive influence on the behavior of private decision-makers. The resulting tax-induced distortions in the use of labor and capital and in consumer choices have severe costs in terms of lower productivity, lost production, and reduced consumer satisfaction.

The existing taxation of capital and business income is particularly non-neutral. It favors capital-intensive industries over others, such as services. The tax system favors industries that are unusually dependent on equipment over those -- such as wholesale and retail trade -- that rely more heavily on other forms of capital, including inventories and structures. High technology companies are put at a particular disadvantage. Since they do not require large capital investments that benefit from preferential tax treatment they bear the full brunt of high tax rates. A tax system that interferes less with market forces in the determination of what business should produce -- and how -- would be more conducive to productive investment and economic growth.

Inequities

Erosion of the tax base also creates inequities. Most obviously, it is unfair that two households with equal incomes should pay different amounts of tax, simply because one receives or spends its income in ways that are tax-preferred. There is, for example, no reason that employees should be allowed to escape tax on fringe benefits and entertainment provided by their employers, while others must buy the same benefits and entertainment with after-tax dollars. Even at moderate income levels, taxpayers with similar incomes can incur tax liabilities that differ by thousands of dollars. Moreover, gaps in the tax base create inequities across income classes, as well as within income classes. Some of the most important tax preferences -- those that give rise to tax shelters -- benefit primarily those with high incomes.

Unfair Treatment of the Family

Thirty years ago the personal exemption for the taxpayer, spouse, and each dependent was $600, and there was a standard deduction of 10 percent of adjusted gross income, up to $1,000. Thus a family of four would pay no tax until income exceeded $2,675. Even though the personal exemption is now $1,000 and a larger "zero-bracket amount" has replaced the standard deduction, inflation has resulted in a substantial decline in the real value of the "tax-free amount," the level of income at which tax is first paid. Some families with incomes below the poverty level have become subject to tax. Tax burdens have increased relatively more for large families with many dependents than for other taxpayers.

The tax law was designed for a society in which dependents are generally present as part of a family with both parents present. Some groups with greater-than-average proportions of poor families, such as the elderly and the disabled, receive special tax treatment, but this treatment is often arbitrary and random, and depends on the source of the income, not on the need of the family. Until recently, the working poor have almost always been excluded from such special treatment. The special burdens faced by many single heads of households -- especially those caring for dependents and trying to work at the same time -- have been addressed inadequately.

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Inflation and the Income Tax

The U.S. income tax was not designed to be immune from inflation. Thus when inflation accelerated in the 1970s, taxpayers with constant real incomes were pushed into progressively higher tax brackets. The proportion of income paid to the government increased, even when real income did not, and higher tax rates created serious disincentives. Historically, "bracket creep," as this effect is called, could only be offset by periodic congressional action to increase the personal exemption, zero-bracket amount (ZBA), and bracket limits. But bracket creep sensitized the public to the problem of high and rising tax rates, and the Economic Recovery Tax Act of 1981 made a major step in tax reform by reducing tax rates and curing bracket creep. Even though many taxpayers are still subject to needlessly high marginal tax rates, the personal exemption, ZBA, and bracket limits will be indexed, starting in 1985. However, another important cause of inflation-induced tax increases remains uncorrected.

During inflationary times, taxes are collected on totally fictitious income. Capital gains taxes are paid when the prices of assets merely rise with inflation. Business firms are not allowed tax-free recovery of their real capital investments in inventories and depreciable assets. Moreover, high interest rates that merely reflect expected inflation overstate the real income of recipients of interest and inflate deductions for real interest expense.

The interaction of inflation and taxes creates further inequities and distortions. The overstatement of real interest income and deductions arbitrarily increases the tax burden on savers and rewards borrowers. Resource allocation is distorted by effective tax rates on some types of capital income that can easily exceed 100 percent. During the 1970s, the combination of high rates of inflation and a tax system that was not inflation-proof caused an increase in the tax-induced bias in favor of investment in owner-occupied housing; this probably aggravated the shortage of funds for business capital formation.

The combination of lower rates of inflation, the Accelerated Cost Recovery System of depreciation, and the lower tax rates on long-term capital gains have relieved some of the problem. Even so, the present tax system does not accurately measure real income from business or capital under most circumstances. Moreover, the tax treatment of business inventories and of debtors and creditors remains dependent on the rate of inflation.

The Rise of Tax Shelters

The well-advertised boom in the tax shelter industry in recent years has had particularly adverse effects. Some shelters involve little more than thinly veiled, if sophisticated, tax fraud. But even perfectly legal tax shelters distort the allocation of scarce capital because they produce highly visible inequities in taxation. Perhaps most importantly of all, they undermine taxpayer confidence in the integrity and fairness of the tax system. Tax shelter losses typically result from a combination of current deductions for future expenses, deferral of taxable income, and conversion of ordinary income to preferentially taxed long-term capital gains. Thus, shelters allow taxpayers to defer tax liability far into the future. Tax deferral is equivalent to an interest-free loan from the Federal Government.

Recent data on tax returns of partnerships, a commonly used vehicle for tax shelters, indicate the nature and magnitude of the problem. In 1981 partnerships operating in the United States reported aggregate losses in excess of aggregate profits. This is not a cyclical phenomenon; partnership losses have increased steadily, relative to profits, for two decades. (See Figure 1-1.) Yet there is no reason to believe that Americans are losing more and more money each year by investing in these enterprises. Rather, many partnership investments are profitable on an after-tax basis, because they generate accounting losses that can be used to reduce or eliminate tax *on other income (that is, to shelter other income from tax)*. But many shelter activities that offer attractive after-tax yields have little social value, as evidenced by before-tax yields that are low and sometimes even negative.

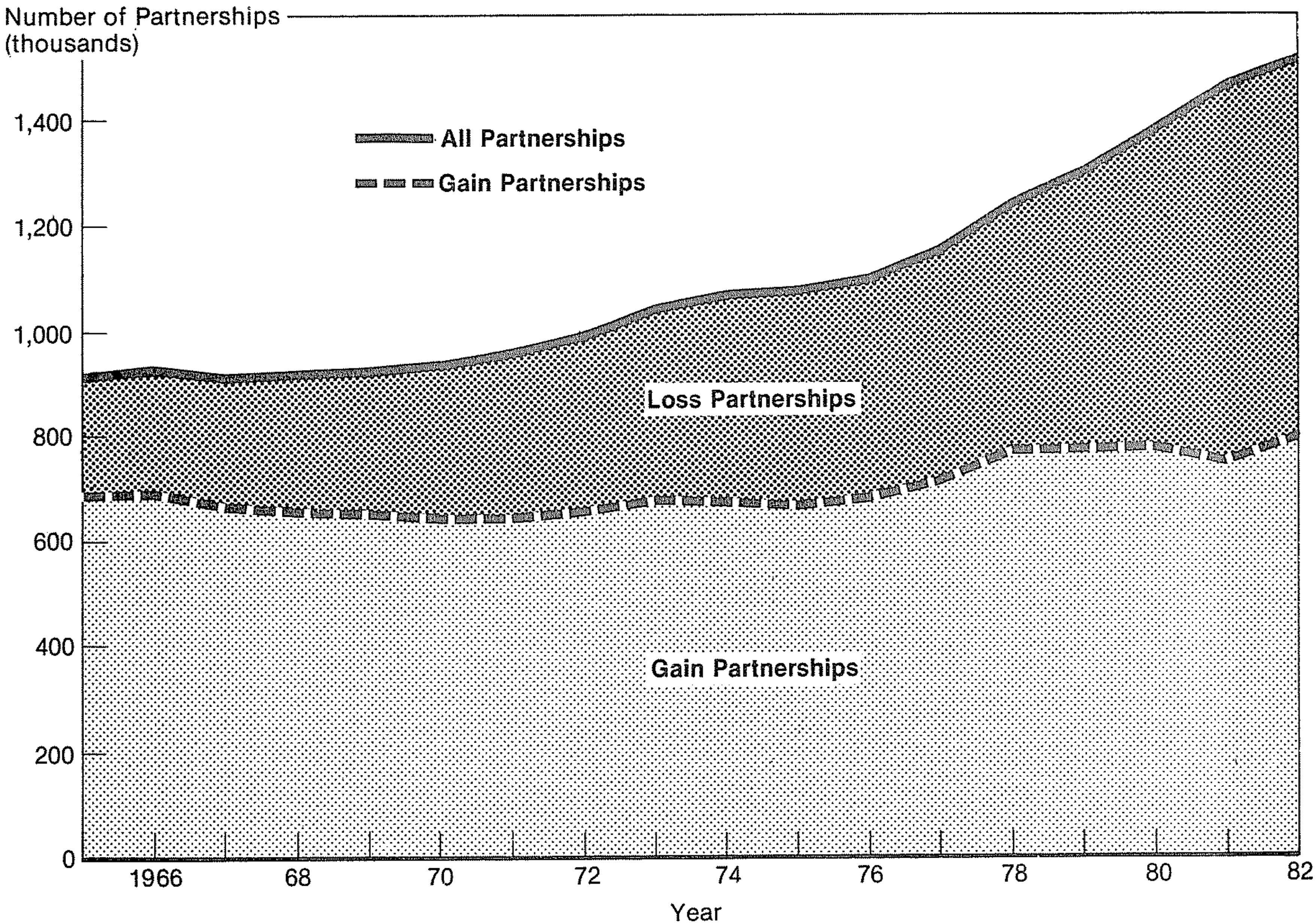
Partnerships in two industries that are favorites with tax shelter investors -- oil and gas and real estate -- are a case in point. In 1982, of the $60 billion in aggregate losses reported by all partnerships, $31.6 billion were attributable to losses reported by oil and gas and real estate partnerships, even though partnerships reporting losses in these two industries had a positive net cash flow of $7.6 billion.

Between 1963 and 1982, the number of taxpayers who claimed partnership losses on their individual returns increased by 400 percent, from 412,000 to 2.1 million, even though the total number of individual tax returns filed during the same period increased by only 50 percent. As a result of this growth in tax shelter activity, there has been a significant erosion in the base of the Federal income tax, particularly among taxpayers with the highest incomes. In 1983, partnership losses claimed by individual taxpayers may have sheltered as much as $35 billion of individual income from taxation. An estimated 82 percent of this total ($28.6 billion in partnership losses) was reported by taxpayers whose gross income before losses was $100,000 or more, and 60 percent ($21.0 billion) was reported by taxpayers with gross income before losses in excess of $250,000. By comparison, these groups reported 9 percent and 4 percent, respectively, of all gross income before losses reported by individuals.

A sample of taxpayer returns illustrates quite strikingly the way in which tax shelter accounting losses can be used to shelter substantial amounts of income from tax. A group of 88 taxpayers who held interests in certain non-abusive tax shelters -- shelters whose legitimacy was not being questioned by the Internal Revenue Service -- were chosen for statistical analysis. Though this sample was not

Figure 1-1

GROWTH IN PARTNERSHIPS, 1965—1982



selected scientifically, there is no reason to believe it is not representative; certainly it indicates the nature of the problem.

Taxpayers in this sample reported positive income -- that is gross income before losses -- of $17 million, or an average of $193,000. On average, each of these taxpayers owned interests in 6 partnerships, and a total of $6.4 million in net partnership losses was reported on the 88 returns. When these losses are added to other business and investment-related losses of almost $8.7 million, the taxpayers in the sample reported gross income of only $1.9 million. Thus, accounting losses from tax shelter partnerships reduced the gross income of taxpayers in the sample by almost 40 percent, and other losses reduced income by an additional 49 percent. (See Table 1-1.) The taxable income of these individuals was further reduced by adjustments to gross income and by itemized deductions.

Of the 88 returns sampled, 19 returns, with an average gross income before loss (positive income) of $243,710, reported a total income tax payment of $500 or less; 37 returns, with an average gross income before loss of $172,113 reported a total tax payment of $6,000 or less. By comparison, a typical family of four, with positive income of $45,000, but no tax shelter losses, would pay $6,272 in taxes. The extent to which tax shelter losses can be used to dramatically reduce tax liabilities is further documented by estimates from the 1983 Treasury tax model which show that 9,000 taxpayers with gross incomes before losses of $250,000 or more paid no tax as a direct result of partnership losses, while 59,000 taxpayers with that much positive income were able to reduce their tax payments by at least one-half.

The Decline in Taxpayer Morale

The United States has long been proud of the "taxpayer morale" of its citizens -- the willingness to pay voluntarily the income taxes necessary to finance government activities. Taxpayer morale ultimately depends, however, on the belief that taxes are fair. If the basis for this belief comes under suspicion, voluntary compliance with the tax laws is jeopardized. Thus, the perceived lack of fairness of the income tax may be as important as actual complexities, economic distortions, and inequities. Taxpayers resent paying substantially more tax than their neighbors who have equal or higher incomes. This is true even if the neighbor reduces taxes through commonly available and perfectly legal exclusions, adjustments, deductions, and credits, rather than by questionable or illegal means. Many witnesses at tax reform hearings the Treasury Department held throughout the country during June 1984 emphasized that tax should be collected on virtually all income, with little regard to how the income is earned or spent. Taxation can be thought to be unfair because the basic tax structure is defective, as well as because taxpayers who do not comply with the law are not penalized. The proliferation and publicity of tax shelters has a particularly pernicious effect on taxpayer morale.

Table 1-1

How Tax Shelter Losses Reduce Gross Income*

(Sample Of 88 Individual Income Tax Returns of Tax-Shelter Partners)

Gross Income Before Loss Class	Number of Returns	Total Gross Income Before Losses	Total Net Partnership Losses	Total Other Losses**	Gross Income After Losses
Less than $60,000	22	$ 590,435	$ -278,805	$ -120,136	$ 191,494
$60,000 - $100,000	20	1,634,839	-204,311	-260,361	1,170,166
$100,000 - $200,000	17	2,499,210	-993,585	-709,124	796,502
$200,000 or more ...	19	12,311,199	-4,667,042	-7,848,097	-203,940
Total	88	17,035,683	-6,143,743	-8,937,717	1,954,222
Average		$ 193,587	$ -69,815	$ -101,565	$ 22,207

Office of the Secretary of the Treasury
Office of Tax Analysis

October 30, 1984

* Calculations are from a sample of 88 individual income tax returns secured from four IRS Service Centers. Taxpayers filing these returns have investments in tax shelter partnerships that have previously been classified by an experienced examiner and accepted as nonabusive.

** Other losses include items such as nonpartnership business losses, partnership losses carried from prior tax years, and net capital losses.

Needed: Taxes That are Broad-Based, Simple, and Fair

Fundamental reform of the tax system is required to correct the problems just described. The tax system must be made simpler, more economically neutral, fairer, and more conducive to economic growth. These objectives are described more fully in the next chapter. The key to their achievement is to define real taxable income comprehensively, to exempt families with poverty-level incomes from tax, and to subject taxable income to a rate structure that, while mildly progressive, avoids rates so high that they stifle incentives and prevent economic growth. In short, the income tax should be broad-based, simple, and fair.

Chapter 2

GOALS OF FUNDAMENTAL TAX REFORM

In undertaking fundamental reform and simplification of the tax system of the United States, it is important to specify clearly and explicitly the goals or criteria that should guide such an undertaking. The criteria underlying the Treasury Department's study of fundamental tax reform are described here. Though some are framed in the familiar context of an income tax, in general they are equally applicable in the context of the less familiar tax on consumed income.

Economic Neutrality

One of the primary advantages of a free market economy is its tendency to allocate economic resources to their most productive uses. For example, market forces lead business firms to produce what consumers want in ways that are relatively efficient and economical. Any tax inevitably discourages the type of activity that is taxed. An ideal tax system would, however, interfere with private decisions as little as possible. That is, it would not unnecessarily distort choices about how income is earned and how it is spent. It would not unduly favor leisure over work, or consumption over saving and investment. It would not needlessly cause business firms to modify their production techniques or their decisions on how to finance their activities. A neutral tax policy would not induce businesses to acquire other firms or to be acquired by them merely for tax considerations. It would not discourage risk-taking or the formation of new businesses. It would not discourage competition by granting special preferences only to one industry or one type of financial institution. In short, an ideal tax system would be as neutral as possible toward private decisions. Any deviation from this principle represents implicit endorsement of governmental intervention in the economy -- an insidious form of industrial policy based on the belief that those responsible for tax policy can judge better than the marketplace what consumers want, how goods and services should be produced, and how business should be organized and financed.

Economic neutrality is furthered by a few simple rules of tax design. Perhaps most importantly, income from all sources should be taxed equally; otherwise, too many resources will be devoted to activities subject to the lowest taxes. For the same reason, tax liability should not depend on how income is spent. Uniform treatment of all sources and uses of income requires a comprehensive definition of income for tax purposes.

Lower Tax Rates

The higher tax rates are, the more taxes interfere with economic choices -- choices about working, about saving and investing, about production techniques and business finance, and about invention and innovation. Moreover, any omission from the tax base is more valuable at high tax rates than at low rates. As a consequence, there is more political pressure for preferential treatment of selected activities at high rates, and tax shelters are more important at high rates. Thus an important goal of tax policy is to keep tax rates as low as possible, given other objectives. Of course, the tax rates needed to raise a given amount of revenue can be lower, the more income is subject to tax. This is a second important reason for adopting a comprehensive definition of taxable income. It is far better -- more neutral, as well as simpler and more equitable -- to levy low tax rates on all income than to impose high tax rates on only part of income.

Revenue Neutrality

The Treasury Department study of fundamental tax reform has concentrated on questions of tax structure and has not considered any proposals to increase the level of tax revenues that will result from current law. Thus the Treasury Department proposes tax reforms that are revenue neutral, that is, reforms that would leave revenues essentially unchanged from what they would be under current law.

Equal Treatment of Equals

A tax that places significantly different burdens on taxpayers in similar economic circumstances is not fair. For example, if two similar families have the same income, they should ordinarily pay roughly the same amount of income tax, regardless of the sources or uses of that income. A fair tax system does not allow some taxpayers to avoid taxes by legal means or to evade them by illegal means.

The only way to achieve equal treatment of equals is to define the tax base comprehensively. If some items of income are omitted from the tax base, or if particular expenditures are treated preferentially, then taxpayers who are otherwise in equal positions will not be treated equally.

Fairness for Families

It is commonly agreed that households with incomes below the poverty level should pay little or no tax. Otherwise, they will be paying taxes with income that is needed to maintain a minimal standard of living. In a real sense, families with poverty-level incomes do not have taxpaying ability. Taxpaying capacity exists only once income exceeds the poverty level.

Fairness Across Income Classes

Most Americans probably agree that those with high incomes should pay a greater percentage of their income in tax than those with intermediate levels of income. But the proper pattern of effective tax rates -- the percentage of income paid in taxes at various income levels -- is a matter on which opinions differ.

In its study of fundamental tax reform the Treasury Department has adopted the simple working assumption that the existing distribution of tax payments across income classes should not be significantly changed by tax reform. If any change in the existing distribution of tax burdens is desired, it can and should be implemented by adjusting the proposed personal exemptions and rate schedules. It should not be achieved by taxing some sources or uses of income more or less heavily than others, since that would violate both economic neutrality and the principle that those with equal incomes should pay approximately equal taxes.

Defining the tax base comprehensively is necessary for the achievement of equity across income classes. Any exclusion or deduction is worth more, the higher the marginal tax bracket of the taxpayer. Moreover, wealthy taxpayers make relatively greater use of many provisions of the tax law that reduce the tax base, especially those yielding business deductions that result in the mismeasurement of economic income and produce tax shelters. As long as these tax preferences exist, the tax system will be less progressive than the rate structure suggests, and high marginal rates will be advocated as a means of achieving progressive taxation. Conversely, if income is defined comprehensively, the existing pattern of progressivity can be maintained with markedly lower marginal tax rates on upper income groups, as well as other taxpayers.

Tax reform that does not alter the distribution of tax burdens across income groups will, of course, involve redistribution of tax burdens -- winners and losers -- within income classes. This is only natural in the context of reform that attempts to replace the inequities of the present tax system with equal treatment of households with a given income. Those who gain from any such reform will be those who, at a given level of income, have been paying more than average amounts of tax, and those who lose will have been paying less than their fair share of taxes. But many of the losers will not lose permanently; they will simply divert funds from uneconomic investments to more productive investments and pay lower tax rates on the higher income that results.

Simplicity

An important goal of the Treasury Department study of fundamental tax reform is simplification. During June of 1984, the Treasury Department held hearings on fundamental tax reform in seven U.S. cities. One of the themes repeated most frequently by citizens appearing at those hearings was the need for simplification of the income tax.

Though simplicity in taxation may be difficult to define, everyone knows what it is not. Simplicity is not reflected in a tax system that requires extensive recordkeeping by ordinary citizens. A simpler system would require fewer taxpayers to collect and retain receipts or cancelled checks in order to calculate and document tax deductions, adjustments, and credits. Simplicity is not wondering which receipts and checks to save because the tax law is too complex and is constantly changing. Simplicity is not computing dozens of deductions and credits, and wondering all the while whether other means of saving tax might have been missed through ignorance of the laws. Nor is simplicity being forced to wade through long and complicated instruction booklets or resort to professional assistance, in order to meet the civic responsibility to pay taxes. A simple tax system would not require 41 percent of all taxpayers -- and about 60 percent of those who itemize deductions -- to engage professional assistance in preparing their tax returns. Under a simple system, most responsible taxpayers would be more certain of their tax liabilities.

Reduced costs and greater ease of administration for the government are the mirror image of simplicity for the taxpayer. Many provisions of the tax code could be administered effectively only by devoting exorbitant resources to their enforcement. About 90 percent of taxpayers who itemize deductions make at least one error in claiming their deductions, but the Internal Revenue Service simply does not have the capacity to audit all returns and either collect the tax due or make refunds to these taxpayers. The current tax structure creates a dilemma for tax administrators. Effective enforcement of complicated laws generally creates complexity for the taxpayer and fosters apprehension and resentment against the fiscal authorities. On the other hand, ineffective enforcement loses revenue, it creates uncertainty for taxpayers, it converts the tax system into an unfair tax on honesty, and it may also generate hostility toward the tax system. A primary focus of the tax reform study has been to eliminate and avoid provisions that would unduly complicate tax administration and compliance for most taxpayers.

Perceived Fairness

The perception of fairness may be as important as fairness itself as a goal of tax policy. The United States was once justly proud of the taxpayer morale of its citizens. With media coverage of tax shelters now commonplace and talk of "beating the system" prevalent in conversation, taxpayers increasingly view the tax system as unfair and wonder why they should pay taxes. One of the primary goals of the Treasury Department study of fundamental tax reform is the reversal of this threatening trend.

The growing use of the income tax to subsidize various forms of economic activity is a major source of the increase in the perceived lack of fairness of the tax system. The U.S. Government has long spent public funds in ways that many taxpayers question. While this may cause many to believe that their tax dollars are being wasted, it does not raise doubts about the equity of the tax system itself. The situation is very different when the tax system, rather than direct spending, is used to provide subsidies. Similarly situated taxpayers can pay considerably different amounts of tax, depending on how they earn and spend their income, and high-income families may pay tax on a smaller portion of their income than do poorer families. The result is a perception that the income tax itself is unfair, both within and across income classes.

Reforms of many types are needed to improve the image of the U.S. income tax. Families below the poverty line should pay little or no tax. Income tax compliance should be easier and less expensive. Most forms of economic income should be subject to tax, but fictitious income representing nothing but inflation should not be taxed. The tax system generally should not be used to implement subsidy programs. Opportunities for tax shelters should be sharply curtailed, if not eliminated. Tax evasion should be made more difficult. Adoption of fairer tax rules would have a multiplier effect, as increased fairness would lead to an improved perception of fairness and, in turn, to better compliance.

An Inflation-proof Tax Law

Starting in 1985 personal exemptions, the zero bracket amount, and the tax brackets in the individual income tax will be adjusted for inflation. This important innovation, commonly called indexing, will prevent taxpayers with a given real income from being forced by inflation to pay higher taxes. It should remain an inviolate part of the tax system. Indexing of this kind, important as it is, meets only part of the need to protect taxpayers from inflation. Inflation adjustment in the calculation of taxable income is perhaps more important, because it cannot be achieved by periodic adjustments of personal exemptions and the rate structure. Without it inflation causes mismeasurement of business and capital income.

Inflation currently causes income to be overstated in at least four ways. First, depreciation allowances based on historical costs are generally not adequate to allow tax-free recovery of investment in a time of inflation. Second, deductions for the cost of goods sold from inventories are inadequate if based on historical costs. Third, capital gains include nominal appreciation that merely reflects the general rise in prices, rather than an increase in the real value of assets. Fourth, nominal interest receipts include an inflation premium that should not be taxed. By the same token, full deduction for nominal interest expenses during inflationary times results in the understatement of real economic income.

Congress has made some ad hoc adjustments in depreciation allowances and the taxation of capital gains in response to inflation. In most cases these measures do not accurately adjust for inflation, and they are too inflexible to deal adequately with changes in the rate of inflation.

An ideal income tax system would provide inflation adjustments in the measurement of taxable income in order to prevent the taxation of fictitious income and the deduction of fictitious interest expenses. Such adjustments would prevent the effective tax rates imposed on business and capital income from varying dramatically and arbitrarily every time the inflation rate changes.

Neutrality Toward Business Form

Corporate income that is distributed as dividends is subject to tax twice, first at the corporate level and again when received by individuals. Many observers -- among them economists and lawyers, businessmen, and public officials -- have argued that a separate unintegrated tax on corporate profits has adverse economic effects and makes no sense. Yet the corporate and individual income taxes cannot be fully integrated, for technical reasons, and the corporate tax cannot simply be eliminated without creating a large loophole. It is, however, possible to relieve double taxation of dividends, keeping full taxation at the corporate level only for income that is retained.

The Treasury Department study of tax simplification and reform has been guided by the need for balance in the treatment of corporations and individual taxpayers. The corporate tax rate should be no higher than -- and, as has been the case historically, perhaps somewhat below -- the top rate applied to income of individuals. If the corporate rate and the top individual rate differ significantly, there would be an artificial inducement either for or against use of the corporate form.

Economic Growth

The U.S. economy has long been hampered by a combination of defects in its tax system. High marginal tax rates discourage work, saving and investment, and invention and innovation. Heavy reliance on income taxation, rather than taxes on consumption, has produced a further disincentive for saving. Preferential tax treatment of particular industries -- industrial policy implemented through tax policy -- causes too much labor and capital to flow into the favored industries, and too little into other sectors. In many instances, it is difficult to establish new businesses simply because the tax system places them at a severe competitive disadvantage. In extreme cases tax-preferred investments that lose money on a before-tax basis are profitable once tax savings are considered. The result of all this tax-induced interference with market forces is lost opportunities for productive investment and needless sacrifice of national output. Economic growth, a primary goal of the study of fundamental tax reform, depends on a neutral tax system -- one that would not hinder the potential for growth inherent in a free market economy.

Trade-offs

In many cases the objectives of tax policy discussed above are quite consistent. Elimination of deductions not required for the accurate measurement of income would generally simplify the tax system, promote horizontal equity, allow lower tax rates, and reduce existing distortions of economic decisions. Sometimes, however, it is necessary to strike a balance among competing objectives of sound tax policy. In some cases -- extraordinary medical expenses or the presence of dependents, for example -- deductions are justified because they affect ability to pay even if they do not affect income.

Many of the deductions and credits that complicate the tax system were enacted -- and are defended -- as necessary to avoid inequities. For example, almost everyone agrees that taxpayers should be allowed to claim exemptions for dependents, but implementing the dependency test can be complicated in certain cases. Deductions for extraordinary medical expenses are necessary for the measurement of the ability to pay taxes; but documenting them can be very time-consuming. Low-income individuals may not realize that they are eligible for the earned income tax credit; they are also least able to deal with the complexity it entails and may not realize that the IRS will compute the credit if a return is filed. The two-earner deduction involves complicated conflicts between equal treatment of equals, incentive effects, fairness to families, and fairness across income classes, as well as trade-offs between these effects and simplicity.

Measuring income accurately or implementing a tax on consumed income, either of which would be desirable on grounds of fairness and neutrality, may involve difficult problems of compliance and administration, for example, in the valuation of certain fringe benefits. Measurement of income as it accrues on infrequently traded or unique assets would present insurmountable administrative problems. On the other hand, taxing capital gains on realizations allows tax to be postponed indefinitely. Calculation of business income is complicated, but legitimate business expenses, including estimated depreciation allowances, must be allowed on both equity and neutrality grounds. Implementing an inflation-proof income tax is complicated, but the alternative is to allow inflation to play havoc with effective tax rates, creating distortions and inequities. And any tax on consumption, whether a sales tax or a progressive personal tax on consumed income, raises troublesome issues of distributional equity.

The Treasury Department has carefully weighed these competing objectives in appraising the strengths and weaknesses of the four options it considered in its study of fundamental tax simplification and reform. Most individuals will face a dramatically simpler tax system under the Treasury Department proposals. But in some cases proposed reforms that are necessary to improve the equity and neutrality of the tax law do conflict with the important goal of simplification.

Fair and Orderly Transition

The present income tax is complex, it is inequitable, it causes economic distortions, and it impedes economic growth. But movement to a comprehensive tax on all income or consumption, while desirable in the long run, would involve substantial short-run shifts in resource allocation and tax burdens. Even here there are conflicts and trade-offs -- between the advantages of rationalizing tax policy and the disruptions caused by doing so too suddenly or too rapidly.

Tax reform has often -- and long -- been held hostage by failure to deal with transition issues; those who would be hurt by tax reform have successfully resisted change. An important objective of the Treasury Department's study of fundamental tax reform is the specification of transition rules that will allow tax reform to become a reality. Transition steps are necessary both to ease the impact of tax changes and to make tax reform a political reality. Without them, reform will not occur, and this generation will leave to the next a tax system that remains deeply flawed.

Rather than being introduced suddenly, with little or no time for adjustment, some components of fundamental tax reform should be introduced gradually, in order to avoid windfall gains and losses and economic dislocations. Gradual introduction of fiscal measures can take a number of forms, depending on circumstances. Effective dates can be postponed and implementation can be phased in, starting either at once or at a subsequent effective date. Grandfathering of income from certain assets or of groups benefitting from certain provisions (for example, applying new provisions only to new purchasers of assets, and not to income from old assets) is appropriate in some cases. These mechanisms are among those proposed to meet the final criterion of a fair and orderly transition to a simpler, fairer, and more neutral tax system.

Addendum: Implications for Spending

Most of the exclusions, adjustments, itemized deductions, and credits currently found in the income tax are not required for the accurate measurement of income or ability to pay taxes. Rather, they are simply subsidies for private activities that are administered through the tax system.

Administering subsidies through the tax system creates complexity for taxpayers. By allowing taxpayers in similar circumstances to pay greatly different amounts of tax, it undermines taxpayer morale in a way that direct spending does not. The Treasury Department thus recommends that most of the exclusions, adjustments, deductions, tax deferral provisions, and credits that are inconsistent with a comprehensive definition of income for tax purposes be repealed or sharply curtailed.

This recommendation should not be construed to imply that none of the currently tax-preferred activities is worthy of direct public support. Such a judgment would go beyond the mandate from the President to propose reforms that will make the tax system broad-based, simple, and fair. Except in a few cases this study makes no recommendations about the need to enact spending proposals to replace subsidies currently administered through the tax system. Of course, to the extent that direct spending replaces tax subsidies, tax rates could not be reduced as much as proposed.

Chapter 3

THE FOUR OPTIONS

In its study of fundamental tax reform, the Treasury Department focused on four basic options: a pure flat tax; a "modified" flat tax; a consumed income tax; and a general sales tax, such as a value-added tax or a Federal retail sales tax. These four options are described and analyzed briefly in this chapter. Chapters 4 to 8 describe the Treasury Department proposal for a modified flat tax in greater detail and compare it with similar proposals that have been advanced recently by several members of Congress. Chapters 9 and 10 provide further analysis of the consumed income tax and value-added tax, two options which are not being proposed. (Volume II contains details of the Treasury Department proposal for a modified flat tax and Volume III analyzes a value-added tax in greater detail.)

I. The Pure Flat Tax

Most pure "flat tax" proposals share two characteristics: a much more comprehensive tax base than under current law and a single low tax rate. In some flat tax proposals the tax base is consumption, rather than income. In the most extreme proposals there are virtually no deviations from a comprehensive definition of income or consumption, except for personal exemptions.

A. Advantages of the Flat Tax

A pure flat tax would have major advantages over current law, because of the breadth of the tax base and the low tax rate made possible by the comprehensive base. Such a tax would reduce the inequality of tax treatment of families with equal incomes, the distortions of economic decisions, the disincentives to growth, and some of the complexities that plague the current tax system. Because the present system contains many exclusions, exemptions, deductions, and credits not required for the accurate measurement of income, it requires higher tax rates than would be necessary under a pure flat tax. In addition, a uniform tax rate lessens problems inherent in steeply graduated rates, such as the bunching of income, discrimination between single persons and married couples, and incentives to shift income artificially to family members subject to lower tax rates.

B. Distributional Inequity of the Pure Flat Tax

These important advantages must be compared to the troublesome distributional implications of a pure flat rate tax. A single, totally flat rate, whether imposed on income or on consumption, would involve a substantial shift of tax burden from those in the highest income brackets to low- or middle-income taxpayers. Under current law families with less than $20,000 of income pay 5.5 percent of the

Table 3-1

Percentage Distributions of Individual Income Tax Liability
Under Current Law, a Pure Flat Tax and
the Treasury Department Proposal,
by Economic Income Class of Families

(1983 Levels of Income)

Family Economic Income Class	Share of income	Share of Tax 1/ Current law tax 1/	Pure flat tax 2/	Treasury Department proposal 3/
	(percent)			
Less than $20,000	13.7	5.5	9.5	5.1
$20,000 to $50,000	41.6	34.6	41.6	34.3
$50,000 to $100,000	30.4	32.7	32.6	33.1
$100,000 or more	14.3	27.2	16.3	27.5
Total	100.0	100.0	100.0	100.0

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1/ Current law applicable in 1986.

2/ A single rate of 16.8 percent applied to taxable income under the Treasury Department proposal, which essentially exempts from tax those in poverty.

3/ A three-rate graduated structure applied to taxable income under the Treasury Department proposal, which essentially exempts from tax those in poverty.

individual income tax, although they receive 13.7 percent of the income. (See Table 3-1.) A pure flat tax -- even one with liberalized personal exemptions and zero-bracket amounts designed to eliminate tax for families at or below the poverty level -- would raise the share of taxes paid by families with less than $20,000 of income to 9.5 percent of the total. This pure flat tax would sharply reduce the share of individual taxes paid by those with incomes over $50,000, from 59.9 percent under current law to 48.9 percent. Stated differently, taxpayers with incomes above $50,000 would pay about 18 percent less under a revenue-neutral flat-rate tax than under current law. (See Table 3-2.) Conversely, those with incomes between $20,000 and $50,000 would pay one-fifth more tax than under current law. Because of the massive redistribution of tax burdens a pure flat tax would produce, the Treasury Department recommends against its enactment.

II. Reconciliation: The Modified Flat Tax

In order to simplify and reform the existing income tax, but avoid the massive redistribution of tax liabilities of a pure flat tax, the Treasury Department proposes that a modified flat tax on income be enacted. The proposal is broadly consistent with several modified flat tax proposals advanced by members of Congress, but it goes beyond them in the scope of its recommendations for simplification and reform.

Many believe that conflict between the goal of distributional equity, on the one hand, and the goals of simplicity, economic neutrality, encouragement of growth, and equal tax treatment of equals (horizontal equity), on the other, is inherent in any flat tax proposal, whether pure or modified. In fact, this conflict is more apparent than real. Most of the advantages commonly attributed to pure flat tax proposals result primarily from the inclusion of all income (or consumption) in the tax base and have relatively little to do with whether tax rates are flat or graduated. Conversely, the redistribution of the tax burden from high- to middle-income taxpayers that would result from application of a flat rate cannot be traced to implementation of a comprehensive definition of the tax base. It results entirely from the substitution of a flat rate for graduated rates.

Because the effects produced by a totally flat rate are quite distinct from those resulting from base-broadening, it is possible to achieve most of the base-broadening advantages of a pure flat tax without the shift in tax burdens among income classes a pure flat rate would entail. This is, in effect, the approach taken in proposals for a modified flat tax. By combining a more comprehensive definition of income than under current law with modestly graduated low rates, modified flat tax proposals are able to achieve gains in simplicity, economic neutrality, equal tax treatment of families with equal incomes, and economic growth, without sacrificing distributional equity.

Table 3-2

Changes in Tax Resulting from a Pure Flat Tax
and the Treasury Department Proposal
Distributed by Family Economic Income Class

(1983 Levels of Income)

Family Economic Income Class	Current law tax 1/	Pure Flat Tax 2/			Treasury Proposal 3/		
		Amount	Change from current law		Amount	Change from current law	
			Amount	Percent		Amount	Percent
	(.... $ billions		.....)	(. % .)	($ billions	)	(. % .)
Less than $20,000	14.6	25.0	10.5	72.1	12.3	-2.3	-15.7
$20,000 - $50,000	91.2	109.6	18.4	20.2	82.8	-8.4	-9.2
$50,000 - $100,000	86.4	86.1	-0.3	-0.4	80.0	-6.4	-7.4
$100,000 or more	71.6	43.1	-28.6	-39.9	66.4	-5.2	-7.2
Total	263.8	263.8	0	0	241.5	-22.3	-8.5

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1/ Current law applicable in 1986.

2/ A single rate of 16.8 percent applied to taxable income under the Treasury Department proposal, which essentially exempts from tax those in poverty.

3/ A three-rate graduated structure applied to taxable income under the Treasury Department proposal, which essentially exempts from tax those in poverty.

A modified flat tax that includes only two or three tax rates covering a wide range of low to middle income would be indistinguishable from a pure flat tax for most taxpayers. (Of course, low-income taxpayers would pay lower rates under a modified flat tax than under a pure flat tax.) The use of flat rates over wide ranges of incomes minimizes marriage penalties and bonuses, as well as problems caused by bunching of income in one year.

A. Questions Common to Income and Consumed Income Taxes

The term "modified flat tax" could be applied to an expanded income tax base or to a consumption tax base. The only inherent difference between these two tax bases involves the treatment of saving. Under a tax on consumed income, a deduction is allowed for net saving, whereas under an ordinary income tax it is not. This distinction is explained briefly in part B of this section and at greater length in chapter 9. Under either approach many of the issues that must be answered in defining the tax base are the same. Should fringe benefits provided by employers be taxed, or should they be exempt? How are business assets to be distinguished from private assets? Should housing receive preferential treatment? Should charitable contributions be favored? Should activities of state and local governments be subsidized through the tax system? Should a tax continue to be levied on corporations? The remainder of this section focuses on questions such as these, on suggested modifications of the present taxation of capital and business income, and on proposed deviations from the pure income tax model.

B. Advantages of a Comprehensive Measure of Income

A comprehensive definition of taxable income or consumption is generally conducive to simplicity and to equal treatment of equally situated taxpayers, while retreat from a comprehensive base generally involves complexity and horizontal inequity. A comprehensive tax base is also necessary for economic neutrality, since high tax rates and discrimination between various ways of earning and spending income distort economic decisions.

Omissions from the tax base generally also result in a distribution of tax liability between families with different income levels that is at least somewhat different -- and frequently markedly different -- from what the schedule of marginal tax rates suggests. Finally, any deviations from a comprehensive definition of income, unless based on widely-held views of tax equity and other generally accepted economic objectives, are likely to reduce the perceived fairness of the tax system and therefore undermine taxpayer morale.

Erosion of the tax base also has a heavy political cost. If one special interest group is allowed a deduction or credit not required for the accurate measurement of income, it becomes more difficult to resist others. Ultimately, the only way to maintain a fair tax base -- one without the many loopholes in the present tax code -- is to resist requests for special treatment. For all those reasons, the tax base should be defined as broadly as possible.

C. Distributional Neutrality

Modification of the uniform rate contained in flat-tax proposals also involves difficult trade-offs. Fairness suggests that a single flat tax rate should not be levied at all income levels. And yet tax equity and due regard for the disincentive effects of high marginal tax rates dictate that the top marginal tax rates should not be excessive. By-and-large, the rate structure proposed by the Treasury Department, when applied to an expanded definition of taxable income, is designed to approximate the distribution of tax liabilities that prevails under current law. The primary exception is at the bottom of the income scale. Increased personal exemptions and zero-bracket amounts will ensure that most taxpayers with incomes below the poverty line will be exempt from income tax altogether.

An important feature of modified flat tax proposals is a reduction in the number of tax rates. Because rates would be constant over much wider ranges of incomes than under current law, a modified flat tax system would resemble a flat-rate system for most taxpayers. Of course, for marginal tax rates to be reduced significantly, without sacrificing revenue, it would be necessary to define the tax base much more comprehensively than under current law.

D. Issues in Income Measurement

At a conceptual level, the proper tax treatment of many currently untaxed sources and uses of income is clear. Fringe benefits provided by employers and payments that represent wage replacement should be included in income subject to tax. Only in a few cases do problems of valuation make this ideal unattainable, as in the case of small hard-to-value fringe benefits recently determined to be tax-exempt in the 1984 Deficit Reduction Act. Taxpayers should not be allowed business deductions for what are really personal expenses, and they should not be allowed artificially to shift income between family members to reduce taxes. Preferential treatment of above-average amounts of charitable contributions is desirable, in order to maintain incentives for contributions; moreover, taxpayers making extraordinary contributions may be considered to have less taxpaying ability than others with similar incomes. The deduction of state and local taxes should be phased out, both because it is unnecessary for the measurement of income and because there is no compelling reason for the deduction. The Federal Government, through the tax system, in effect pays part of the cost of expenditures by state and local governments. Only real income should be taxed; capital gains and nominal profits that only represent inflation should not be taxed.

Special credits and deductions that are not required to measure income accurately should be repealed. These include depreciation allowances that are greater than real economic depreciation, percentage depletion allowances in excess of cost depletion, intangible drilling expenses, and various forms of preferential treatment currently accorded certain financial institutions. Particularly important is the need to deal with inconsistencies in the tax law that give rise to tax shelters. Tax shelters and the complexities, inequities, and distortions they create can be eliminated only by repealing the tax preferences that make them possible. The disparate tax treatment of corporations and partnerships should be rationalized by reducing the double taxation of dividends and by treating large limited partnerships like corporations for tax purposes.

E. Disparities in Effective Tax Rates

A simple example illustrates the lack of fairness and neutrality of the present income tax. The first column of Table 3-3 shows how the current tax system treats two different types of labor income, wages and salaries and fringe benefits, and two forms of capital income, interest and capital gains. Under present law, a taxpayer subject to the top statutory rate of 50 percent would actually pay effective tax rates on various forms of real income ranging from zero to 125 percent. The disparities in effective rates are less dramatic for taxpayers with lower incomes, but they are qualitatively the same.

Whereas wages and salaries are taxed at an effective rate equal to the statutory rate, certain fringe benefits are not taxed under current law. The inequity and non-neutrality of this tax treatment are obvious. Recipients of fringe benefits are treated more favorably than those who receive labor income as wages and salaries. Besides being unfair, this provides an artificial incentive for greater consumption of goods and services that can be provided as tax-free fringe benefits. Under a comprehensive definition of income, wages and fringe benefits would be taxed identically, that is, at the same effective rates.

The story is somewhat more complicated for capital income, since the effective tax rate depends crucially on the rate of inflation. The example in Table 3-3 assumes that the interest rate is 4 percent if there is no inflation, but 10 percent if the inflation rate is 6 percent. It also assumes that capital assets that have no current yield are appreciating at the rate of interest, either 4 percent or 10 percent. In the absence of inflation, interest and long-term capital gains are taxed at rates of 50 percent and 20 percent, respectively. But if the inflation rate is 10 percent, tax on nominal interest income is 125 percent of real interest income, and real long-term capital gains are taxed at an effective rate of 50 percent, despite the apparent top rate on long-term capital gains of 20 percent. At higher rates of inflation, effective tax rates on real interest income and real capital gains are even higher.

The statutory tax rate collected on interest income equals the effective rate only if there is no inflation. At inflation rates within recent experience, the effective tax rates on real interest income are much higher than the statutory rates suggest. Besides being unfair, this penalizes saving and encourages borrowing, with adverse effects on capital formation and growth. This problem can be overcome in the context of an income tax only by providing an inflation adjustment for debt.

Long-term capital gains nominally benefit from preferential tax treatment. Thus in the absence of inflation, they are taxed less heavily than wages and salaries and interest income, as shown in Table 3-3, creating both inequities and misallocations of capital. A comprehensive definition of income would not apply different tax rates to capital gains and other income. But if inflation is high and illusory capital gains are taxed, as under the current system, effective tax rates on real gains are high; inequities and distortions are magnified and invention and innovation suffer. A comprehensive definition of income that included indexing (inflation adjustment) of the basis (cost) of assets used in calculating capital gains and losses would ensure that fictitious gains are not taxed.

The second column of Table 3-3 illustrates the advantage of a comprehensive definition of taxable income. The current top statutory rate of 50 percent is used for illustrative purposes; of course, with a more comprehensive definition of income, a lower rate would be possible. For taxpayers subject to the highest marginal tax rate under current law, income from all sources would be taxed at a rate of 50 percent, regardless of the rate of inflation. Subjecting all real income to tax treats equally situated families equally and reduces tax-induced distortions of economic decisions.

F. Simplification

Simplifying the income tax for most individual taxpayers has been an important objective of the Treasury Department study. Simplification would result from several general approaches. First, increasing the personal exemptions and zero-bracket amounts will eliminate many poor Americans from the income tax rolls. Second, several itemized deductions will be eliminated or subjected to floors. Like the floor under the current deduction for medical expenses, these floors will reduce the need for so many to keep records of deductible expenditures for extended periods of time. With the expanded zero-bracket amount and fewer deductions, about one-third fewer taxpayers will find it advantageous to itemize deductions. Third, most tax credits would simply be eliminated. The Treasury Department believes that most Americans would rather pay low taxes on all of their income than pay high taxes on part of it; doing so is simpler, as well as fairer and more neutral toward economic behavior.

Table 3-3

Illustration of Disparities in Effective Tax Rates

Type of Income	Effective Tax Rate on Taxpayer in 50% Bracket: Current Law	Effective Tax Rate on Taxpayer in 50% Bracket: Comprehensive Definition of Real Income
Taxable wages and salaries	50	50
Tax-free fringe benefits	0	50
Interest:		
No inflation	50	50
6 percent inflation	125	50
Long-term capital gains:		
No inflation	20	50
6 percent inflation	50	50

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III. *Consumed Income Tax*

Consumption provides an alternative to income as the basis for personal taxation. A personal tax on consumption, or consumed income, would be levied by exempting all saving from tax, allowing a deduction for repayment of debt, and taxing all borrowing and withdrawals from savings. Consumed income would be reported on a form much like the present form 1040. Deductions would be allowed for deposits in "qualified accounts" similar to existing individual retirement accounts (IRAs); withdrawals from such accounts would be subject to tax. (Further details of such a tax are described in Chapter 9.)

Though a flat rate could be applied to the consumption base calculated in this way, most proposals for a consumed income tax postulate personal exemptions and graduated rate schedules. Thus, a consumed income tax could be progressive, if that were desired. Itemized deductions could also be allowed, as under the existing income tax.

A. Administrative Advantages

The current income tax is based on the principle that income should be taxed annually as it is realized. It represents a practical compromise between administrative feasibility and the objective of taxing income as it accrues. Conceptually, accrued income can be defined as the amount a taxpayer could consume without reducing his or her net wealth, that is, as the total of what the taxpayer actually consumes plus the change in his or her net wealth. Many practical difficulties plague application of this conceptual ideal as the basis of an income tax. Compromise between achieving the ideal, on the one hand, and avoiding complexity, on the other, produces a system that departs significantly from the conceptual ideal. Examples of compromise include taxation of capital gains only when they are realized, commonly by sale of an asset, rather than as they accrue. Compromises such as this can allow tax on large amounts of income to be postponed indefinitely, or even avoided altogether, as when appreciated property is transferred at death. On the other hand, efforts to administer the tax on an accrual basis, by levying tax before realization occurs, can introduce significant complexity and hardship. For example, if tax were levied on unrealized gains on closely-held business, valuation would be difficult; payment of tax, moreover, could frequently be required even though there is no cash flow with which to pay the tax.

Because it avoids the problems inherent in accrual taxation, a tax on personal consumption is simpler in many respects than an income tax. The consumed income tax is simpler because all costs of investment are deducted immediately ("expensed"), rather than depreciated over the life of assets; because all costs of creating inventories are expensed, rather than being recognized only as goods are sold; and because capital gains are not taxed, as such. A corporate income tax is not an essential part of an ideal tax system based on consumption; if retained, it would serve only as a withholding device.

The consumed income tax has another major administrative advantage over the income tax. Under the present income tax, the measurement of income is commonly distorted by inflation. Because consumption inherently occurs in dollars of the current year, the measurement of the base of the consumed income tax cannot be distorted by inflation. Since depreciable assets and inventory investments are expensed, inflation cannot erode the value of future deductions because there are none. Interest is not taxed, unless spent on consumption, and thus the inflation premium is not taxed. Purely inflationary capital gains are not taxed, because there is no tax on capital gains, per se.

B. Economic Advantages

Advocates of a consumed income tax argue that it is preferable to the ordinary income tax on conceptual and economic grounds, as well as on administrative grounds. First, an income tax penalizes saving by inducing taxpayers to consume rather than save for future consumption. By comparison, under certain circumstances, a tax on consumption does not distort the choice between consuming now and saving for future consumption. This is a major attraction of any tax on consumption.

Second, seen from a lifetime perspective, a tax on consumed income is said to be more equitable than an income tax. A taxpayer's total tax burden under a tax on consumed income does not depend on when income is earned or spent, at least under fairly restrictive simplifying assumptions. By comparison, an income tax imposes a heavier burden on those who earn income relatively early in life or spend it relatively late.

Despite the manifest attractions of the tax on consumed income, the Treasury Department does not propose it as either a replacement for, or a supplement to, the income tax. Several defects and difficulties of a consumed income tax lead to this conclusion.

C. Transition Problems

First, the current existence of substantial wealth, much of which has been accumulated from after-tax income, poses difficult transition problems. Taxing all consumption financed from such wealth would constitute a cruel trick on those who did not expect it -- especially those who have saved after-tax dollars for retirement. Nor would complete exemption of consumption financed from existing wealth be satisfactory. Such an exemption would either be enormously expensive in terms of lost revenue or entail extremely high tax rates during the transition period. Worse, it would allow wealthy taxpayers to escape taxation for many generations if they consumed only old wealth and saved all current income.

On equity grounds, a compromise between complete exemption and full taxation of consumption from existing wealth would be necessary. Such a compromise might allow each taxpayer above a given age to enjoy a given amount of tax-free consumption during his or her lifetime.

But phasing in a consumed income tax in this way would involve transition rules that could complicate the tax system for ordinary taxpayers for a generation.

A different type of transition problem would result from the possibility of avoiding taxes by hoarding money before the effective date of the new tax. After the effective date the taxpayer could either deposit the hoarded funds in a qualified account in order to get a tax deduction for saving or use them to meet living expenses without paying tax. Alternatively, pre-effective date investments in foreign banks could be liquidated after the effective date and reinvested as tax-deductible saving. Even though this would be a temporary problem of transition, it would undermine both the revenue yield and fairness of the tax during that period.

D. Perception Problems

Even though a taxpayer's standard of living, as reflected by his level of consumption, may be considered by many to be an appropriate base for taxation, the consumed income tax suffers from an important perception problem. Taxpayers presumably would welcome the opportunity to postpone taxes on amounts saved, paying tax only when dissaving and consumption occurs; such is the tax treatment currently accorded saving in qualified pension accounts. But to be consistent, it would also be necessary to tax amounts borrowed and allow a deduction for repayment of loans. This treatment of saving and dissaving would create a pattern of tax liabilities over the lifetime of the taxpayer that might be perceived to be unfair. Relative to experience under current law, tax liability would be greater during early adulthood and during retirement -- periods when financial resources are commonly strained. Tax would be relatively lower during middle age, the time when many taxpayers receive most of their income. The fairness of including amounts borrowed in taxable consumption might be questioned, and this tax treatment might even require a constitutional amendment.

E. Complexity for Individuals

A consumed income tax would be more complicated than the existing income tax for many individual taxpayers. Under the present income tax, amounts withheld on wages and salaries roughly offset tax liabilities for many taxpayers who have only modest amounts of income from capital. Relatively few taxpayers must worry about estimating liabilities and paying significant amounts of tax in addition to amounts withheld. Under the consumed income tax the situation could be quite different. Withholding might be required on borrowing and withdrawals from savings; if so, "reverse withholding" would be appropriate when a loan is paid off. Even then, far more taxpayers might need to file estimated returns than now, because it would be difficult to adjust withholding rates on financial transactions to the personal circumstances of taxpayers. Moreover, many young adults and retired individuals are not required to file or pay tax under an income tax, but would be required to file and pay tax under a consumed income tax.

Owner-occupied housing would not be treated as an item of consumption, to be taxed in full in the year of purchase. Rather, inclusion of the purchase price in taxable consumption would be spread over the lifetime of the home, in effect, by requiring taxpayers to pay tax as their mortgages were paid off. This could be accomplished through special treatment of mortgages outside of qualified accounts. But purchases of homes from amounts saved in qualified accounts could require special averaging features that would complicate compliance for taxpayers. Ironically, individual taxpayers would, in a sense, be asked to keep accounts resembling depreciation accounts at the same time that such accounts were eliminated for businesses.

F. The Dilemma of Gifts and Bequests

The proper treatment of gifts and bequests under a tax on consumed income is a fundamental issue. Under one view such transfers would not be taxed to the person making the gift or bequest; they would only be taxed when consumed by the recipient. Under a very different view, transfers would be taxed to the donor, as well as when consumed by the recipient. Advocates of this second approach argue that taxing gifts and bequests is necessary in order to realize fully the beneficial equity and efficiency effects of a consumption-based tax. They refer to this type of tax as a tax on lifetime income, to distinguish it from the conventional tax on annual income. The distributional differences in the two ways of treating gifts and bequests are, of course, substantial. The first approach would allow great fortunes to be passed from generation to generation without tax, whereas the second would subject transfers to tax.

G. International Aspects

No country has a tax on consumed income, although Sweden and the United Kingdom have considered it, and India and Sri Lanka (then Ceylon) attempted to impose the tax for a brief period following World War II. Any country imposing a consumed income tax would be very much out of step with its trading partners, all of which employ income taxes, and would face the task of renegotiating its foreign tax treaties.

IV. Sales Tax

The fourth option considered by the Treasury Department in its study of fundamental tax reform was a general sales tax, such as a value-added tax or retail sales tax. Chapter 10 of this volume examines sales taxes in greater detail, and Volume III contains an even more detailed analysis, especially of the value-added tax.

Serious consideration was given to only two forms of sales tax: a single-stage retail sales tax and a value-added tax extending through the retail level. Alternatives such as a gross receipts or turnover tax, a general manufacturer's tax, and a value-added tax that excludes the retail level contain fundamental defects that render them inappropriate for use by a developed country such as the United States. These defects are described in greater detail in Chapter 10.

Though the value-added tax (VAT) is now familiar throughout Europe and much of the rest of the world, it is new and unfamiliar in the United States. Americans therefore are likely to have difficulty appraising its economic effects. The kind of VAT most likely to be considered seriously in the United States is best seen as a particular way to administer a sales tax with economic effects very similar to those of a retail sales tax. Thus, in what follows, the discussion of the effects of a "sales tax" applies to both a VAT and a retail sales tax.

General sales taxes have the advantages of not penalizing saving and investment, as income taxes do, and of being fairly neutral between ways of earning and spending money. Because their base is very large and they are collected in small increments on billions of transactions, they can efficiently and relatively painlessly raise large amounts of revenue to finance federal spending or to take pressure off the income tax. Some advocates of a national sales tax believe this to be a disadvantage and propose that any tax of this kind should be accompanied by constitutional limits on the tax rate or on Federal spending, as a percent of GNP.

The following points also argue against use of a sales tax: it would involve some shift of tax liability to low-income groups; it would probably cause a one-time increase in prices; its implementation would require substantial administrative resources; and it would involve Federal intrusion on a revenue base long thought to be the fiscal preserve of state and local governments. Of these, the regressivity problem is probably the greatest.

Regressivity could be eliminated, or at least reduced, by exempting from tax sales of certain goods such as food, housing, and medical care, or by taxing them at reduced rates. However, exemptions and differential rates increase complexity and require higher general rates of tax. Alternatively, regressivity could be redressed by establishing a comprehensive system of refundable credits under the income tax, or by adjusting transfer payments and providing non-refundable credits. The slight tendency toward regressivity higher up the income scale should not be addressed by application of differential rates to "luxury" consumption. European experience indicates clearly that administrative costs far outweigh any benefits of such an approach.

A value-added tax would be preferable to a retail sales tax, despite the greater familiarity of the latter. A Federal retail sales tax, when combined with the retail sales taxes levied by most states, would provide irresistable inducement to tax evasion at the retail level. By comparison, the VAT would involve collection of about two-thirds of revenue before the retail stage. Moreover, a VAT would contain self-enforcement features that, while easily overstated, are quite important.

An additional reason for preferring the VAT over a retail sales tax is its treatment of capital goods and intermediate products and of goods in international trade. Under a VAT, exports, capital goods, and other intermediate inputs are automatically freed of tax. By comparison, under a retail sales tax this desired result is only approximately achieved; under many state sales taxes it is not even sought.

Total substitution of a sales tax for the current income tax was rejected because of the distributional inequity of such a policy. In a revenue-neutral reform package, revenues from a sales tax could be used to reduce the income tax. This would have the advantage of shifting some of the burden of taxation from income to consumption and of allowing lower income tax rates, taking pressure off the definition and measurement of taxable income. It would have the disadvantage of reducing the progressivity of the tax system. Given the considerable administrative costs implementing a sales tax would entail, however, it probably should not be imposed merely as a replacement for part of the income tax.

Chapter 4

SUMMARY OF TREASURY DEPARTMENT PROPOSALS AND THEIR EFFECTS

I. The Proposals in Brief

This chapter summarizes the Treasury Department proposals for reform and simplification of the income tax and their effects on revenues and the distribution of tax burdens. Chapter 5 provides a detailed discussion of proposals that would affect most individual taxpayers. For the most part, it deals with taxation of income from labor and self-employment. Details of proposals for reform of the taxation of corporations and of income from business and capital are presented and discussed in chapters 6 and 7. The Treasury Department proposals that affect these features of the tax law are of little direct significance for most individual taxpayers. However, the most important reforms affecting retirement saving, the tax treatment of interest income and expense, and the taxation of capital gains are summarized briefly in chapter 5.

It is worth repeating here the watchwords (described further in chapter 2) that guided development of these reforms: simplicity; fairness; lower rates; economic neutrality; economic growth; and fair and orderly transition.

A. Individuals

The financial affairs of most American taxpayers are not very complicated -- certainly, they are not as complicated as the income tax law makes them appear. Exclusions, adjustments, itemized deductions, and tax credits create much of the complexity in the individual income tax. If not required for the fair and accurate measurement of income or taxpaying ability, these provisions violate basic notions of fairness and distort economic choices. By reducing the tax base, they make necessary the high tax rates that stifle incentives and retard economic growth.

1. Fairness for families. The personal exemptions will be increased to $2,000, and the zero-bracket amounts will be raised to $3,800 for a couple filing a joint return, to $3,500 for a head of household, and to $2,800 for a single person. This will eliminate income tax for virtually all families with incomes below the poverty level. The dollar limits on the earned income tax credit will be indexed for inflation. The tax-exempt level for the elderly will be increased slightly, even though the extra exemption for the aged will be eliminated. The special exemption for the blind will be folded into an expanded credit for the elderly, blind, and disabled.

2. Lower tax rates. The present 14 tax rates (15 for single returns) will be collapsed into 3 rates, 15, 25, and 35 percent. (See Table 4-1.) The first of these will apply only to income above the

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Table 4-1

Proposed Tax Rates for 1986

Taxable Income Covered by the Tax Rate 1/

Tax Rate	Single Returns	Joint Returns	Head of Household Returns	Married Filing Separately Returns
0%	Less than $2,800	Less than $3,800	Less than $3,500	Less than $1,900
15%	$2,800 to $19,300	$3,800 to $31,800	$3,500 to $25,000	$1,900 to $15,900
25%	$19,300 to $38,100	$31,800 to $63,800	$25,000 to $48,000	$15,900 to $31,900
35%	$38,100 and over	$63,800 and over	$48,000 and over	$31,900 and over

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1/ Taxable income is equal to adjusted gross income less $2,000 for each exemption for a taxpayer or dependent.

Note: After 1986, both personal exemptions and tax bracket boundaries will be indexed to reflect inflation.

tax threshold, which will be $11,800 for a family of four. The personal exemption, zero bracket amount, and other bracket limits will be indexed, as under current law.

A couple filing a joint return will not reach the 25 and 35 percent rates until taxable income exceeds $31,800 and $63,800, respectively. By comparison, in 1986 under current law and expected 1985 inflation, the 25 percent rate will apply to income in excess of $26,850, and rates of 38 to 50 percent will be levied on incomes in excess of $49,980.

On average, the marginal tax rates that will be paid on economic income under the Treasury Department proposals are 20 percent lower than under current law. Individual tax liabilities will be reduced an average of 8.5 percent. Of course, the percentage reduction in taxes is greater at the bottom of the income scale, due to the increase in the tax threshold. Tax liabilities of families with incomes below $10,000 will fall by an average of 32.5 percent and the reduction in taxes for families with income of $10,000 to $15,000 will be 16.6 percent. These changes are discussed further in section III.

3. Fair and Neutral Taxation. In order to achieve fair and neutral taxation and to allow rates to be reduced, it is necessary to define the tax base more accurately and more comprehensively than under current law. Certain fringe benefits -- most notably the cost of medical insurance in excess of $175 per month for a family and $70 per month for a single person and group term life insurance -- will be subject to tax. Payments that replace lost wages will also be taxed. Since several forms of wage replacement will be eligible for the expanded credit for elderly, blind, and disabled, subjecting these forms of income to tax generally will not affect families with incomes below the poverty line. Real capital gains will be taxed as ordinary income, but interest income and capital gains that only reflect inflation will not be taxed at all.

Deductions for expenditures that are presently tax-preferred will be eliminated or curtailed. The deduction for State and local taxes will be phased out, and itemized deductions will be allowed for charitable contributions only to the extent that they exceed 2 percent of adjusted gross income. The deduction for charitable contributions by nonitemizers will be repealed. Deductions will be allowed for interest expense in excess of investment income only up to the amount of mortgage interest on the principal residence of the taxpayer, plus $5,000. The existing deductions for medical expenses and casualty and theft losses will be retained unchanged. The complicated credit for child and dependent care will be converted to a simpler deduction, available to nonitemizers as well as itemizers, in recognition that child and dependent care is an expense of earning income. Other expenses of earning income will be combined into one adjustment, or above-the-line deduction, subject to a *de minimis* floor of one percent of adjusted gross income. The two-earner deduction will be repealed.

Under the Treasury Department proposals it will not be possible to use gifts to children or trusts to circumvent the graduated rate structure.

4. Retirement Saving Incentives. Present law refrains from fully taxing economic income by providing tax-preferred treatment of saving for retirement. The Treasury Department proposals will retain this treatment and, indeed, will liberalize the present tax treatment of Individual Retirement Accounts (IRAs). Spouses who work in the home will be eligible to make tax-deferred contributions to an IRA on equal terms with those who are employed in the marketplace. The Treasury Department proposes that the limits on tax-deferred contributions to IRAs be raised to $2,500 ($5,000 for a husband and wife). This proposal will, in effect, allow the vast majority of taxpayers to defer tax on most of their financial saving.

5. Simplification. The increased personal exemptions and zero-bracket amounts and the curtailment of itemized deductions and credits will bring considerable simplification. Of the 97 million tax returns filed currently, 16 percent involve no tax liability. This figure will rise to 22 percent. Roughly 35 percent of all returns now report itemized deductions. This figure will drop by about a third under the Treasury Department proposals, relieving an additional 10 to 11 percent of all taxpayers of the need to record expenses and itemize deductions.

In order to simplify tax compliance further, the Internal Revenue Service (IRS) will examine the possibility of implementing a system under which many taxpayers would no longer be required to prepare and file tax returns. Under such a "return-free" system, the IRS would, at the election of each eligible taxpayer, compute their tax liability, based on withholding and information reports provided to the IRS currently and send the taxpayer a report on the calculation of tax liability. The taxpayer would, of course, be allowed to question the IRS calculation of tax. Institution of the "return-free" system, together with the increases in zero-bracket amount and the personal exemptions, would substantially reduce the number of returns that taxpayers need to file with the IRS each year. This, in turn, would eliminate burdensome recordkeeping and cost requirements incurred by taxpayers in preparing returns.

B. Taxation of Capital and Business Income

The taxation of capital and business income in the United States is deeply flawed. It is best characterized as irrational and internally inconsistent. Effective tax rates on investment income are unpredictable, as they vary tremendously with inflation. The tax law provides subsidies to particular forms of investment that are unfair and that seriously distort choices in the use of the Nation's scarce capital. The interaction of various provisions results in opportunities for tax shelters that allow wealthy individuals to pay little tax, create the perception of a fundamentally unfair tax system, and further distort economic choices. The double taxation of dividends discourages equity investment in the corporate sector, and needlessly high marginal tax rates create disincentives for saving, investment, invention, and innovation. Moreover, high marginal rates encourage efforts to obtain additional special tax benefits which, if successful, further erode the tax base and necessitate even higher rates in a vicious cycle. The international allocation of U.S. capital is also distorted.

The tax reforms proposed by the Treasury Department will rationalize the taxation of income from business and capital. The primary objective of reform is to subject real economic income from all sources to consistent tax treatment. Uniform taxation of all income is necessary in order to minimize interference of the tax system with the market-determined allocation of economic resources among competing uses. A comprehensive and consistent definition of the tax base is also needed to restore both the fairness of the tax system and the public perception of fairness. Finally, the tax base must be broadened in order to allow the reduction of both individual and corporate income tax rates.

1. Taxing Real Economic Income. Real economic income should be measured accurately during periods of inflation. The Treasury Department proposes that inflation adjustments be made in the calculation of depreciation allowances, capital gains, the cost of goods sold from inventories, certain charitable contributions, and interest income and expense. This reform will eliminate the need for the arbitrary ad hoc adjustments for inflation currently incorporated in the investment tax credit, the accelerated write-off of depreciable property, and the partial exclusion of long-term capital gains. Replacing the investment tax credit (ITC) and the Accelerated Cost Recovery System (ACRS) with real economic depreciation and taxing real capital gains as ordinary income will eliminate the great disparities in the taxation of various industries under current law. Inflation adjustment will prevent effective tax rates on investment income from depending on the rate of inflation in ways that vary across asset types and industries. The taxation of real economic income at lower rates, coupled with several additional reforms, will reduce the opportunities and incentives for tax shelter activities and, thus, allow investment decisions to be motivated by economic realities rather than by tax considerations.

2. Retirement Savings Incentives. The tax treatment of retirement savings, a major source of funds for capital formation in the United States, should be expanded and rationalized. The Treasury Department believes that the basic elements of the current tax structure which favor retirement savings should be retained and that the tax incentives encouraging such saving should be expanded. Accordingly, the Treasury Department proposes that the limits on contributions to individual retirement accounts (IRAs) be increased and that availability of IRAs be extended on an equal basis to spouses not employed in the marketplace. Under the Treasury Department proposals much of the financial saving of families will be accorded favorable tax treatment. According to one survey, only 39 percent of all

American families have accumulated total financial assets of more than $5000. An even smaller percentage would save as much as $5000 in any one year As a result, individuals will experience much of the tax preference for saving associated with a consumed income tax, but the many problems involved in implementing such a personal tax on consumption (discussed in chapter 9) will be avoided. The Treasury Department also proposes that the tax treatment of retirement savings be rationalized by subjecting all pre-retirement distributions to uniform rules, and by simplifying the contribution limits applied to various tax-preferred plans.

3. Neutrality Toward Business Form. Corporations and partnerships should be taxed in more nearly the same way. The Treasury Department proposes that corporations be given a partial deduction for dividends paid in order to reduce the double taxation of dividends, and that certain large partnerships be taxed as corporations.

4. Industry-Specific Subsidies and Tax Shelters. Highly preferential tax treatment that benefits only a few selected industries should be eliminated. This special treatment is undesirable both because it is inequitable and because it violates the principle of economic neutrality. A consistent definition of taxable income would allow market forces, rather than the tax system, to determine the allocation of the Nation's scarce economic resources.

C. Economic Effects

Implementation of the tax reforms proposed by the Treasury Department will cause a substantial reallocation of economic resources. The lower tax rates made possible by base-broadening and the more accurate rules for the measurement of income and calculation of tax liabilities will stimulate investment in industries that are burdened by the current unfair and distortionary tax regime. The proposed reforms will thus benefit both some established industries as well as new "high-tech" industries.

However, the primary beneficiaries of the Treasury Department's proposals will be the American public. No longer will the allocation of the Nation's scarce economic resources -- its labor, its capital, its land, and its inventive genius -- be distorted by the biases of the current tax system. Instead, under the economically neutral tax system proposed by the Treasury Department, market forces will direct resources to those activities where returns are greatest. The result will be more productive investment and thus greater output. A more effectively utilized capital stock will result in a more productive, and thus more highly paid, labor force. Output prices in currently tax-favored industries will increase, while output prices in currently tax-disadvantaged industries will fall. As a result, a more useful mix of goods will be produced, since consumer prices will adjust to reflect these changes in costs, and consumer demand will no longer be artificially distorted.

In addition, the biases under current law against emerging firms, especially those with relatively low demands for physical capital, will be eliminated. The current bias toward firms with relatively large investments in depreciable assets, especially short-lived equipment, will be eliminated under a capital recovery system that approximates economic depreciation. Economic depreciation will reduce the current bias toward established firms that can fully utilize special deductions and credits by replacing the present "front-loaded" capital recovery system of ACRS and the ITC. Moreover, the current bias toward established firms with retained earnings will be reduced by decreasing the marginal tax rate on corporate income paid out as dividends. Since retained earnings would not have as large a tax advantage over new equity, firms in need of new equity financing will find it more readily available. Since many firms in the "high technology" industries are emerging and relatively low capital intensity, the proposed reforms will foster invention and innovation by benefitting such firms. The reform proposal thus would promote faster economic growth, in addition to improving the allocation of the Nation's resources at any single point in time.

The Treasury Department proposals will affect different industries in different ways; in particular, not all industries would benefit from tax reform. That is the nature of the tax reform problem. The only way to reduce the burden of taxes on industries that pay above-average taxes under current law is to shift part of that burden to industries where taxes are now artificially reduced by special provisions. Taxpayers that would lose special tax preferences under the proposed reforms include the oil and gas industry; banks, life insurance companies, and other financial institutions; and industries in which production extends over several years.

Although it is possible to identify the industries that would lose special tax preferences, it is impossible to predict the precise economic effects of the entire package of Treasury Department proposals on all industries and individuals in the economy. Although many mathematical models of the economy exist, economic science simply is not sufficiently precise to allow accurate prediction of the effects of reforms as fundamental and pervasive as those proposed by the Treasury Department; accordingly, this Report contains no such attempt at precise quantification of economic effects.

D. Transition

Enactment of the Treasury Department proposals would undoubtedly result in a sizable reallocation of resources. Costly dislocations and unanticipated losses caused by tax reform can -- and should -- be mitigated through provisions for fair and orderly transition. This Report contains many recommendations (see Volume 2) for delayed or phased-in enactment dates. Moreover, "grandfathering" provisions designed to maintain current tax treatment for commitments made under present law would mitigate the dislocations and windfall losses associated with implementing reform. Nevertheless, transition to a more equitable and more neutral system must occur. To resist permanently the need to tax all real economic income consistently and uniformly would be to perpetuate the high tax rates, inequities, and tax-induced distortions of resource allocation that currently plague the economy. It would also threaten the viability of our voluntary income tax system by allowing these defects to continue to undermine taxpayer morale.

II. Effects on Revenues

The Treasury Department proposals are designed to be revenue neutral. That is, they raise roughly the same amount of revenue as current law, when fully phased in, and during each of the transition years, FY 1986-90. Table 4-2 shows projected tax receipts under both current law and the Treasury Department proposals, plus receipts under the proposals as a percent of current law receipts, for fiscal years 1986-90.

During FY 1986, receipts under the proposals exceed those under current law by $0.5 billion. In FY 1987, they fall short of current receipts by $5.8 billion. During the FY 1988-90 period, receipts under the proposal exceed those under current law by an average of $6.0 billion, or 0.9 percent of current law receipts. These deviations from receipts under current law are small enough, compared to potential errors in estimates, that the proposals should be characterized as revenue neutral.

It would not be helpful to show actual dollar receipts beyond the transition period, given the vagaries of forecasting so far into the future. But, when fully phased in, the proposal raises about 1 to 3 percent less revenue than current law. In other words, if receipts under current law would have otherwise been $1 trillion, they will be $10 to $30 billion less under the Treasury Department proposal when fully phased in. Thus, even when fully phased in, the proposals are revenue neutral.

The estimates of receipts for 1986-90 are based on the economic forecast in the 1984 Mid-session Review. The estimates reflect the assumption that the level of economic output is not affected by the tax reforms being proposed. In fact, the dramatic reductions in marginal tax rates that are being proposed can be expected to generate additional work effort, saving, investment and innovation. As a result, economic output -- and with it tax receipts -- will probably be higher than projected. Predicting how much higher is, however, inevitably a difficult task. Any estimates of the effects of increased incentives would be far outside the range of recent experience.

Table 4-2 also shows the breakdown of annual receipts between individual and corporate taxpayers. Over the period FY 1986-1990, individual receipts will be reduced by some 6 to 9 percent per year relative to current law, while corporate receipts will be 25 to 37 percent higher. Fully phased in individual receipts will be 8.5 percent lower; corporate receipts will be about 24 percent higher.

Table 4-2

Unified Budget Receipts

	1986	1987	1988	1989	1990
	Fiscal years				
	($ Billions)				
Current service receipts: current law -- (Midsession Review of the 1985 budget)					
Individual	373.0	407.7	452.4	493.1	537.4
Corporate	87.9	102.7	111.6	117.0	122.6
Estate and gift	5.4	5.0	4.8	4.8	5.1
Excise	36.1	36.8	35.4	34.7	34.0
Total	502.5	552.2	604.2	649.6	699.2
Current service receipts: proposed law					
Individual	350.9	371.1	427.2	467.2	499.7
Corporate	110.1	133.3	141.0	155.1	167.4
Estate and gift	5.6	4.9	4.7	4.7	5.0
Excise	36.3	37.1	35.3	33.0	30.9
Total	503.0	546.5	608.1	659.9	703.0
Net effect of the proposal - total receipts	.5	-5.8	3.9	10.3	3.9
	(Percent)				
Proposed law receipts as a percent of current law receipts					
Individual	94.1	91.0	94.4	94.7	93.0
Corporate	125.2	129.8	126.3	132.5	136.5
Estate and gift	104.1	98.1	97.8	97.7	98.4
Excise	100.6	100.9	99.7	95.0	90.9
Total	100.1	99.0	100.6	101.6	100.6

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Note: Details may not add to totals due to rounding.

III. Effects on Income Distribution and Incentives

The Treasury Department has designed its proposals to be basically neutral from a distributional point of view, as well as revenue neutral, once fully phased in. That is, the distribution of individual income tax burdens across income classes does not differ significantly from that under current law, except in one important respect. An explicit goal of the study is the elimination of income tax liability from families with incomes below the poverty level. To achieve the increase in the tax threshold required to meet this objective, the personal exemptions and zero-bracket amounts will be increased, thus increasing slightly the relative burdens of all taxpayers above the new tax-exempt levels of income.

One way to see the distributional neutrality of the proposed package of tax reforms and simplification is to examine the percentage distribution of tax liabilities under present law and proposed law. A comparison of lines 5 and 6 of Table 4-3 reveals that the percentage distribution of tax liabilities would not be changed significantly, except at the bottom of the income scale, where burdens would clearly be reduced.

Although the proposed tax reforms reduce total revenues from the individual income tax by 8.5 percent, the increase in the tax threshold is reflected in substantially greater reductions in taxes paid in the bottom two income classes. Liabilities of families with incomes below $10,000 fall by 32.5 percent and those of families with incomes between $10,000 and $15,000 fall by 16.6 percent. Above average, but smaller reductions are also experienced in the next three income classes. In the three income classes above $50,000 the reduction in taxes is slightly less than average, at 6.4 to 8.0 percent. (See line 9 of Table 4-3 and Figure 4-2.)

The distributional neutrality of the proposed reforms is also shown by the pattern of average tax rates paid at each income level, under present law and the proposed law. (See lines 10 and 11 of Table 4-3 and Figure 4-1.) Under current law, the average rates increase steadily from about 1-1/2 percent for those with incomes below $10,000 to roughly 21 percent for taxpayers with income in excess of $200,000. Under proposed law the range of average rates is from about 1 percent to just above 19 percent.

The pattern of <u>average</u> tax rates, that is, the percentage of <u>total</u> income taken by taxes at various income levels, is relevant for judging the distributional fairness of the tax system. The figures just presented show that the reforms proposed do not significantly redistribute tax burdens across income classes except insofar as tax burdens at the very bottom of the income scale are reduced dramatically; that is, the proposals are basically distributionally neutral.

Average tax rates do not indicate the extent to which taxation creates disincentives for productive economic activities. To appraise

Table 4-3

Distribution of Adjusted Gross Income, Taxable Income, Income Tax, And Tax Rates Under Present Law And Under The Tax Reform Proposal 1/

	Family Economic Income Class (in thousands) 2/								
	$0 - 10	10 - 15	15 - 20	20 - 30	30 - 50	50 - 100	100 - 200	200 & over	All Income Classes
I. Percentage Distribution of:									
Adjusted Gross Income Under									
1. 1986 present law	1.7	4.1	5.7	14.3	28.4	31.7	8.2	6.0	100.0
2. Tax reform proposal	1.8	4.1	5.7	14.3	28.2	31.4	8.1	6.5	100.0
Taxable Income Under									
3. 1986 present law	1.5	3.9	5.6	14.6	28.9	31.6	8.1	6.0	100.0
4. Tax reform proposal	1.2	3.3	5.0	13.5	28.1	32.6	8.9	7.5	100.0
Tax Liability Under									
5. 1986 present law	.5	1.8	3.3	10.3	24.3	32.8	12.3	14.9	100.0
6. Tax reform proposal	.3	1.6	3.1	10.2	24.1	33.1	12.6	15.0	100.0
II. Percentage Change in									
7. Adjusted gross income	4.5	3.3	3.5	3.3	2.1	2.0	1.4	10.1	2.8
8. Taxable income	-16.3	-13.7	-10.5	-6.4	-1.8	4.4	11.2	24.9	1.0
9. Tax liability	-32.5	-16.6	-12.1	-9.1	-9.3	-7.4	-6.4	-8.0	-8.5
III. Average Tax Rate Under									
10. 1986 present law	1.4	3.2	4.6	6.2	7.8	9.4	13.2	20.9	8.7
11. Tax reform proposal	.9	2.7	4.0	5.7	7.0	8.7	12.3	19.3	8.0
IV. Average Marginal Tax Rate									
12. 1986 present law	4.2	9.4	12.4	16.0	20.9	27.6	37.5	46.1	23.6
13. Tax reform proposal	3.7	8.5	11.0	14.0	16.5	22.1	30.5	33.2	18.9
14. Percentage change	-11.9	-9.6	-11.3	-12.5	-21.1	-19.9	-18.7	-28.0	-19.9

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1/ See Appendix 4-B for a listing of the tax reform provisions included in the analysis. Distributions are based on 1983 levels of income.
2/ Restricted to families with nonnegative income. See Appendix 4-A for description of economic income.

Figure 4-1

AVERAGE RATES OF TAX ON FAMILY ECONOMIC INCOME UNDER CURRENT LAW AND THE PROPOSAL

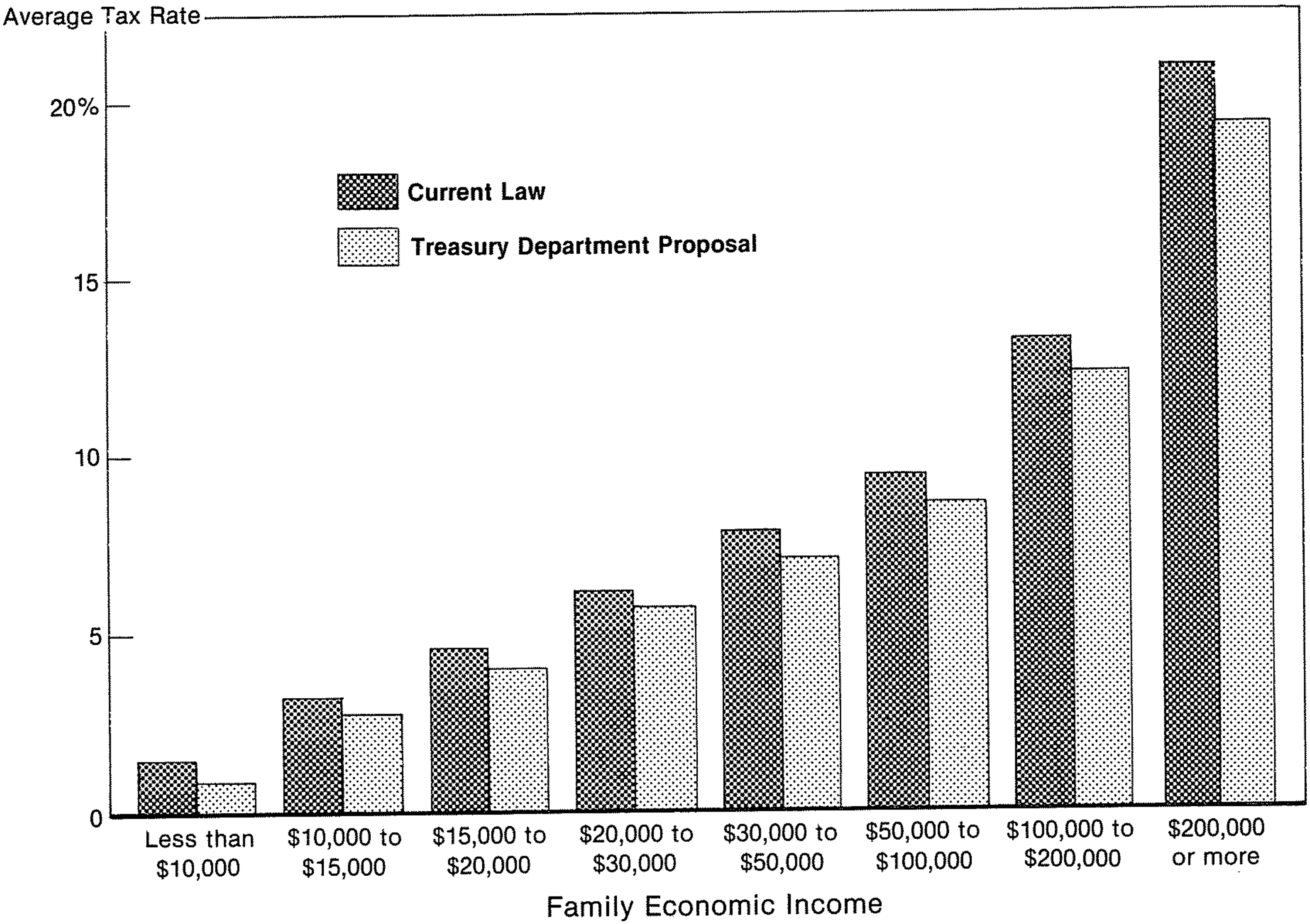
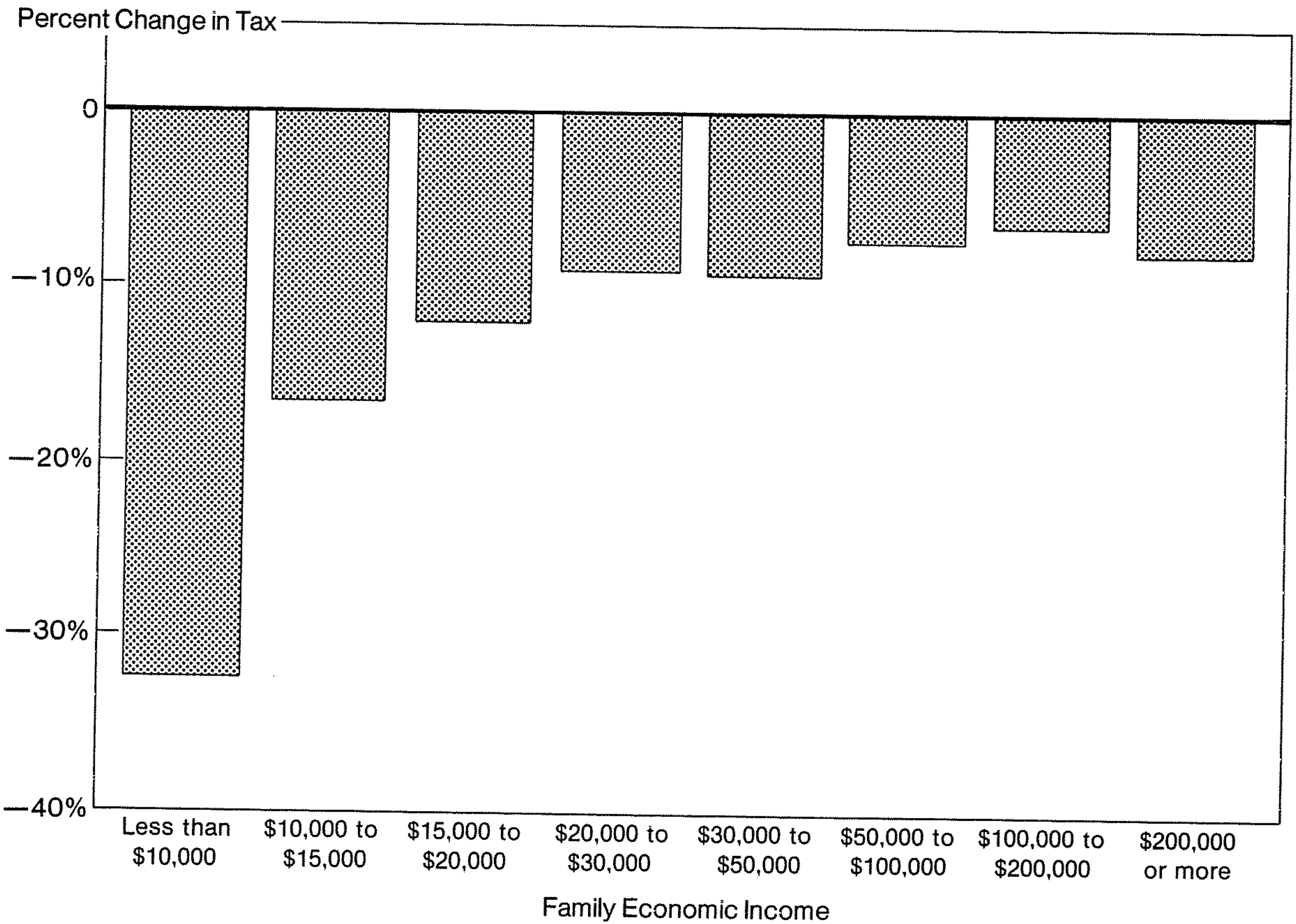


Figure 4-2

PERCENT CHANGE IN TAX UNDER THE PROPOSAL BY FAMILY ECONOMIC INCOME



incentive effects it is necessary to know marginal tax rates, that is, the percentage of an additional dollar of income that will be taken by taxes.

Lines 12 to 14 of Table 4-3 and Figure 4-3 present data on marginal tax rates paid, on the average, at various income levels. In the aggregate the proposed reforms reduce marginal tax rates by 19.9 percent, from 23.6 percent to 18.9 percent. The fact that marginal tax rates can be cut this much while average tax rates fall by only 8.5 percent shows clearly the advantage of defining taxable income comprehensively. By levying lower marginal tax rates on a broader tax base, it is possible to avoid the disincentive effects of higher rates.

Marginal tax rates paid by families in the three income classes between $30,000 and $200,000 fall, on average, by about 20 percent. The marginal tax rates paid, on the average, by families with income below $30,000 fall by 10 to 13 percent. Even though marginal income tax rates do not fall as much at this income level as at others, they are low, on average, ranging from only 4 to 14 percent under the proposed law.

In the very highest income bracket, that above $200,000, the marginal tax rate falls by 28 percent, from 46 percent to 33 percent. It bears repeating that this relatively greater cut in marginal rates in the top income classes does not imply that high-income taxpayers will experience a relatively greater tax cut than taxpayers with lower incomes. As line 9 of Table 4-3 indicates, all income groups above the $50,000 income level experience smaller than average tax reductions. Rather, marginal rates fall furthest at the top of the income distribution because that is where the tax base is increased by the largest fraction. The proposed tax reforms increase adjusted gross income (AGI) for all families by only 2.8 percent. (See line 7 of Table 4-3.) But for families with income in excess of $200,000, AGI increases by 10.1 percent, as a result of eliminating many provisions that allow income to be sheltered from tax.

The total of taxable income for all families is virtually unchanged under the Treasury Department proposals. (See line 8 of Table 4-3.) But for those with incomes below $15,000, taxable income falls dramatically -- by 14 to 16 percent, due primarily to the increase in the personal exemptions. Smaller reductions in taxable income extend through the $30,000 to $50,000 income class. Above that point, taxable income increases, with taxable income of those with incomes of more than $200,000 rising by 24.9 percent. (See Figure 4-4.)

The dramatic reduction in marginal tax rates that base-broadening makes possible at the top of the income scale emphasizes the importance of taxing all income in a consistent manner. Simply by defining the tax base comprehensively, it is possible to achieve a percentage reduction of marginal tax rates paid by high-income individuals that is larger than that provided in the Economic Recovery

Figure 4-3

MARGINAL RATES OF TAX UNDER CURRENT LAW AND THE PROPOSAL

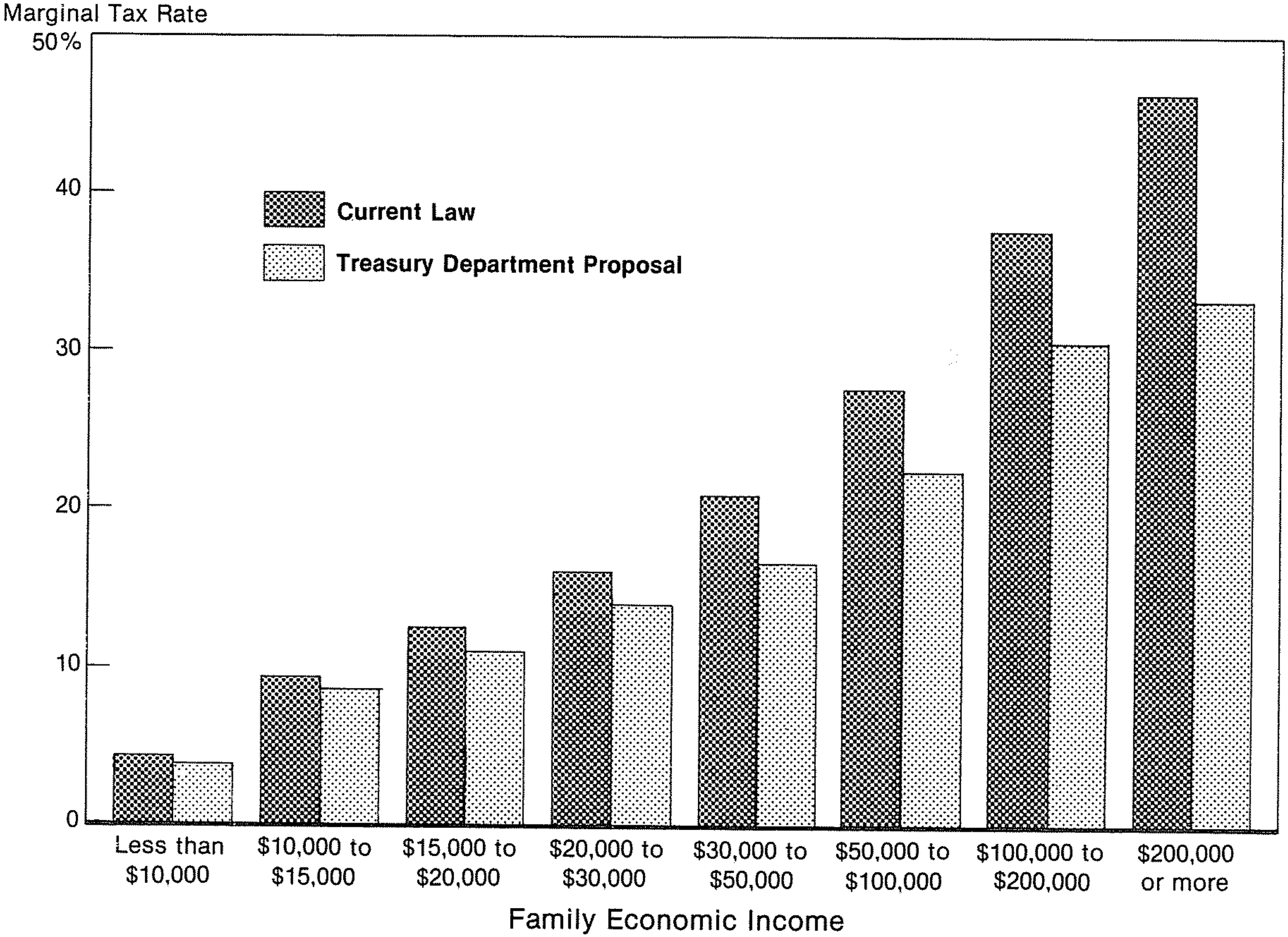
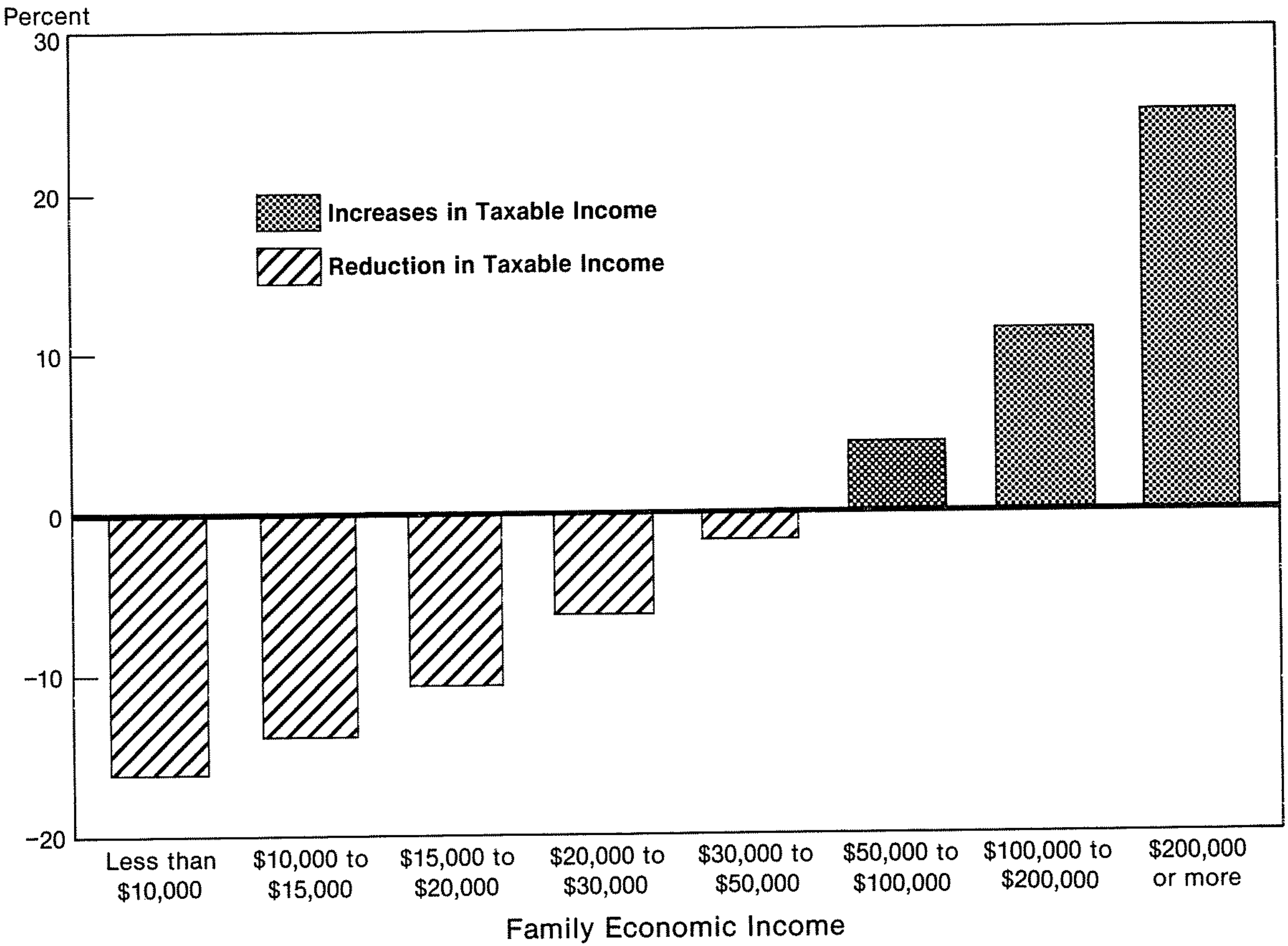


Figure 4-4

PERCENTAGE CHANGE IN TAXABLE INCOME RESULTING FROM THE TREASURY PROPOSAL



Tax Act of 1981, and to do so while cutting taxes for them by less than they are cut for lower income classes. A reduction of marginal tax rates of this magnitude will open wide the doors of opportunity to those who are willing to work, to save and invest, and to innovate.

The advantage of base-broadening can also be seen from Table 4-4 and from Figure 4-5. Of the 91.4 million families in the country, fewer than 20 million, or about 22 percent, will experience any tax increase as a result of the Treasury Department proposals. By comparison, 56 percent will have their taxes reduced. At the lower income levels the fraction of families with tax increases is even smaller, ranging from less than 5 percent in the zero to $10,000 income class to about 20 percent in the $15-20,000 income class.

In every income class far more families will benefit from the Treasury Department's proposals than will lose. Moreover, there are far more families whose average tax rate will fall by a given amount (for example, less than one percentage point or more than two percentage points) than there are families whose average rates will rise by that amount. (See Table 4-4.)

Table 4-4

Distribution of Families by Change in Tax as a Percent of Income
Comparing The Tax Reform Proposal With 1986 Present Law 1/

	Family Economic Income Class (in thousands) 2/								
	$0 - 10	10 - 15	15 - 20	20 - 30	30 - 50	50 - 100	100 - 200	200 & over	All Income Classes
I. Number of families with:									
Tax INCREASE as percent of income:									
More than 2 percent.............	303	625	691	1,138	1,013	904	286	80	5,040
1 to 2 percent..................	123	368	457	1,004	1,337	870	143	28	4,330
Less than 1 percent 3/..........	224	709	980	2,160	3,667	2,458	258	26	10,482
Tax DECREASE as percent of income:									
More than 2 percent.............	1,281	1,591	1,380	2,758	4,096	2,712	514	218	14,550
1 to 2 percent..................	905	1,505	2,482	4,162	4,453	2,716	301	41	16,565
Less than 1 percent 3/..........	1,096	3,136	2,597	4,379	5,082	3,780	347	40	20,457
No change in tax..................	9,779	3,715	2,115	2,031	1,638	617	44	8	19,947
Total, all families..........	13,712	11,649	10,702	17,633	21,286	14,057	1,894	441	91,374
II. Percent of Families with:									
Tax INCREASE as percent of income:									
More than 2 percent.............	2.21	5.36	6.45	6.45	4.76	6.43	15.10	18.02	5.52
1 to 2 percent..................	.90	3.16	4.27	5.69	6.28	6.19	7.54	6.43	4.74
Less than 1 percent 3/..........	1.64	6.09	9.16	12.25	17.23	17.48	13.63	5.94	11.47
Total with tax increase........	4.75	14.61	19.88	24.39	28.27	30.10	36.27	30.39	21.73
Tax DECREASE as percent of income:									
More than 2 percent.............	9.34	13.66	12.89	15.64	19.24	19.30	27.12	49.41	15.92
1 to 2 percent..................	6.60	12.92	23.20	23.61	20.92	19.32	15.91	9.40	18.13
Less than 1 percent 3/..........	7.99	26.92	24.27	24.84	23.87	26.89	18.35	9.01	22.39
Total with tax decrease........	23.93	53.50	60.36	64.09	64.03	65.51	61.38	67.82	56.44
No change in tax..................	71.32	31.89	19.76	11.52	7.70	4.39	2.35	1.79	21.83
Total, all families..........	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

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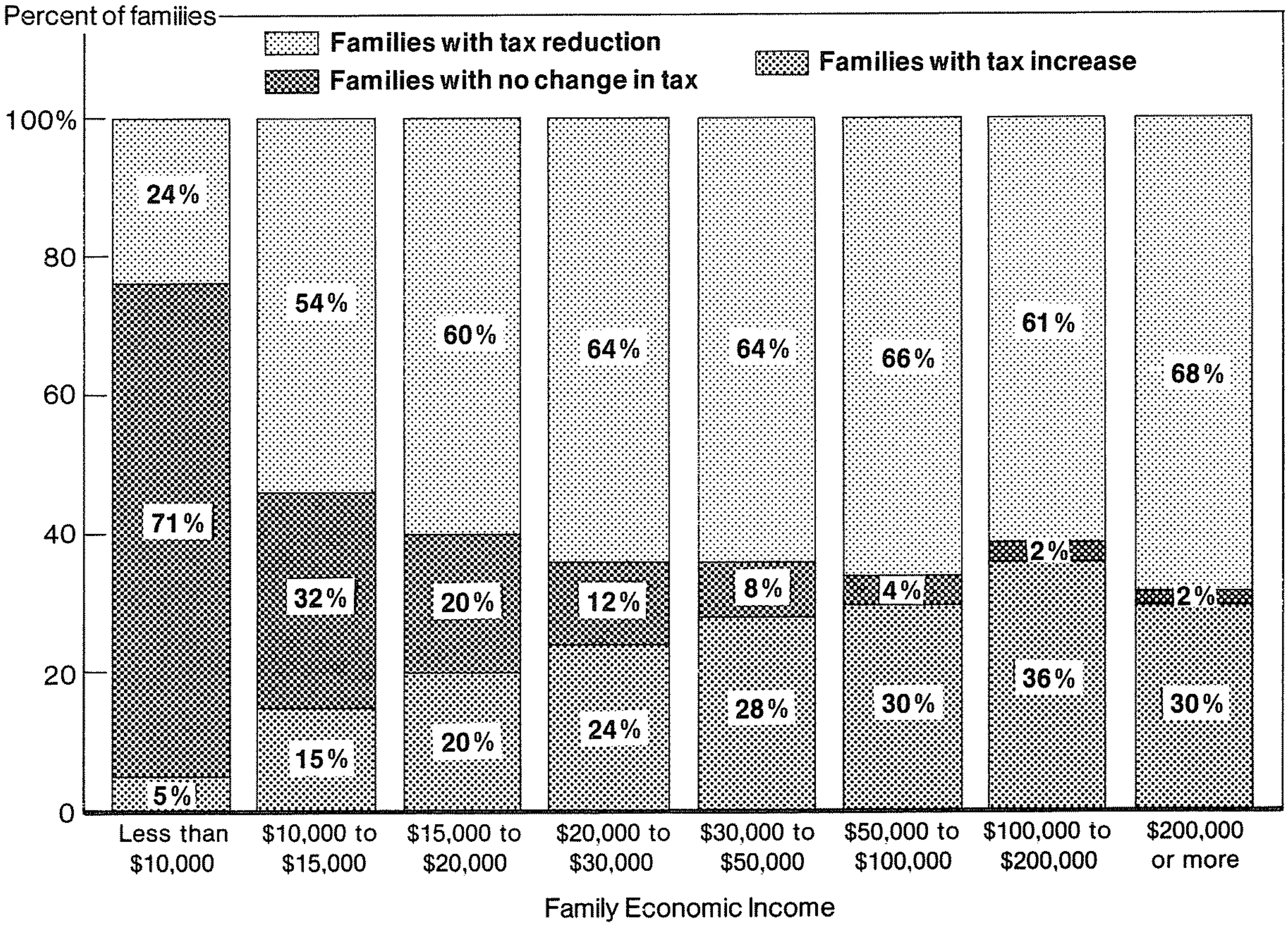
1/ See Appendix 4-B for a listing of the tax reform provisions included in the analysis. Distributions are based on 1983 levels of income.
2/ Restricted to families with nonnegative income. See Appendix 4-A for description of economic income.
3/ Families with tax changes of less than 0.05 percent of their income were considered to have only a negligible tax change and were therefore excluded from the tax-change groupings.

Figure 4-5

FAMILIES WITH TAX CHANGE AS A PERCENT OF ALL FAMILIES BY FAMILY ECONOMIC INCOME



Appendix 4-A

Explanation of Concept of Economic Income Used in Distributional Tables

The tables in this Report showing the distribution of current and proposed tax liabilities by family income class represent an important improvement over the kinds of comparisons the Treasury Department has been able to display in the past. They differ from the usual tables in two ways: (1) taxes and the effects of changes in tax policy are distributed over all families in the population, rather than over tax-filing units; and (2) the definition of income is a broad measure of economic income, rather than adjusted gross income.

Families

For many people, the tax unit and the family are the same. A family can, however, consist of several tax filing units if dependents have incomes of their own. For instance, if the children in a family have jobs or have investment funds in their names, they may have to file returns to pay taxes or to receive a refund of taxes that were withheld. For judging the fairness of the distributional burden of the tax system, the incomes and the taxes of those dependents should be included with the incomes and taxes of the taxpayers (usually parents) who support them.

Another difference between the tax return unit and the family is that many families and individuals have too little income for them to be required to file a tax return under current law. These "nonfilers" should be recognized in surveying the tax system's impact on people at different income levels. Tables based on tax returns cannot show how many people at a given income class are not even in the tax system, whereas the tables in this Report do reflect the families and individuals who do not file tax returns.

Income Definition

The definition of income used in this Report for classifying families and for comparing tax burdens differs from adjusted gross income and other tax system concepts of income in a number of ways. (The income classifier does not serve as the basis for actual taxation.) Economic income is a comprehensive measure of income that is intended to approximate as closely as possible the standard definition of income, consumption plus change in net worth. It includes forms of income that are not subject to tax, such as interest from tax-exempt state and local bonds and government transfer payments. It also measures more accurately certain other forms of income that are subject to tax, such as real interest income. This broader measure of income, therefore, provides a better yardstick for comparing families -- that is, for determining their abilities to pay taxes and comparing tax burdens by income class.

"Economic income" starts from adjusted gross income as reported on tax returns and adds in unreported or underreported income. It adds back certain "adjustments to income," principally IRA and Keogh contributions and the second earner deduction. Since economic income aims to measure income in the current year, it adds back net operating losses carried over from previous years. It includes cash and near-cash transfers that are not subject to tax, principally social security benefits, welfare payments, unemployment and workers' compensation, veterans' compensation, and food stamps. It adds in the untaxed portion of compensation such as employer contributions for pensions and health and life insurance and other fringe benefits. So that pension income not be double counted, it excludes pension income as received but includes the accrual of earnings on pension and life insurance plans, and on IRA and Keogh accounts. It includes tax-exempt interest. Since home owners receive implicit income from their houses, economic income includes an estimate of the real imputed net rent on owner-occupied housing.

"Economic income" reflects the view that corporations are not separate from their stockholders, but that the income of corporations is income of its stockholders; therefore, economic income allocates pre-tax corporate profits both to individuals who own stock directly and to those who own stock indirectly, for example, through shares of pension or life insurance funds. Economic income attempts to measure capital income correctly: by indexing interest receipts and expenses, by indexing capital gains and losses, by replacing tax depreciation with real economic depreciation, and by including the tax-preference component of intangible drilling costs and percentage depletion allowances.

The derivation of economic income from adjusted gross income is described in greater detail in Table 4A-1. Figure 4A-1 compares the distribution of tax returns classified by AGI with the distribution of families classified by economic income. The most striking difference is that twice as large a percentage of tax returns fall in the smallest class -- below $10,000 -- than do families. Conversely, a much higher percentage of the families appear in the higher income classes of economic income. The chart shows clearly how poorly the distribution of tax returns by AGI approximates the distribution of families by economic income, which is a more appropriate way of viewing the population for most analytical purposes.

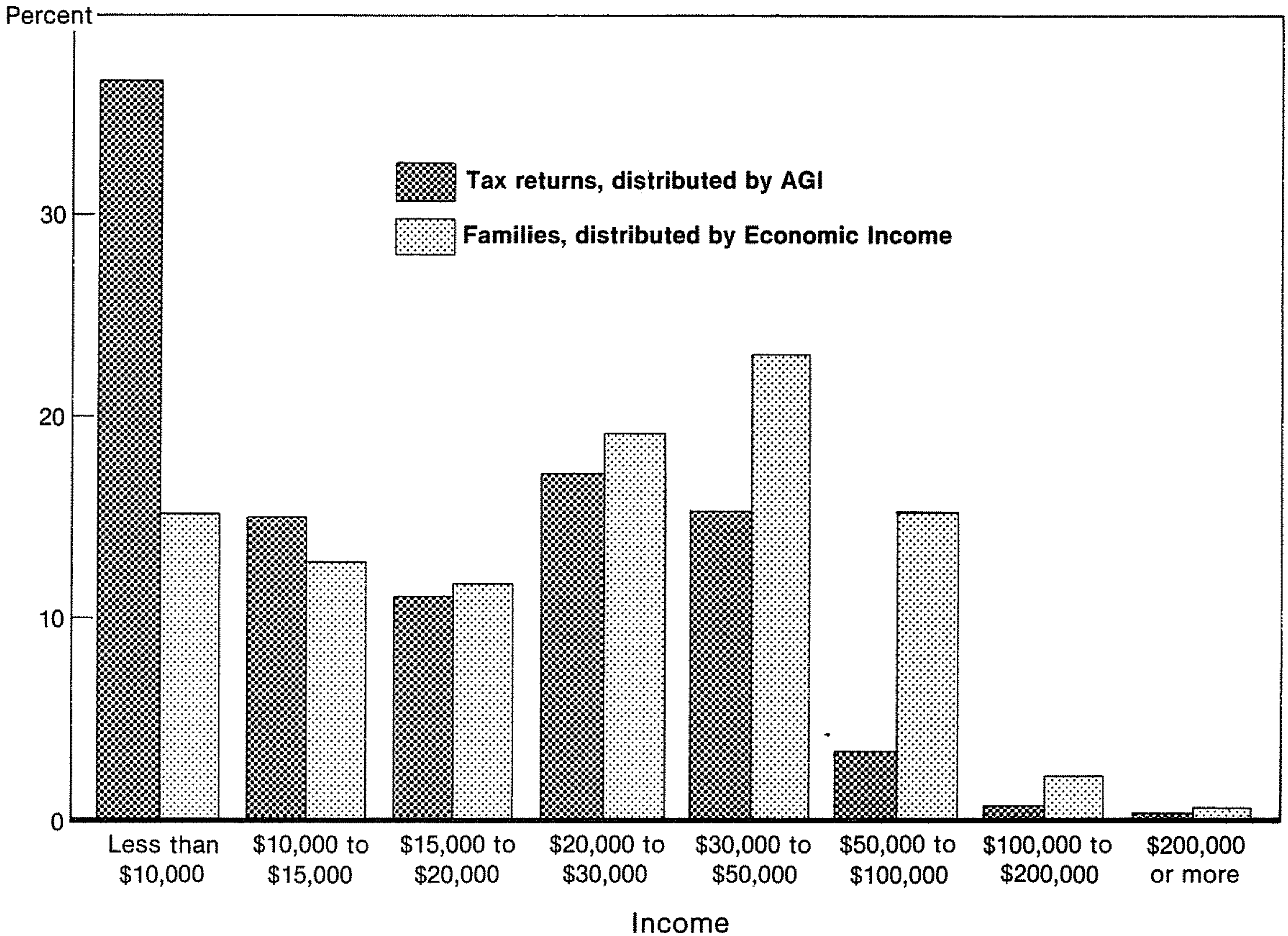
Table 4A-1

Economic Income Equals

Adjusted gross income:
reported on tax returns
unreported or underreported
plus net operating losses carried over from previous years
plus adjustments to income:
IRA and Keogh contributions
two-earner deduction
other adjustments
plus untaxed employer contributions for:
pensions
health and life insurance
profit sharing
other benefits
plus certain fringe benefits
plus certain military benefits
plus untaxed cash benefits for:
unemployment compensation
workers' compensation
AFDC
SSI
veterans' compensation
social security
railroad retirement
plus *food stamps benefits*
plus non-corporate earnings on pension and life insurance plans
less taxable pension income
plus earnings on IRA and Keogh plans
plus tax-exempt interest
plus real net imputed rent on owner-occupied homes
less realized corporate income
plus accrued pre-tax real corporate income
plus adjustment for indexing of non-corporate capital gains and losses
plus adjustment for indexing of interest income and expense
plus replacement of tax depreciation with economic depreciation
plus tax preference for intangible drilling costs, and percentage depletion

Figure 4A-1

DISTRIBUTION OF TAX RETURNS BY ADJUSTED GROSS INCOME CLASS AND FAMILIES BY ECONOMIC INCOME CLASS



Appendix 4-B

Provisions Included in the Distributional Analysis in Tables 4-3 and 4-4

- Income Tax Reform and Simplification for Individuals
  - Rate reduction
    - rate schedules
  - Fairness for families
    - increase in the Zero Bracket Amount (see Table 4 for details)
    - increase the taxpayer and dependent exemption amounts (see Table 4 for details)
    - repeal the two-earner deduction
    - index the earned income credit
    - convert the child-care credit to an above-the-line deduction
    - replace the elderly and blind exemptions with an expanded elderly credit
  - Fair and neutral taxation
    - partial taxation of employer contributions to health insurance plans
    - repeal the exclusion for group-term life insurance and other employer-provided life insurance
    - repeal special treatment of cafeteria plans
    - repeal tax-exempt threshold for unemployment compensation
    - repeal exemption for workers' compensation
  - Preferred uses of income
    - repeal deduction for state and local taxes
    - limit charitable contribution deduction (2% income floor)
    - repeal 30 & 50 percent limitation on charitable contributions
  - Tax abuses
    - restrict entertainment expense deductions and limit deduction for business meals
    - require allocation of travel expenses
    - elimate certain shifting of income to trust income
  - Further simplifications
    - repeal individual minimum tax
    - group miscellaneous deductions with employee business expenses and impose a 1 percent of income floor
    - repeal political contributions credit
    - disallow income averaging for full-time students
- Basic Taxation of Capital and Business Income
  - Taxing real economic income
    - index capital gains and tax as regular income
    - index depreciation for inflation and adjust depreciation schedules
    - repeal the investment tax credit
    - index interest receipts and payments
  - Retirement saving
    - increase IRA limits
    - repeal the 3-year rule for retirement distributions
    - repeal the combined plan limit for non top-heavy plans
  - Neutrality towards the form of business organization
    - repeal the dividend exclusion
  - Industry specific subsidies, tax shelters, and other tax issues
    - repeal percentage depletion
    - repeal expensing of intangible drilling costs
    - repeal exclusion of life insurance build-up
    - limit interest deduction

Chapter 5

INCOME TAX REFORM AND SIMPLIFICATION FOR INDIVIDUALS & FAMILIES

I. Summary

The Treasury Department proposals will lower tax rates and reduce the current number of rate brackets from 15 to three: 15, 25, and 35 percent. The amount of income that can be earned tax-free will also be increased by raising to $2,000 the personal exemptions for the taxpayer, spouse, and dependents and by increasing the zero bracket amounts. Very few families below the poverty level will be subject to income tax.

The tax base will be broadened to make this rate reduction possible, simplify the system, and make it fairer by eliminating special preferences and abuses. The definition of individual taxable income will be expanded to include certain fringe benefits and other items. Deductions for tax shelter investments and business expenses that involve personal consumption will be curtailed. The itemized deduction for State and local taxes will be phased out, and charitable contributions will be deductible only to the extent that they exceed 2 percent of adjusted gross income. Left intact will be the current itemized deductions for interest on the principal residence of the taxpayer, medical expenses, and casualty losses.

Elimination of several tax credits and other items will substantially simplify the tax forms. The Internal Revenue Service will consider the possibility of initiating a new system under which it calculates tax liability for many taxpayers.

The deductions for contributions to Individual Retirement Accounts will be increased to $2,500 per employee and from $250 to $2,500 for spouses working in the home. Other proposed changes that involve the taxation of business and capital income, including the corporation income tax, are of less concern to most individuals and are discussed in chapters 6 and 7. (The appendix to the present chapter contains a detailed listing of all proposals primarily affecting individuals and families.)

II. Rate Reduction

The reforms proposed by the Treasury Department will expand the income tax base enough to allow substantial rate reductions for individuals. On incomes above the tax threshold ($11,800 for a family of four) three rates -- 15, 25, and 35 percent -- will apply. Under current law, marginal rates range from 11 percent to 50 percent. Thus the top marginal rate will be cut by 30 percent under the Treasury Department proposals. The proposed rate schedules for single returns, head of household returns, and joint returns are compared with those under current law in Table 5-1. On average, marginal tax rates will be 20 percent lower under these proposals than under current law. The effects on marginal rates paid at various points in the income distribution were discussed further in Chapter 4.

Individual income taxes in 34 States rely on the Federal income tax base. Taxpayers will experience further rate reductions if States cut rates to hold their revenues constant in the face of an increased tax base.

As noted in previous chapters, rate reduction will encourage saving, investment, work effort, innovation, and other productive behavior. It will reduce the attraction of both tax avoidance through legitimate tax shelters and illegal underreporting of income. Even without elimination of tax preferences, credits, and deductions, rate reduction will lessen the disparities in the tax treatment of various sources and uses of income. When combined with some of the other proposals described below, rate reduction should also help to reduce interest rates and lead to a more robust and efficient economy.

While lower marginal rates tend to increase work incentives for everyone, beneficial incentive effects will be especially pronounced for secondary workers, persons who often have considerable discretion over their labor market activity. Lower marginal rates will also reduce the extent to which the tax system influences choices of occupation and the amount of personal investment in education.

Rate reduction will provide significant benefits to those who receive little or no income in preferred forms. Thus, rate reduction will be particularly helpful to persons who now receive the bulk of their labor income in the form of cash wages. This group includes secondary workers, workers in retail and certain service industries, and other workers who generally do not benefit from large fringe benefit packages. By the same token, those employers who now pay their employees in cash, rather than fringe benefits, will find that the after-tax wages of their employees will rise slightly relative to those of other employers, without any added cost to the employer. These employers will find that any competitive disadvantage they experience in attracting workers because of the current tax law will be diminished.

On the other hand, rate reduction will have a less favorable impact on the sectors of the economy that benefit most from preferential treatment under current law. Rate reduction will reduce the attraction of tax-exempt bonds relative to taxable investments. Since charitable contributions are encouraged by high marginal tax rates that reduce the after-tax cost of giving, reducing marginal rates may reduce contributions. Deductions or exclusions for the cost of health insurance (whether provided by employers or by individuals) will becomes less valuable, thus leading to a reduction in the demand for such insurance and for health services.

Table 5-1

Proposed Tax Rate Schedule

Single Returns		Head of Household Returns		Joint Returns	
Taxable income	Marginal tax rate	Taxable income	Marginal tax rate	Taxable income	Marginal tax rate
	(percent)		(percent)		(percent)
Less than $2,800	0	Less than $3,500	0	Less than $3,800	0
$2,800 to 19,300	15	$3,500 to 25,000	15	$3,800 to 31,800	15
$19,300 to 38,100	25	$25,000 to 48,000	25	$31,800 to 63,800	25
$38,100 or more	35	$48,000 or more	35	$63,800 or more	35

1986 Current Law Tax Rate Schedules

Single Returns		Head of Household Returns		Joint Returns	
Taxable income 1/	Marginal tax rate	Taxable income 1/	Marginal tax rate	Taxable income 1/	Marginal tax rate
	(percent)		(percent)		(percent)
Less than $2,510	0	Less than $2,510	0	Less than $3,710	0
2,510- 3,710	11	2,510- 4,800	11	3,710- 6,000	11
3,710- 4,800	12	4,800- 7,090	12	6,000- 8,290	12
4,800- 7,090	14	7,090- 9,490	14	8,290- 12,990	14
7,090- 9,280	15	9,490- 12,880	17	12,990- 17,460	16
9,280-11,790	16	12,880- 16,370	18	17,460- 22,040	18
11,790-14,080	18	16,370- 19,860	20	22,040- 26,850	22
14,080-16,370	20	19,860- 25,650	24	26,850- 32,630	25
16,370-19,860	23	25,650- 31,430	28	32,630- 38,410	28
19,860-25,650	26	31,430- 37,210	32	38,410- 49,980	33
25,650-31,430	30	37,210- 48,780	35	49,980- 65,480	38
31,430-37,210	34	48,780- 66,130	42	65,480- 93,420	42
37,210-45,290	38	66,130- 89,270	45	93,420-119,390	45
45,290-60,350	42	89,270-118,190	48	119,390-117,230	49
60,350-89,270	48	118,190 or more	50	177,230 or more	50
89,270 or more	50				

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1/ Estimated.

The impact on currently favored sectors can, of course, easily be exaggerated. All tax rate reductions can be opposed on the grounds that high tax rates increase the value of exemptions and deductions for favored activities. But imposing high tax rates on most income, in order to accord favorable treatment to some sources and uses of income, is hardly an efficient way to provide subsidies, even if that is desired. A more efficient and productive economy in the end helps participants in all sectors. For example, though rate reductions would initially raise the after-tax cost of health insurance, the overall cost of health care should eventually be less than in the absence of tax reform. Costs will respond to the reduced demand for such care and to the greater attention that would be focused on the cost of both health care and insurance.

III. Fairness for Families

Families with incomes at or below the poverty level should not be subject to income tax. Thus, the tax threshold -- the level of income at which tax is first paid -- will be raised so that for most taxpayers it approximates the poverty level, as determined by the Bureau of the Census. The proposed tax threshold will be increased relatively more for returns filed by heads of household (those single persons who maintain households for dependents), in recognition of the particular economic difficulties of such households.

After considering various means of setting the tax threshold, the Treasury Department proposes to retain the basic structural features of the present income tax: the personal exemption and the zero-bracket amount. The personal exemption for taxpayers, spouses, and dependents for 1986 will be increased to $2,000, compared with a projected $1,090 under current law (after indexing for inflation expected to occur during 1985). The zero-bracket amounts for single persons, heads of household, and married couples filing jointly will be increased, as shown in Table 5-2. The personal exemptions, zero-bracket amounts, and tax brackets will continue to be indexed to prevent their value from being eroded by inflation. These proposed changes are designed to reflect differences in ability to pay taxes that result from differences in family size and composition. The increase in the personal exemption recognizes the greater financial responsibilities and lesser ability to pay of those taking care of dependents.

The proposed changes in the personal exemptions and zero-bracket amount would raise the 1986 tax threshold for a married couple filing jointly with no dependents from $5,890 to $7,800. A couple with two children would pay no income tax unless its income exceeded $11,800. Under current law, the same family will pay tax on income above $9,613, assuming full use of the earned income credit. (See Table 5-2 and Figure 5-1.)

Table 5-2

Comparison of Personal Exemptions, and ZBA
Under Current Law and Treasury Department Proposals

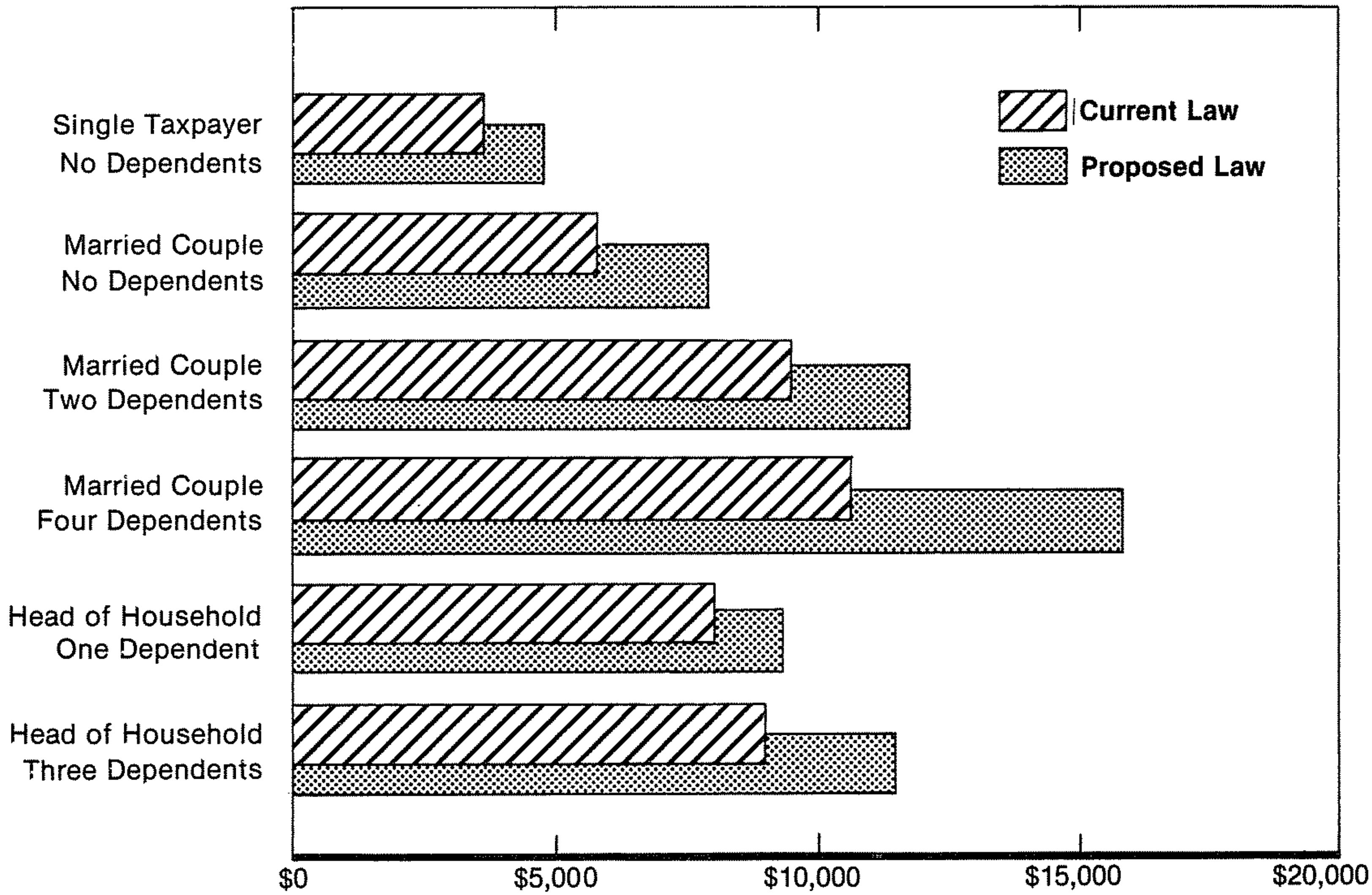
	1986 Levels	
	Current Law 1/	Treasury Proposal
Personal Exemption	$1,090	$2,000
Zero-Bracket Amount		
Single persons	2,510	2,800
Heads of households	2,510	3,500
Married couples	3,710	3,800

1/ Includes indexation for expected inflation in 1985.

Figure 5-1

COMPARISON OF TAX FREE INCOME LEVELS UNDER CURRENT LAW (1986) AND UNDER THE PROPOSAL

For Taxpayers Under Age 65



This increase in the tax threshold will exempt all families in poverty from Federal income tax. Table 5-3 shows the relationship between the poverty level of income and the tax threshold for households of different sizes and compositions under both current law and the Treasury Department proposals. For single persons without dependents, where the tax threshold will still be $1,000 less than the poverty level. If the tax-free income level for single taxpayers were raised further, in order to benefit those single persons whose tax threshold is below the poverty level, it would be too high relative to the levels for heads of household and married couples. An increase in tax -- or marriage penalty -- would be imposed on single persons who decide to marry.

For single taxpayers without dependents who live with relatives or unrelated persons, the comparison of the tax-free income level with the poverty income level may be misleading. When the tax-free income level for these individuals is combined with the tax-free income levels for other members of the household, the total generally exceeds a poverty income level. For example, the tax-free income levels for taxpayers who are under age 21, who account for over one-quarter of all single persons with income subject to tax, often should be combined with the tax-free income levels of parents and other household members. Similarly, the combined poverty level for two single persons who share living quarters might, if appropriately measured, be close to that of a married couple. Their combined tax-exempt income level might exceed that poverty level.

The existing tax treatment of the blind, disabled, and elderly has evolved with little rationale. The Treasury Department proposes that all special treatment provided these groups under current law, including the additional personal exemptions, be replaced with a single tax credit for the elderly, blind, and disabled. Under the proposal, persons receiving workers' compensation, black lung payments, and certain veterans' disability pay would be treated similarly to persons who are permanently and totally disabled and receive disability pay from employers. Once the tax benefits of this expanded credit are taken into account, the tax-exempt level of income for a single person who is disabled for an entire year, and whose income is composed mainly of such disability payments, would be $9,700. For a family of four, the level would be $17,200. These tax-exempt levels substantially exceed of those applying to other taxpayers ($4,800 for single persons; $11,800 for families of four). In about 80 percent of States, a family of four solely dependent upon workers' compensation would pay no Federal income tax even if it received the maximum payment under that State's program.

Under the Treasury Department proposal, as under current law, tax-exempt levels for the elderly will be substantially higher than those for the non-elderly. When both the increased personal exemption and

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Table 5-3

Comparison of the Poverty Threshold and the Tax-Free Income Level Under Current Law and the Treasury Proposal 1/ (1986 Levels)

Status	Poverty Threshold	Tax-free Income Levels: Current Law 2/	Tax-free Income Levels: Treasury Proposal 2/
Single persons without dependents	$5,800	$3,600	$4,800
Heads of households with one dependent	7,900	7,979	9,303
Married couples 3/	7,400	5,890	7,800
Married couples with two dependents 3/	11,600	9,613	11,800

1/ Includes expected indexation for inflation in 1985.

2/ Assumes full use of the earned income tax credit where applicable.

3/ Assumes one earner.

the new expanded credit for the elderly, blind and disabled are taken into account, the tax-exempt level for elderly couples receiving no social security income, at $14,533, will be essentially unchanged from current law. It will be $16,800 for a couple receiving the average amount of social security income, virtually the same as under current law. By comparison, a non-elderly couple will have a tax-exempt amount of only $7,800. (See also Figure 5-2.)

The benefits of the existing two-earner deduction are not well-focused for families where marriage increases tax burdens. While marriage penalties are reduced in some cases, marriage bonuses are created in others. With the proposed increase in personal exemptions and flatter rate structure, the two-earner deduction will be unnecessary. For most taxpayers the work incentive of second earners will be greater under the proposed lower and flatter rate structure than under existing law, with its two-earner deduction. The Treasury Department therefore proposes that the two-earner deduction be eliminated in favor of tax rate reduction.

The earned income tax credit (EITC) adds considerable complexity to the system, especially for those least able to understand it. If simplicity were the primary goal of tax reform, the EITC would be eliminated, and with it a large number of tax returns filed only to claim the refundable credit. Given the equity objectives of reform, however, the EITC is retained, and it is indexed to prevent its erosion by inflation.

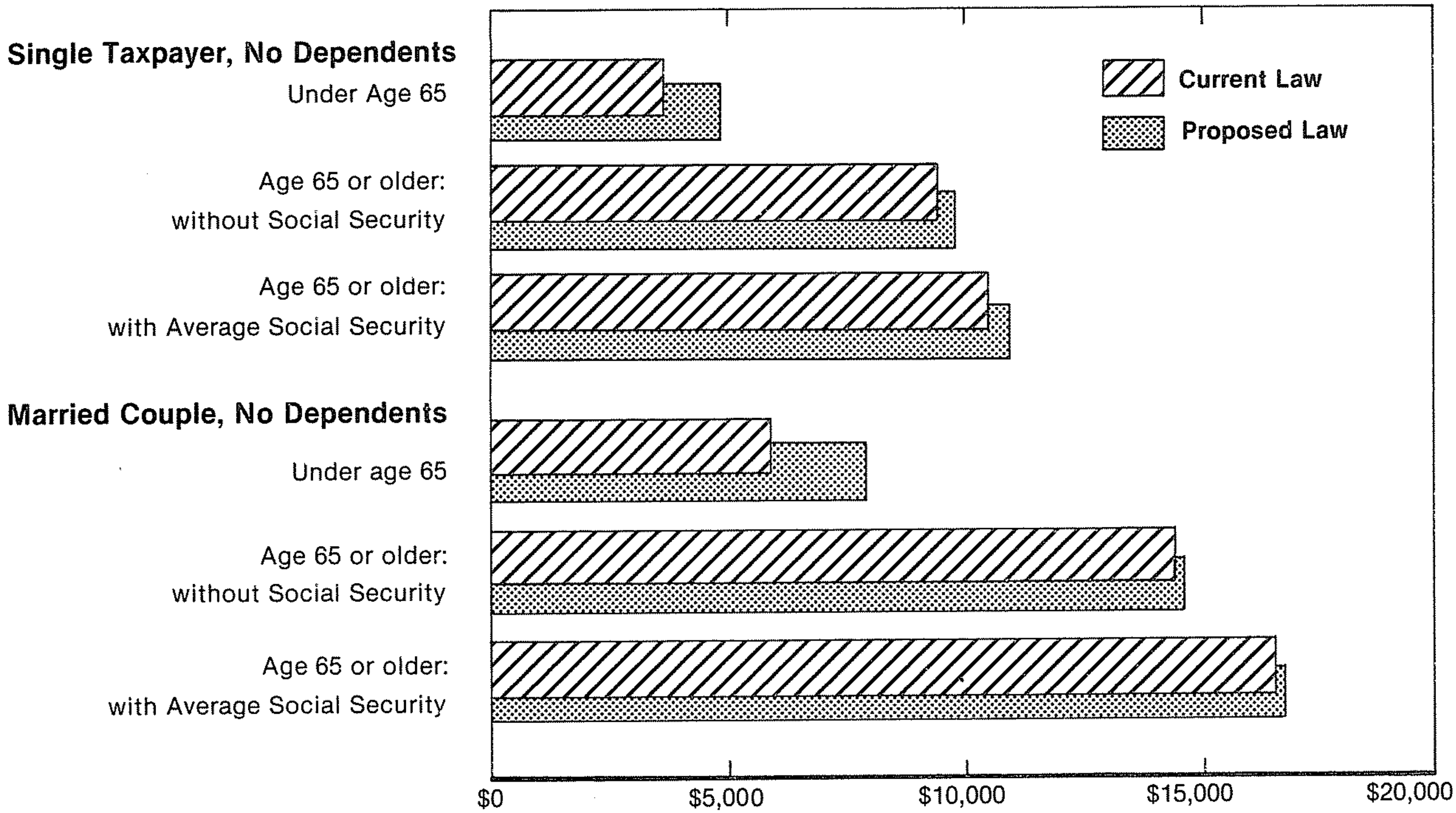
The complicated child and dependent care credit should be replaced by a simpler deduction. A deduction is more appropriate than a credit, because child and dependent care is an expense related to earning income. Accordingly, the true net income of those who incur child care expenses in order to be employed will be better measured if they are allowed to deduct such costs, up to a limit. Failure to allow a deduction, besides being unfair, would adversely affect work incentives. Of course, a deduction is relatively less favorable to low-income taxpayers than is a credit. The choice of a deduction in this case reflects the view that progressivity should be provided directly, through changes in the rate structure, rather than through individual provisions that lack logic and add to complexity.

Recognition of the cost of raising dependents, the cost of maintaining a household, and the cost of child care will be especially beneficial to low-income single heads of household, a group that has grown from 2.6 percent of total income tax returns in 1963 to 8.9 percent in 1982. In combination the Treasury Department proposals should have an especially positive effect on the amount of labor supplied by members of this group.

Figure 5-2

COMPARISON OF TAX FREE INCOME LEVELS UNDER CURRENT LAW (1986) AND UNDER THE PROPOSAL

For Taxpayers Under and Over Age 65



IV. Fair and Neutral Taxation

Equity and neutrality require that all income be subject to tax regardless of its source or use. Otherwise, families in similar circumstances will pay different amounts of tax, depending on how they earn or spend their income.

A. Excluded Sources of Income

1. Fringe benefits. Many fringe benefits are not subject to tax under current law; among the most important fringe benefits presently excluded from tax are contributions to qualified retirement plans, and accident, health, and group term life insurance provided by employers. It is unfair that one taxpayer is excused from paying income tax on the value of a fringe benefit, while another who wants to enjoy the same good or service, but does not receive it as a fringe benefit, must purchase it with after-tax dollars. Nor is the solution to extend the exemption of fringe benefits even further, as some have suggested. Health care is made much more expensive for all because it is effectively subsidized through the tax system for some. The tax advantage now accorded some fringe benefits causes more of them to be consumed than if, like most goods and services, they could only be bought with after-tax income. This distortion of consumer choices would only be accentuated by widening the exemption of fringe benefits. Moreover, extending the scope of the exclusion of fringe benefits would exacerbate inequities in the treatment of employees receiving fringe benefits and those who receive income in other forms. Finally, the growing tendency to pay compensation in tax-exempt forms reduces the base for the social security taxes and thus weakens the social security system. These inequities and distortions can be reduced only if statutory fringe benefits are taxed more nearly like other income.

The Treasury Department supports the proposal contained in the Administration's Budget for fiscal year 1985 to place a limit on the amount of health and accident insurance provided by an employer that can be obtained tax-free by an employee. The Treasury Department proposes to repeal the exclusion of such premiums, to the extent that they exceed $70 per month for a single person and $175 per month for a family. The proposed limits would have no effect on approximately 70 percent of all employees, because the limits exceed their employers' contributions. For example, for 1985 the maximum monthly contribution by the Federal Government to plans for its non-postal employees will be $52 for a single person and $116 for a family. The Treasury Department also proposes to repeal the current exclusions for employer-provided group life insurance, death benefits, dependent-care services, housing and housing allowances for ministers, and certain military cash compensation and proposes to permit provisions dealing with educational assistance plans and group legal services to expire. The value of taxable fringe benefits will be reported by the employer, and tax will be withheld on it. No revenue gain is projected from repealing the exclusion of military compensation, because it is expected that compensation will be increased to offset the loss of this tax benefit.

Presently the exclusion of fringe benefits from taxable income has gone so far that it has become necessary to offset the distorting effects of some tax provisions by allowing employers to offer a choice of tax-free benefits. On the one hand, current law encourages the use of tax-free forms of compensation, but on the other it attempts to counteract these incentives by allowing employers to offer employees the choice that is normally associated with payment of wages in cash. Under the Treasury Department proposals, it will not be necessary to restrict so-called cafeteria plans, plans that allow employees to choose among tax-exempt fringe benefits. Since premiums for medical insurance below the proposed cap will be the only major statutory fringe benefit that will remain exempt, the provisions authorizing tax-free cafeteria plans will be largely redundant and should be repealed. Of course, employers -- and their employees -- may find nontax reasons, such as lower insurance rates for groups and the accommodation of different preferences, for allowing employees to select from a menu of taxable fringe benefits. Cafeteria plans might continue for this purpose.

Taxing most statutory fringe benefits will greatly simplify the administration of the tax laws by relieving the pressure to pay compensation in non-taxable forms. Employers can continue, in effect, to offer certain goods and services for sale through salary deductions, but in the absence of tax inducements for paying wages as fringe benefits, most compensation will be in cash.

Employees will compare the full market prices of formerly subsidized consumption with other uses of their after-tax dollars. As a result, it is expected that employers will provide less life insurance and legal insurance, and that employees will purchase more directly. Purchases of insurance for marginal amounts of health coverage will also decline. These purchases are often quite inefficient because administrative costs, while small relative to large health bills, can be quite large relative to the cost of moderate or small amounts of health care. The rapidly rising cost of health care in the United States can be attributed in part to the large subsidy inherent in the current tax laws. The proposal to cap these health insurance benefits will help contain future increases in costs of health care.

Repeal of the current exemption of fringe benefits will require both employees and employers to reconsider the mix of fringe benefits offered and accepted. To allow time for adjustment, taxation of fringe benefits will be phased in gradually, as existing employment contracts expire.

2. Retirement savings. Current law allows saving for retirement to be sheltered from tax until retirement. Tax-preferred vehicles for retirement saving include qualified retirement plans established by corporate employers, individual retirement accounts (IRAs), and H.R.

10 plans for the self-employed (Keogh plans). The Treasury Department proposes that eligibility for IRAs be extended on equal terms to those who work in the home without pay and to those who work in the labor market. Moreover, the limit on tax-deferred contributions to an IRA will be raised to $2,500 ($5,000 for a husband and wife). This proposal will allow most American families to pay no tax on the income they save, as under a tax on consumed income, and will stimulate saving.

3. Wage replacements. Under the Treasury Department proposals, unemployment compensation will be made fully subject to taxation. There is no reason to tax moderate-income workers more heavily than unemployed persons with the same incomes. Employees in many seasonal industries are employed, then laid off, and then rehired on a predictable annual cycle. For them, unemployment compensation is more accurately seen as a part of annual earnings than as insurance against lost wages. Beyond that, many recipients of unemployment compensation have income from other sources or are married to working spouses. Tax equity is not served by exempting from tax the unemployment compensation they receive, while fully taxing other families with the same amount of income received from other sources.

The failure to tax wage replacement programs under current law is quite unfair. If a program is designed to replace 70 percent of before-tax wages for all employees, tax exemption results in a 70 percent wage replacement for low-income employees who have no other source of income. By comparison, it produces total wage replacement for a taxpayer in the 30 percent tax bracket, and lost wages are more than fully replaced for taxpayers in higher tax brackets.

The current tax law provides quite inconsistent treatment of persons who are elderly, blind, and disabled. The proposed new credit for these groups will ensure greater equality of treatment of various sources of income that they receive. Tax-exempt levels of income will continue to exceed substantially the levels applying to other taxpayers. Families with large amounts of income from other sources, however, will no longer be allowed a complete exclusion for workers' compensation or for black lung or certain veterans' disability payments. Instead, such income will be taxable, but made eligible for the credit. The proposed taxation of wage replacement programs will apply only to amounts received as a result of future settlements.

The taxation of wage replacements will have little effect on families with low or moderate incomes; these families generally will not be taxable because of the increase in exemptions and zero-bracket amounts proposed in this package. Many moderate income disabled workers will also receive additional benefit from the credit for the elderly and the disabled. For example, a family of four that receives $9,000 or more of workers' compensation will not owe tax until its income exceeds $17,200. Further, workers in 80 percent of States who are totally disabled for the entire year will be exempt from tax if they had no other income. For persons with high incomes -- including both those with generous rates of wage replacement and those with substantial income from other sources -- taxation of wage replacement payments will have a positive work incentive effect. Under current law, some individuals receive nontaxable wage replacement in excess of the after-tax wages they would receive if they continued work. Under the proposal, these individuals will again be given a positive incentive to work.

4. Scholarships and fellowships. Scholarships and fellowships should be taxable, to the extent that they exceed tuition, because the stipends are used largely for consumption, such as food and lodging. For most students, the higher tax threshold provided by the personal exemptions and zero-bracket amount will prevent the taxation of these benefits. Students with substantial other sources of income, however, will be treated like other individuals with the same income.

5. Capital gains. Only 40 percent of long-term capital gains -- appreciation on assets held for more than 6 months -- are currently subject to tax. On the other hand, capital gains and losses are measured without regard to inflation during the time the taxpayer holds an asset. In other words, tax is applied to fictitious gains that only reflect inflation, as well as to real increases in the value of capital assets. Thus real (inflation-adjusted) gains are taxed at effective rates that can far exceed the nominal tax rate, and in some cases tax is collected even when assets decline in real value.

The Treasury Department proposes to eliminate the taxation of fictitious gains by allowing taxpayers to index (adjust for inflation) the basis (usually the cost) of assets in computing capital gains. Moreover, real capital gains should be fully taxed as ordinary income. By equalizing the tax treatment of real capital gains and other sources of income, these reforms will improve the equity and neutrality of the tax system.

Given recent rates of inflation, taxing real capital gains as ordinary income would be no less generous, on average, than current law. Thus, the Treasury Department proposals should have no negative effect on capital formation and the supply of venture capital. This is discussed further in chapter 6.

Elimination of the distinction between capital gains and ordinary income will allow substantial simplification of the tax law and facilitate taxpayer compliance and tax administration. Each year the courts hear literally hundreds of tax cases involving capital gain versus ordinary income issues. Moreover, some of the most technical and complicated provisions of the Internal Revenue Code are necessary to deal with ramifications of the distinction between ordinary income and capital gains. These include the provisions dealing with depreciation recapture, collapsible partnerships and corporations, dealer versus investor determinations, and so-called section 1244 (small business corporation) stock. Finally, taxpayers and their advisors spend enormous resources for tax planning designed to achieve capital gain characterization.

6. Interest indexing. During an inflationary period, interest payments include an element that is neither income to the lender, nor an expense for the borrower, but merely compensates the lender for the reduction in the purchasing power of principal that results from inflation. Under current law this so-called "inflation premium" is subject to tax as interest income to the lender and is allowed as an interest expense to the borrower.

At even moderate rates of inflation, tax liability can exceed the amount of interest earned, once adjustment is made for inflation. Suppose, for example, that the interest rate is 12 percent at a time when the inflation rate is 8 percent; the real (inflation-adjusted) interest rate is thus 4 percent. A taxpayer in the 20 percent tax bracket who holds a $1,000 bond that pays interest of $120 per year pays $24 in tax. Since the real component of interest, after adjustment for inflation, is only $40, the taxpayer pays an effective tax rate of 60 percent, not the statutory rate of 20 percent. For a taxpayer in the 40 percent bracket the situation is even worse; tax liability is $48, or 120 percent of real interest income.

The Treasury Department proposes that a portion of interest receipts be excluded from tax in order to avoid this taxation of the inflation premium. An equal reduction is proposed for the deduction of non-mortgage interest expense in excess of $5,000 per year. The proposal for interest indexing is discussed briefly below and in greater detail in chapter 6.

7. Dividends-received exclusion. Current law provides an exclusion from gross income for the first $100 ($200 for married taxpayers filing a joint return) of dividend income received from a domestic corporation. Because the exclusion provides little, if any, investment incentive and contributes to complexity in the tax system, it should be repealed. The proposed partial deduction for dividends paid (described in Chapter 6) can be expected to have far more favorable benefits to the owners of corporate stock.

B. Preferred Uses of Income

Deductions for certain personal expenditures should be curtailed, in order to broaden the tax base, simplify compliance and administration, reduce government interference with private decision-making, and allow rates to be reduced for all. Two of the most important itemized deductions represent substantial Federal subsidies to State and local governments and to charities.

The deduction for State and local taxes, other than the deductions for State and local taxes constituting expenses of earning income, will be phased out. Therefore, no itemized deductions for State and local taxes will be allowed. The above-the-line deduction of charitable contributions by nonitemizers will be repealed a year before its current expiration date, and the itemized deduction for contributions will be limited to the excess over 2 percent of adjusted gross income. On the other hand, the existing deductions for medical expenses and casualty losses, which are allowed only to the extent that expenses and losses exceed 5 percent and 10 percent, respectively, of adjusted gross income, will be retained. Table 5-4 indicates floors applied to various itemized deductions under both current law and the Treasury Department proposal.

Itemized deductions for State and local taxes and charitable contributions together totalled some $122 billion in 1982, and they reduced individual income tax collections by roughly $30 billion. Had the policies proposed by the Treasury been in effect in that year, individual income tax rates could have been cut by about 10 percent, on average, without sacrificing revenue. Federal support of this magnitude can be defended only if there is reason to believe that the subsidized activities would otherwise be carried on at too low a level and if the present tax deduction is an efficient form of subsidy.

1. State and local taxes. Itemized deduction for State and local taxes are not required for the accurate measurement of income. Many years ago, with top rates in the neighborhood of 90 percent, the deduction was perceived to be necessary to prevent the sum of the marginal tax rates for Federal and State income taxes from exceeding 100 percent. Given the present levels of tax rates, such an argument is no longer relevant. The deduction is sometimes defended as a subsidy that is required to reduce the taxpayer's net cost of paying State and local taxes. Some would argue that the deduction has the advantage of encouraging greater expenditures by State and local governments.

Expenditures by State and local governments provide benefits primarily for residents of the taxing jurisdiction. To the extent that State and local taxes merely reflect the benefits of services provided to taxpayers, there is no more reason for a Federal subsidy for spending by State and local governments than for private spending. Both equity and neutrality dictate that State and local services should be financed by taxes levied on residents or on businesses operating in the jurisdiction, in the absence of evidence that substantial benefits of such expenditures spill over into other jurisdictions. There is no reason to believe that most expenditures of State and local governments have such strong spillover effects that they would be greatly under-provided in the absence of the deduction for State and local taxes. There is no reason to have high Federal tax rates and provide implicit Federal subsidies to spending of State and local governments by allowing deduction for their taxes. It would be better -- fairer, simpler, and more neutral -- to have lower Federal tax rates and have State and local government services -- like private purchases -- funded from after-tax dollars.

Moreover, the deduction for State and local taxes is not an efficient subsidy. Because itemized deductions are claimed by approximately one-third of all families (or 35.1 percent of total returns in 1982), it is doubtful that they increase significantly the

Table 5-4

Floors for Deductions on Individual Income Tax Returns*

Item	Floor: Current Law	Floor: Proposal
Medical expenses	5% of AGI	5% of AGI
Casualty expenses	10% of AGI	10% of AGI
Charitable contributions	No floor	2% of AGI
Itemized deductions for miscellaneous expenses	No floor (Available only to itemizers)	1% of AGI (Combined and made available to all taxpayers)
Employee business expenses	No floor (Available to all taxpayers)	

*Deductions generally would be allowed only to extent they exceed the floor.

level of State and local government services. The benefits of the subsidy thus accrue primarily to high-income individuals and high-income communities. To the extent that such subsidies are warranted, they could be provided in a much more efficient and cost-effective way through direct Federal outlays.

The three most important sources of State and local tax revenue in the United States are the general sales tax, the personal income tax, and the property tax. There may be a tendency to believe that itemized deductions should be eliminated for some of these taxes, but retained for others. The Treasury Department rejects this view, because the degree of reliance on these three tax bases varies widely from state to state. Five States have no general sales tax, and six have no personal income tax. Moreover, local governments in various States make widely different use of the property tax; in 1982 the tax represented from below 40 percent to almost 100 percent of total local tax collections in various states. To allow itemized deductions for some of these revenue sources, but not others, would unfairly benefit residents of the States levying the deductible taxes, relative to those who live elsewhere. Moreover, it would distort tax policy at the State and local level away from the non-deductible revenue source. Current law does this by allowing deductions for certain taxes but not for many fees and other taxes.

Moreover, because the deduction for State and local taxes leads to higher Federal tax rates for all, there is a net benefit only for States (and localities) that levy above-average taxes. Residents of States (and localities) with below-average taxes are worse off than if there were no deduction.

Finally, because income levels vary across the country, taxpayers in various States make differing use of itemized deductions and pay different marginal tax rates, on average. That is, residents of high-income States make more use of itemized deductions and pay higher marginal tax rates, on average, than do residents of low-income States. Under current law, the Federal Government pays part of State and local taxes only for those who itemize, and it pays a higher percentage of State and local taxes the higher the average income of those who do itemize deductions. Thus, under present law, the Federal Government underwrites a greater share of State and local expenditures in high-income States than in low-income States. In order to be even-handed and avoid this distributionally perverse pattern of subsidies, no itemized deductions should be allowed for taxes and fees paid to State and local governments. In order to minimize dislocations and inequities, the Treasury Department proposes that these deductions be phased out over a two-year period.

Elimination of this itemized deduction will probably have little direct effect on the revenues of State and local jurisdictions, unlike direct reductions in revenue sharing or similar cutbacks in Federal grants. It may make citizens more conscious of the actual social cost of services provided by State and local governments. Governments will have incentives to rely more heavily on user charges when appropriate. Under current law, the use of such charges is discouraged, since they are not deductible. Finally, these proposed changes will reduce the extent to which low-tax and low-income jurisdictions indirectly subsidize high-tax and high-income jurisdictions.

In considering the effect of the Treasury Department proposals on State and local governments, it should be noted that 34 State income tax systems piggyback on the Federal individual income tax base, and many of the 46 States with corporate income taxes rely on income measurement rules of the Federal corporate tax. The base broadening contained in the Treasury Department proposals will produce large increases in individual and corporate tax revenue for these States, with little or no effort on their part. Therefore, if State revenues are not to increase, rate reduction will also be necessary at the State level.

2. Charitable contributions. Many organizations that benefit from the deduction for charitable contributions provide services that have important social benefits. Services of this kind may not be provided at optimal levels if left to the marketplace. In the absence of charitable organizations, these services might have to be provided or funded directly by government. Instead, in our pluralistic society they have been subsidized through the tax system by the allowance of itemized deductions for charitable contributions. Some would argue that a deduction is especially appropriate when charitable contributions of a high percentage of current income substantially reduce the taxpayer's true ability to pay, as measured by income available for private use. The important question is whether it is necessary or efficient to allow a deduction for all contributions -- and thereby force tax rates to be higher -- in order to achieve the desired stimulus to charitable giving. To the extent that contributions would have been made in the absence of the tax benefit, the deduction only reduces revenues and causes all tax rates to be higher, without stimulating giving. For example, little incentive is provided by a deduction for the first dollars of contributions -- those that are most likely to be made in any case.

The Treasury Department proposes to allow a tax deduction for charitable contributions only to the extent that they exceed 2 percent of adjusted gross income. For example, a taxpayer with $25,000 of income and $1,200 of contributions, would be allowed to deduct only $700; the first $500 would be nondeductible.

Under present law, charitable donations of appreciated property can result in substantial tax saving. The full value of certain donated property can be deducted against ordinary income, without any requirement that gain on the property be recognized for tax purposes. Such treatment conflicts with basic principles governing the measurement of income, produces an artificial incentive to donate appreciated property rather than cash, and also leads to abuse and administrative problems for the Internal Revenue Service when taxpayers overvalue donated property. The Treasury Department proposes that the deduction for a charitable contribution of appreciated property be limited to the smaller of the indexed basis of the asset or its fair market value. This reform would increase tax equity and eliminate the attraction of fraudulent schemes based on donation of property with overstated values. It is consistent with tax law in circumstances where appreciated property is used to pay a deductible expense, or where such property is the subject of a deductible loss; a taxpayer generally is not allowed a tax deduction in respect of untaxed appreciation in property.

Under current law, the deduction for charitable contributions is generally limited to 50 percent of adjusted gross income. Thus, those who contribute more than 50 percent of their income to charity are taxed on the amount contributed in excess of 50 percent of income. Individuals who contribute all of their income to charity, such as those who have taken a vow of poverty, must therefore pay tax on one-half of their contribution. By repealing the limits on the deductible charitable contributions, the Treasury proposal will benefit those who contribute all or most of their income to charity.

Before 1982, only itemizers were allowed a deduction for charitable contributions. Extension of this deduction to nonitemizers -- taxpayers who on average have only small amounts of deductions -- creates unnecessary complexity, while probably stimulating little additional giving and presenting the IRS with a difficult enforcement problem. In 1983, 33 percent of those who did not itemize claimed the "above-the-line" deduction for charitable contributions. Of these, 70 percent claimed $25, the maximum amount allowed. In appraising this deduction, it would be useful to know whether taxpayers actually made these contributions or only claimed them. If the donations were made, one must ask whether they would have been made in the absence of the deduction. If they would have been made, the deduction provides no incentive for increased giving and is equivalent to an increase in the zero-bracket amount. The above-the-line deduction is scheduled to be increased in 1986, then eliminated thereafter. Since there is some lag in taxpayers' response to incentives, eliminating the incentive in 1986 is unlikely to have a significant effect on the level of charitable contributions.

In recent years, a little more than half of all tax returns with itemized deductions reported contributions of less than 2 percent of adjusted gross income (AGI). Even so, these proposed changes in the tax treatment of charitable contributions will have only a modest effect on the amount of charitable giving. It is doubtful that the first dollars of giving, or the giving of those who give only modest amounts, are affected much by tax considerations. Rather they probably depend more on factors such as financial ability to give, membership in charitable or philanthropic organizations, and a general donative desire. As potential giving becomes large relative to income, however, taxes are more likely to affect the actual level of donations. Under the Treasury Department proposal, incentives are maintained for the most sensitive group, taxpayers who give above-average amounts.

By removing tax deductions for small charitable gifts, the Treasury Department proposal simplifies recordkeeping requirements for taxpayers and eliminates the need for IRS to spend resources auditing these small transactions.

3. Interest expense. Under current law all interest expense is deductible, either as a business or investment expense or as an itemized deduction. As a result, taxpayers are allowed deductions for interest expense that does not produce currently taxable income. Home mortgages, automobile loans, and other consumer credit are examples of debt incurred to finance personal consumption, rather than business investments. Debt may also be used to finance investments that yield income that is tax-preferred, either because it is taxed at preferential rates or because tax liability is postponed to a later year. Under a comprehensive definition of income, full interest deductions would not be allowed for debt of either type.

The Treasury Department proposes that the deductions individuals can claim for interest expense be limited to the sum of mortgage interest on the principal residence of the taxpayer, passive investment income (including interest income), and $5,000 per return. This limitation would permit a taxpayer to deduct mortgage interest on his or her home, interest for the purchase of a car, and interest on a considerable amount of consumption and investment-related debt. It would, however, curtail the subsidy implicit in the current law deduction for interest on debt to finance large amounts of passive, tax-preferred, investment assets (such as corporate stock) or extraordinary consumption expenditures (such as second homes).

Interest expense, like interest income, is overstated during a period of inflation. Thus, the Treasury Department proposes that deductions for interest expense also be adjusted for inflation. The adjustment would apply only to the extent that interest deductions exceeded the interest on the taxpayer's principal mortgage, plus $5,000 per return ($2,500 per return for a married couple filing separately). Again, inflation adjustment of interest expense would not affect the current ability to deduct both mortgage interest on the taxpayer's home and on a considerable amount of consumer debt. Neither the indexing of net interest expense nor the limit on interest deduction would affect the vast majority of taxpayers. In 1981, only 3.3 percent of individual tax returns claimed itemized deductions for non-mortgage interest in excess of $5,000.

4. Simplification benefits. Eliminating the deduction for State and local taxes and limiting those for charitable contributions will simplify compliance and administration. It will no longer be necessary for taxpayers to wonder which taxes are deductible and which are not. The table used to calculate deductions for sales tax, a major nuisance and the source of numerous errors and much inaccuracy, can be eliminated. So also can the significant recordkeeping requirements for taxpayers who choose to claim sales tax deductions based on actual receipts rather than the table.

Those who can confidently predict that their charitable contributions will not exceed 2 percent of AGI will not need to worry about either writing checks or obtaining and keeping receipts for contributions. Moreover, disputes over valuation of donated property will be reduced, since deductions will be limited to indexed basis, and disputes over basis can occur only if contributions exceed the two percent threshold.

With itemized deductions limited in this way and the zero-bracket amount increased, the number of returns with itemized deductions will fall by about one-third. Virtually the only taxpayers who would choose to itemize would be those who could claim a deduction for mortgage or other allowable interest, those with large charitable gifts, and those with large medical expenses or casualty losses.

As in the case of taxation of fringe benefits, wage replacements, and other sources of presently excluded income, the increase in the personal exemption and zero-bracket amounts will prevent the few low-income households who itemize from being adversely affected by the proposed reductions in itemized deductions.

C. Abuses

1. Mixed personal and business expenses. Some expenditures combine business expenses with personal consumption. Among obvious examples are expense-account meals and entertainment, travel that has little or no business purpose, and automobiles used for both personal and business transportation. Some of these expenditures are legally deductible under current law as business expenses. Others are improperly claimed as deductions, both by unscrupulous taxpayers and by generally honest taxpayers who give themselves the benefit of the doubt in marginal or uncertain cases. When the expenses are deducted, the government effectively pays part of the cost of personal consumption that others must purchase with after-tax dollars.

As long ago as 1962, this abuse of the tax system was recognized and criticized by President Kennedy: " ... [T]oo many firms and individuals have devised means of deducting too many personal living expenses as business expenses, thereby charging a large part of their cost to the Federal Government. Indeed, expense account living has become a byword in the American scene. This is a matter of national concern, affecting not only our public revenues, our sense of fairness, and our respect for the tax system, but our moral and business practice as well."

The 1984 tax reforms addressed the issue of unjustified business deductions for expensive automobiles, aircraft, personal computers and other mixed-use property. To reduce abuse in this area further, several reforms are proposed. No deduction will be allowed for most entertainment expenses; allowable deductions for meals and lodging will be limited; and deductions for travel involving a substantial personal element will be curtailed in order to avoid government subsidies to thinly disguised vacation trips. The Treasury Department proposal also establishes bright line rules for determining deductible travel expenses in areas that have generated large numbers of audits and substantial amounts of litigation in the past. These reforms will improve the image of the income tax by preventing its abuse by those who take tax deductions for personal expenses. It will also simplify tax administration by providing sharp guidelines as to deductibility.

These proposals would increase the price of purchasing travel and entertainment indirectly through a business to the same price paid by the typical taxpayer, who does not have access to business perks. The demand by businesses and certain executives for expensive meals and various forms of entertainment would decline. As a result, the price of such services and goods would also tend to decline, benefitting the typical citizen who is unable to obtain a subsidy for consumption expenditures by characterizing them as business expenses. Because the providers of these high-priced meals and entertainment would face reduced demand, the production of these goods and services would also tend to fall. At the same time, providers of nonsubsidized consumption goods and services, such as moderately-priced meals, would face an increased demand.

It is doubtful that aggregate employment in food services will decline at all as a result of the Treasury Department proposals. For most taxpayers, consumption of restaurant meals is not subsidized. Elimination of many other preferences throughout the tax law will increase the relative demand for unsubsidized consumption such as this. In assessing the impact on this industry, as well as others, it would be a mistake to look only at the elimination of one type of preference in attempting to assess the overall impact of the tax reform package.

2. Income shifting. Progressive tax rates make it attractive for parents to shift taxable income to their children in order to reduce taxes. Income can be shifted by giving income-earning assets to the children or by establishing trusts that pay income to the children. Though such arrangements clearly can have valid non-tax motivations, their tax consequences violate both the principle that families with equal incomes should pay equal taxes and the notions of vertical equity embodied in the schedule of tax rates, regardless of their motivation in a particular case. Moreover, they contribute to the perception that the tax system is unfair. Although income shifting would be less attractive under the less highly graduated rate structure proposed, it would continue to occur.

The Treasury Department proposes several steps to prevent income shifting. First, under most circumstances unearned income of children under 14 derived from property given to the child by the parents, to the extent it exceeds the child's personal exemption, would be taxed at the parent's marginal tax rate. With a personal exemption of $2,000 and an interest rate of 10 percent, a child with investments of less than $20,000 would not be affected by this proposal. This provision would affect very few taxpayers. In recent years, only about 250,000 children under age 14 claimed as dependents on another's tax return reported unearned income in excess of the personal exemption.

Second, in both the case of a trust that reverts to the creator of the trust and of trust income that is not required to be distributed to beneficiaries or set aside for them, the income of the trust would be taxed to its creator, rather than to the trust or its beneficiaries. This reform, though intended primarily to preserve the fairness of the tax system, also would have substantial advantages in terms of simplification. It would reduce the incentive to create elaborate trusts or engage in other complicated transactions designed to shift income to others.

IV. Simplification

Many of the proposals described in this chapter, though intended primarily to increase the neutrality and fairness of the tax system, would allow simplification of the tax system for most individuals. Yet others, described in this section, are proposed with the primary objective of further simplifying taxpayer compliance.

A. A Return-Free System

To simplify taxpayer compliance, the Internal Revenue Service will consider initiation of a system under which many individual taxpayers would no longer be required to prepare and file tax returns. Instead, the IRS, at the election of eligible taxpayers, would calculate tax liability, based on withholding and information returns currently submitted by employers and third parties. The IRS will not need any information for this purpose that it would not receive from third parties under current law. All taxpayers included in the return-free system would be provided copies of the calculation of tax liability prepared for them by the IRS and would be allowed to question the computation of their taxes.

The return-free system would initially be limited to single wage earners with uncomplicated financial transactions, the population of roughly 15 million taxpayers now filing the simplified form 1040EZ. After a pilot program, the system could be extended to other individual taxpayers, and by 1990, roughly 66 percent of all taxpayers could be covered by the return-free system. It is estimated that at this level of participation this system would save taxpayers annually approximately 97 million hours and $1.9 billion in fees paid to professional tax preparers.

B. Other Simplification for Individuals

Movement toward a broad-base tax requires that better measures of income be obtained and that currently excluded items be counted in income subject to tax. In some cases, additional calculations would be needed, but on balance a broad-base income tax would reduce the complexity caused by current law. Many of the most important sources of complexity under current law arise from tax-induced changes in the economic affairs of millions of individuals. For example, the Treasury Department proposals will reduce the incentive to invest in tax shelters. Thus, many fewer individuals will need to appraise calculations of the after-tax benefits of complicated tax-shelter investments, much less shift assets in search of such shelters. Similarly, if employers insist on providing free in-kind benefits to employees, then the calculation of taxable compensation may be made more difficult. But if they pay wages in cash, or charge appropriately for other goods they want to provide, then their wage and fringe benefit structure, as well as the calculations they make for tax purposes, will actually be simpler than before.

Additional proposals will both simplify the income tax and make it more comprehensive. These include elimination of the preference for capital gains; imposition of a uniform tax on compensation income in whatever form derived (with few exceptions); repeal of the $100/$200 partial dividends received deduction; elimination of provisions such as the credit for political contributions and the presidential campaign checkoff; and restricting eligibility for income averaging. Itemized deductions for expenses of earning income and certain other deductions will be combined into one adjustment (an above-the-line deduction) subject to a floor of one percent of AGI. Because of the floor, taxpayers with only minimal expenses of this kind willnot need to bother with recording the expenses and claiming a deduction.

V. Reducing Noncompliance

A. The Tax Gap

During recent years considerable attention has been focused on the existence and size of the "underground economy." That term has multiple definitions but in the minds of many the focus is on illegal activities or clandestine economic operations. Those engaged in totally legal activities may, nonetheless, improperly fail to comply with the tax laws. This report employs the term "tax gap," in lieu of "underground economy," to encompass the revenues lost from all failures to comply with the tax law.

The tax gap is, thus, a broad concept which represents the difference between total payments received through voluntary compliance and the total amount of tax that would be collected if there were full compliance with the tax law. Thus, the tax gap includes not only the tax due on all unreported income, regardless of whether the underlying activities are legal or illegal, but also the tax that is not paid because of overstated business expenses and personal deductions.

Largely on the basis of studies of taxpayer compliance, the IRS estimated that in 1981 the tax gap was $90.5 billion. (See Table 5-5.) Nine billion dollars of the gap represents a minimal estimate of the lost income tax revenue from illegal activities, primarily illegal drugs, gambling, and prostitution. The remaining $81.5

Table 5-5

Income Tax Gap - 1981
(in billions of dollars)

Legal Sector Tax Gap, Total	$81.5
Corporation tax gap, Total	6.2
Individual tax gap, Total	75.3
Individual income tax liability reporting gap,Total	68.5
Nonfilers' income tax liability (Net of prepayments and credits)	2.9
Filer's income tax liability	65.6
Unreported income	52.2
Overstated business expenses	6.3
Overstated personal deductions 1/	6.6
Net calculation errors	0.5
Individual income tax remittance gap, Total	6.8
Employer underdeposit of withholding	2.4
Individual balances due after remittance	4.4
Illegal sector tax gap (partial) 2/	$9.0
Total legal and illegal tax gap	$90.5

Office of the Secretary of the Treasury
Office of Tax Analysis
November 19, 1984

1/ Includes itemized deductions, personal exemptions, and statutory adjustments.
2/ Income from illegal drugs, gambling, and prostitution only.

Source: Internal Revenue Service. Income Tax Compliance Research, Estimates for 1973-1981. (July, 1983) billion of the gap was from omitted income or overstated deductions in activities that are otherwise completely legal. Of the $81.5 billion, $6.2 billion is attributable to corporations, $6.8 billion results from acknowledged but unpaid liabilities (essentially collection problems), and $2.9 billion is due to those who improperly fail to file tax returns. The remaining $65.6 billion gap is on returns of individuals who file income tax returns but who omit or understate income or overstate expenses: $52.2 billion is attributable to unreported or underreported income; $12.9 billion is due to overstated deductions; and $0.5 billion is due to net calculation errors in the taxpayer's favor.

The total unreported income for individuals (both filers and non-filers) in 1981 was $250 billion. The eight largest areas of omission were: wages and salaries ($94.6 billion) with a 94 percent compliance rate; non-farm proprietorships (including partnership and small business corporations) ($58.4 billion) with a 79 percent compliance rate; interest income ($20.5 billion) with a compliance rate of 86 percent; capital gains ($17.7 billion) with a 59 percent compliance rate; "informal supplier" income ($17.1 billion) with a 21 percent compliance rate; farm income ($9.5 billion) with an 88 percent compliance rate; pension and annuities ($8.8 billion) with an 85 percent compliance rate; and dividends ($8.8 billion) with an 84 percent compliance rate. The causes of these underpayments vary, and resolution will require a number of actions. Fundamental tax reform will help to stem the growth of the tax gap. Although the Treasury Department study was directed primarily toward restoring simplicity and equity to the tax system, its proposals will have some impact on the tax gap.

The breakdown in tax compliance and taxpayer morale during the last 20 years seems to be attributable, at least in part, to growing perceptions of unfairness in the current tax system. For example, a public opinion survey conducted for the IRS during the summer of 1984 supports the view that many taxpayers fail to comply because they believe inequities in the tax structure inherently favor others. Loopholes such as tax shelters, personal use of business assets, deductions for what are essentially personal expenses (e.g., disguised vacations), and nontaxable fringe benefits contribute to this perception. By sharply curtailing these avenues of tax avoidance and evasion, the proposals will diminish this form of rationalization for failure to comply with the tax laws.

Enactment of the reforms described above will reduce the number of taxpayers claiming itemized deductions by about one-third. As the list of deductible expenses is curtailed, the opportunities to inflate itemized deductions will disappear. Also, lower tax rates reduce the benefits of cheating. Hence, though broadening the tax base to allow a reduction in tax rates is the primary objective of these proposals, an important by-product of base-broadening is a reduction in the tax gap.

The tax gap is not entirely a consequence of cheating by taxpayers. In many cases it is a result of oversight or carelessness. This may explain much of the underreporting of interest and wages. IRS statistics indicate that 81 percent of the approximately 25 million taxpayers who make errors in the reporting of interest do so in amounts of $200 or less. In other cases individuals admit to owing tax, but do not have the resources to pay the tax. If the amount of tax owed is small, the cost of collection may exceed the outstanding liability.

The proposal to eliminate filing of returns for a majority of individual taxpayers is motivated primarily by the objective of simplification. However, coincident with this change, the IRS contemplates continued development and expanded use of information returns. Accordingly, in the return-free system, the unreported income from wages, dividends, interest, capital gains and all other form of income on which third-party reports are made to IRS will be subject to greater scrutiny. As a result, it is reasonably anticipated that a significantly greater part of the currently unreported income will be included in the computation of tax liabilities.

While a simpler and fairer tax system reduces both the opportunities and the incentives for tax evasion, some opportunities will remain, and determined taxpayers will continue to use them. There will always be a trade-off between the types and levels of enforcement activities and the amounts of tax evasion. The balance between the two must be determined by public policy, consistent with the traditions and institutions of our free and democratic society.

From the point of view of tax policy and tax administration in a free society, we must recognize that eliminating the tax gap attributable to illegal sector activities is essentially hopeless. If, despite our best attempts, we cannot stop the underlying illegal activity, we should not delude ourselves into believing that we can actually collect taxes on that activity. Thus, tax reform by itself will not help to convert the illegal sector tax gap into tax receipts.

The $81.5 billion tax gap previously estimated for 1981 may substantially overstate the actual gap under current law. The 23 percent rate reduction enacted in the Economic Recovery Tax Act of 1981 (ERTA) substantially lowered the tax consequences of omitted incomes. The 1981, 1982, and 1983 enactments of expanded information reporting for certain income such as tips, capital gains, and mortgage interest payments, and the backup withholding requirements for dividend and interest permanently improved compliance in these areas. The lower tax rates and doubled personal exemptions that The Treasury Department is proposing will further lower the tax gap.

While tax reform and lower tax rates may reduce the benefits of evasion, some benefits would remain. In the so-called "informal" sector and in both farm and non-farm small businesses where business is transacted in cash or where there is a mixing of business and personal activities, many of the problems that lead to the current tax gap will remain.

B. Amnesties

Several states have recently enacted amnesties for past failures to comply with their tax laws, and the possibility of a Federal amnesty has been discussed. Advocates of amnesties view them as a means of encouraging future compliance. They reason that amnesties will improve compliance by those who may be otherwise less than forthright with the tax authorities. Some even see amnesties as a source of substantial short-run revenue as delinquent taxpayers discharge past liabilities. In a well-documented study on tax amnesty titled "Tax Amnesty: State and European Experience," the Congressional Research Service elaborates on many of the difficulties associated with amnesty programs.

The Treasury Department rejects the idea of forgiving past tax liabilities, civil penalties, and interest. To include tax, civil penalties, and interest in an amnesty would further undermine taxpayer morale by sending a clear signal to the American public concerning non-compliance and tax fraud: "Don't bother to pay now. We may forget you owe anything. Even if you have to pay tax, we won't charge interest." Even a limited amnesty that applied only to criminal prosecution, without affecting liabilities for tax, penalties, and interest, would have very much the same effect.

Amnesties can only reinforce the growing impression that the tax system is unfair and encourage taxpayer non-compliance. After reviewing state and foreign experience with amnesties, the Treasury Department rejects their use by the Federal Government.

APPENDIX 5-A

LIST OF PROPOSED REFORMS

INCOME TAX REFORM AND SIMPLIFICATION FOR INDIVIDUALS

A. Rate Reduction

1. Reduce rates and collapse present 15 tax rates for single taxpayers and 14 tax rates for married taxpayers and heads of households into 3 rates.

B. Fairness for Families

1. Increase the zero-bracket amount from $2,510 to $2,800 for single filers, from $2,510 to $3,500 for heads of households, and from $3,710 to $3,800 for joint filers.

2. Increase personal exemptions from $1,090 to $2,000.

3. Fold additional exemptions for the blind and elderly into an expanded credit for the elderly and disabled, and make all taxable disability income eligible for the credit.

4. Repeal deduction for two-earner married couples.

5. Index earned income tax credit.

6. Replace child and dependent care credit with a deduction from gross income with same cap ($2,400 if one child, $4,800 if two or more).

C. Fair and Neutral Taxation

1. Excluded Sources of Income
   a. Fringe Benefits

      1. Repeal exclusion of health insurance above a cap ($175 per month for family coverage, $70 per month for individual coverage).
      2. Repeal exclusion of group-term life insurance.
      3. Repeal exclusion of employer-provided death benefits.
      4. Repeal exclusion of dependent care services or reimbursement.
      5. Repeal special treatment of cafeteria plans.
      6. Repeal exemption of voluntary employee's beneficiary associations and trusts for supplemental unemployment compensation and black lung disability.
      7. Repeal special treatment of incentive stock options.
      8. Repeal exclusion of employee awards.
      9. Repeal exclusion of certain military compensation, with offsetting adjustments in military pay schedules.

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10. Repeal exclusion of rental allowances or rental value of a minister's home.

b. Wage Replacement Payments

1. Repeal tax-exempt threshold for unemployment insurance compensation.
2. Repeal tax exemption of workers' compensation, black lung, and certain veterans' disability payments, but make all such income eligible for the credit for the elderly, blind, and disabled.

c. Other Excluded Sources of Income

1. Repeal exclusion of scholarships and fellowships in excess of tuition.
2. Repeal exclusion of awards and prizes.

2. Preferred Uses of Income

a. Repeal the itemized deduction for state and local taxes.
b. Repeal the above-the-line deduction for charitable contributions.
c. Limit itemized deductions for charitable contributions to those in excess of 2% of gross income.
d. Limit deduction for charitable contributions of appreciated property to indexed basis.
e. Repeal 50% and 30% limits on individual contributions.
f. Repeal 10% limit on corporate contributions (but retain 5% limit in certain cases).

D. <u>Tax Abuses</u>

1. Business Deductions for Personal Expenses

a. Deny all entertainment expenses including club dues and tickets to public events, except for business meals furnished in a clear business setting. Limit deduction for business meals on a per meal per person basis.
b. Limit deductions for meals and lodging away from home in excess of 200% of the Federal per diem. When travel lasts longer than 30 days in one city, limit deductions to 150% of the Federal per diem.
c. Establish bright-line rules to separate indefinite and temporary assignments at one year.
d. Deny any deduction for travel as a form of education.
e. Deny deductions for seminars held aboard cruise ships.
f. Deny any deduction for travel by ocean liner, cruise ship, or other form of luxury water transportation above the cost of otherwise available business transportation with medical exception.

2. Income Shifting

   a. Revise grantor trust rules to eliminate shifting of income to lower rate beneficiaries through trusts in which the creator retains an interest.
   b. During creator's lifetime, tax trusts at the creator's tax rate and allow deductions only for non-discretionary distributions and set-asides. After creator's death, tax all undistributed trust or estate income at the top marginal rate.
   c. Tax unearned income of children under 14 at the parents' rate (to the extent such income exceeds the child's personal exemption).
   d. Revise income taxation of trusts.

E. Further Simplification

1. Non-filing system, in which IRS would compute taxes for many taxpayers.

2. Repeal individual minimum taxes (only if basic reforms are fully implemented).

3. Move miscellaneous deductions above the line, combine with employee business expenses, and make subject to a floor.

4. Repeal preferential treatment of capital gains.1/

5. Repeal political contribution credit.

6. Repeal presidential campaign checkoff.

7. Repeal deduction of adoption expenses for children with special needs, and replace with a direct expenditure program.

8. Disallow income averaging for taxpayers who were full-time students during the base period.

9. Repeal $100/$200 exclusion for dividend income. 1/

F. Other Miscellaneous Reforms

1. Increase limits on moving expenses.

2. Special rule for allowing deduction of some commuting expenses by workers (*e.g.*, construction workers) who have no regular place of work.

1/ Discussed at greater length in Chapter 6.

Chapter 6

BASIC TAXATION OF CAPITAL AND BUSINESS INCOME

I. Summary

The Treasury Department proposals for fundamental reform of the taxation of capital and business income are described in this chapter. Reforms directed at specific industries and at tax shelters are covered in chapter 7.

General reforms of three basic types are proposed. First, in order to measure real economic income more accurately, the Treasury Department proposes that inflation adjustments be made in the calculation of depreciation allowances, capital gains, the cost of goods sold from inventories, and interest income and expense. This will eliminate the need for the current arbitrary ad hoc adjustments for inflation incorporated in the investment tax credit, the accelerated write-off of depreciable property, and the partial exclusion of long-term capital gains.

Second, the Treasury Department proposes that current incentives for retirement savings be expanded by increasing the limits on contributions to individual retirement accounts (IRAs) and extending the availability of IRAs to spouses not employed in the marketplace. Also, the treatment of all tax-favored retirement plans will be rationalized by subjecting all pre-retirement distributions to uniform rules and simplifying the contribution limits applied to various plans.

Third, the Treasury Department proposes that corporations and partnerships be taxed in more nearly the same way by granting corporations a partial deduction for dividends paid and by taxing certain partnerships as corporations.

II. Lower Corporate Tax Rates

The Treasury Department's proposals to define the corporate tax base more comprehensively and eliminate most tax credits would allow the corporate tax rate to be reduced to 33 percent. All corporate income, except income of S corporations, which is accorded pass-through treatment, will be subject to this single rate. With a flat corporate rate only 2 percentage points below the proposed top individual rate, the personal holding company tax can be repealed. The current preferential rates for small corporations will be unnecessary once the corporate tax rate is reduced, especially since the reform package will substantially improve the competitiveness of small businesses.

III. Taxing Real Economic Income

The U.S. tax law takes a schizophrenic view toward the taxation of business income. On the one hand, some forms of income are treated quite favorably. Capital gains are taxed only when they are realized, 60 percent of long-term gains are excluded from the tax base, and gains on appreciated property transferred at death escape tax completely. On the other hand, nominal gains are subject to tax without an adjustment for inflation. Whether, on balance, real capital gains are taxed more or less heavily than ordinary real income depends on complicated interactions between the rate of inflation, the rate of appreciation, and the holding period of the particular asset.

Much the same is true of income from depreciable assets. On the one hand, the investment tax credit (ITC) lowers equipment costs, and asset lives under the Accelerated Cost Recovery System (ACRS) are shorter than economic lives. On the other hand, depreciation allowances are based on historic costs without adjustment for inflation.

The combination of the ITC and ACRS may be more or less generous than real economic depreciation, depending on the particular asset and the rate of inflation. At current rates of inflation, the ITC and ACRS generally provide capital recovery allowances that exceed the present value of the real economic depreciation which is required for the accurate measurement of income. Indeed, for short-lived machinery and equipment, the present value of capital recovery allowances under ACRS and the ITC is roughly equivalent to expensing (and in some instances is even more favorable); that is, at current inflation rates, there is no tax on (or even a subsidy to) the income earned by such assets.

The present tax treatment of depreciable assets is inappropriate in the context of an income tax. It gives rise to a form of tax arbitrage; taxpayers can borrow, receive a full deduction for interest paid, and invest in assets where the return is not fully subject to income tax. (Lenders are generally in lower rate brackets than borrowers, due to the "clientele effect;" that is, high-bracket taxpayers tend to be borrowers while low-bracket taxpayers tend to be lenders under a progressive income tax). Moreover, capital recovery allowances under ACRS and the ITC are "front-loaded," in that they greatly exceed the value of economic depreciation in the early years of an investment; this feature has been an important contributing factor to both the stockpiling of unused tax deductions and credits by some firms and the recent dramatic growth of tax shelters.

The tax treatment of inventories is also rather schizophrenic. Firms are allowed to use last-in, first-out (LIFO) accounting, which provides an approximate adjustment for inflation in the calculation of goods sold from inventory. However, due to the "LIFO conformity requirement," firms using LIFO for tax purposes must use the same accounting method for financial reporting purposes. This requirement discourages the adoption of LIFO, since many firms apparently think that the use of LIFO for financial reports would put them at a competitive disadvantage in attracting investment funds relative to firms that report profits using first-in, first-out (FIFO) accounting.

The Treasury Department proposes that the taxation and measurement of capital income be rationalized. The most critical element of a rational system is the accurate measurement of real economic income in an inflationary environment. To this end, the present system, with its ad hoc adjustments for inflation, such as the partial exclusion of long-term capital gains and the combination of accelerated depreciation and the ITC, will be replaced with explicit inflation adjustments for the basis used in calculating both depreciation allowances and capital gains. Since depreciation will no longer need to be accelerated to compensate for the effects of inflation, ACRS will be replaced with economic depreciation. With taxation based on real capital gains and real economic depreciation, the partial exclusion of long-term capital gains and the investment tax credit will be repealed. To prevent inflation-induced tax discrimination against industries that invest heavily in inventories, the availability of LIFO inventory accounting will be expanded by eliminating the LIFO conformity requirement. Indexed first-in, first-out (FIFO) accounting, a more accurate method of accounting for the effects of inflation on the cost of goods sold from inventory, will be made available, but not required.

Allowing inflation adjustment for capital gains, depreciation, and inventories, without also adjusting interest income and expense, would be neither fair nor neutral. Nominal interest rates include an inflationary component which merely compensates the lender for the reduction in real value of principal resulting from inflation. Without indexing of interest, the income of lenders would be overstated, since they would continue to pay tax on the inflationary component of nominal interest that represents a return of capital, rather than real income. Conversely, the income of borrowers would be understated, since they would continue to take a deduction for the full amount of nominal interest paid including the inflationary component. This problem is particularly serious in an indexed world, since borrowers can invest in assets that benefit from inflation adjustment. In order to mitigate this problem of income measurement, the Treasury Department proposes that both interest expense (in excess of home mortgage interest plus $5,000) and interest income be indexed for inflation, using the fractional exclusion method described below.

The proposed inflation adjustments will assure that taxpayers no longer pay tax on fictitious income from capital that merely reflects inflation; similarly interest deductions subject to the inflation adjustment will not be bloated by inflation premiums that do not represent real costs. For all adjustments, inflation will be measured by the change in the consumer price index for urban households (CPI-U); this index was chosen because it is familiar, readily available, and not subject to revision after it is published.

Allowing deductions for real economic depreciation and for the real cost of goods sold from inventories will improve the measurement of real income from business and capital. This, in turn, will increase tax equity and reduce tax-induced distortions in investment decisions. Many tax shelters are motivated by the combination of the up-front benefits of the investment tax credit and accelerated depreciation, the deductibility of nominal interest expense, and the preferential taxation of capital gains. Eliminating the ITC, indexing capital gains and taxing them as ordinary income, indexing interest expense, and gearing depreciation allowances for tax purposes more clearly to real economic depreciation will substantially reduce the benefits of investments in tax shelters. These measures will simultaneously increase the return to investments in industries that are currently disadvantaged by the tax system, including established industries with disproportionately large inventories or use of structures, as well as new, emerging industries such as those in the "high technology " area. Also, decreased use of tax shelters and the taxation of real corporate income will increase the perceived fairness of the income tax.

Inflation adjustment inherently involves complexity. Nonetheless, the Treasury Department believes that the economic advantages flowing from improvement in the measurement of real economic income during inflation more than offset the cost of increased complexity.

Indexing for inflation may give the impression that inflation is expected; indeed, some will argue that indexation weakens the private sector's resistance to inflation and therefore makes inflation more likely. The proposal for inflation adjustment should not be interpreted as a prediction that high inflation will resume. Prudent monetary policy would keep the inflation rate at the low level forecast by the Administration. Nor does inflation adjustment in the measurement of taxable income necessarily produce higher inflation. While indexing may reduce private resistance to inflation, it also eliminates the possibility of using inflation to raise taxes on real capital and business income.

Inflation adjustment is best seen as insurance against inflation for taxpayers and for the nation. High rates of inflation are not expected, but if they occur, Americans will not be forced, as they were during the 1970s, to suffer the inequities, distortions, and adverse impacts on capital formation that result from an unindexed tax system. Increased complexity is part of the price for that insurance.

A. Capital Gains

Capital gains on assets held for at least a prescribed period have long benefitted from preferential tax treatment. In particular, tax on accrued gains is postponed until gains are realized (usually through the sale of an asset), 60 percent of long-term nominal capital gains are excluded from the tax base, and gains on assets transferred at death completely escape income taxation. Nevertheless, during an inflationary period, capital gains may be subject to very high effective tax rates because purely inflationary gains are included in the tax base; for example, during the high inflation years of the 1970s, effective tax rates on real capital gains frequently exceeded 100 percent, despite the 50 percent exclusion then in force. Similarly, despite the current 60 percent exclusion, real capital gains can be taxed at rates greater than those applied to ordinary income if the rate of inflation is sufficiently high. Moreover, under current law the effective tax rate on capital gains varies tremendously with the inflation rate.

In addition to compensating poorly for the effects of inflation, the current exclusion of 60 percent of long-term nominal capital gains effectively overtaxes taxpayers who have little or no investment success (since sufficiently small nominal gains are actually capital losses), and it undertaxes very successful investors (since the exclusion overcompensates for inflation for sufficiently large gains). This treatment is clearly inequitable.

The Treasury Department proposes that the tax treatment of capital gains be rationalized by making a precise adjustment for inflation through indexing the basis of capital assets for the inflation which has occurred since purchase of the asset or January 1, 1965, whichever is later. Since roughly 84 percent of the inflation during the postwar period has occurred since 1964, this will result in nearly complete inflation adjustment for almost all assets, while limiting the size of the table of inflation adjustment factors. Inflation-adjusted gains will be taxed as ordinary income at the proposed reduced individual rates; that is, the current 60 percent exclusion would be repealed.

In order to limit the transition problems associated with an unexpected change to the new system of taxing indexed capital gains as ordinary income, indexing of assets held as of the date of enactment will be delayed until 1989 and the current approach to taxing capital gains on those assets will be maintained through 1988. (That is, nominal gains will be taxed at a maximum rate of roughly 20 percent through 1988). Assets acquired after enactment, however, will be subject to indexing under the new tax rules as of the date of acquisition.

The existing preferential tax treatment of capital gains has been justified by the need to avoid taxing fictitious gains that merely reflect inflation, to stimulate investments in risky undertakings, to avoid applying highly progressive rates to gains bunched in one year, and to prevent investors from having investments in appreciated assets "locked in" by the tax system. The effects of the Treasury Department proposal in each of these problem areas will be examined in turn.

Inflation adjustment. The current exclusion of 60 percent of long-term capital gains is a very rough way of allowing for the effects of inflation. At high rates of inflation it is inadequate, but at low rates it is too generous.

In contrast with the current ad hoc adjustment for inflation, the proposed adjustment will be precise. At current rates of inflation (4.0 percent in 1983 and 1984), most taxpayers will be subject to roughly the same effective tax rate on long-term capital gains as under current law (preferential taxation of nominal capital gains at a maximum 20 percent rate). At rates of inflation experienced in recent years (an average annual rate of 7.9 percent between 1972 and 1982), the proposal will significantly reduce the effective tax rate on real capital gains. This is shown by Table 6-1, which provides maximum effective tax rates on real capital gains under current law for various combinations of inflation rates, rates of real appreciation, and holding periods. In each part of the table, effective rates below the broken line are higher than the 35 percent maximum rate on ordinary income proposed in this Report; only the current law effective rates above the broken line are less than this proposed rate.

Only for assets held for very long periods is current law likely to be preferred to the proposed 35 percent rate on real gains. If, for example, the real rate of appreciation is 4 percent and the inflation rate is 4 percent or more, a tax rate of 20 percent applied to nominal gains produces an effective rate in excess of 35 percent, except for assets held 10 years or longer. The story is only slightly different if the real rate of appreciation is a rather high 7 percent per year. At an inflation rate of 5 to 7 percent, current law produces effective tax rates on gains on assets held for less than 5 years that do not differ greatly from 35 percent.

Although current inflation rates are relatively low, the "insurance" benefits of a tax system which guarantees an explicit inflation adjustment should not be minimized. For example, inflation averaged 7 percent per year between 1971 and 1975. Over that period, nominal capital gains on sales of corporate stock totaled $24.6 billion. However, once adjusted for inflation, these sales actually represented a loss of $0.4 billion. Similarly, reported nominal gains on sales of real estate over the same period totaled $13.2 billion, while the inflation-adjusted gain was only $5.3 billion. The 50 percent exclusion rate in effect during that period clearly was far from adequate in terms of allowing for inflation. Indeed, no exclusion rate can make up for a negative real rate of appreciation. By comparison, under the Treasury Department proposal, the inflationary component of nominal capital gains will always be excluded from the tax base. The associated reduction in variation in effective tax rates caused by inflation should stimulate investment in capital assets. Thus, the Treasury Department believes that with inflation indexing, reduced tax rates, and a rate structure with only a few wide income brackets there is no need for preferential tax treatment of realized capital gains, beyond that provided by the substantial benefits of deferral of tax until gains are realized and the exemption of gains on assets transferred at death.

<u>Effect on risk-taking</u>. The effect of capital gains taxation on private risk-taking in the economy is of critical importance. Venture capital and associated high-technology industries seem particularly

Table 6-1

Effective Tax Rates on Realized Capital Gains
Under Current Law for 50 Percent Bracket Taxpayer
With Different Real Rate of Return Assumptions

Inflation Rate (Percent)	Nominal Appreciation Rate (Percent)	Holding Period in Years: 1	3	5	10	20
CONSTANT 4 PERCENT REAL RATE OF RETURN						
0	4	20.0	20.0	20.0	20.0	20.0
2	6	30.0	29.4	28.9	27.7	25.6
3	7	**35.0**	34.0	33.1	31.0	27.8
4	8	**40.0**	**38.5**	**37.1**	34.1	29.6
6	10	**50.0**	**47.3**	**44.9**	**39.7**	32.5
8	12	**60.0**	**55.9**	**52.0**	**44.5**	34.7
10	14	**70.0**	**64.0**	**58.8**	**48.6**	**36.3**
12	16	**80.0**	**71.9**	**65.1**	**52.1**	**37.6**
CONSTANT 7 PERCENT REAL RATE OF RETURN						
0	7	20.0	20.0	20.0	20.0	20.0
2	9	25.7	25.2	24.9	23.8	22.4
4	11	31.4	30.3	29.1	27.1	24.1
5	12	34.3	32.8	31.4	28.5	24.7
6	13	**37.1**	**35.2**	33.4	29.9	25.3
7	14	**40.0**	**37.5**	**35.4**	31.1	25.8
8	15	**42.9**	**39.9**	**37.3**	32.2	26.3
10	17	**48.6**	**44.5**	**41.0**	34.4	27.0
12	19	**54.3**	**48.9**	**44.4**	**36.3**	27.6

Note: Figures in bold face type below the broken line indicate combinations of inflation rates and holding periods for which the proposed treatment is more favorable than current law.

sensitive to changes in effective tax rates. The supply of venture capital largely dried up during the 1970s when effective tax rates on real gains were high due to inflation and other provisions in the Code, but revived dramatically after the 1978 and 1981 tax changes reduced the maximum tax rate on realized long-term capital gains to 20 percent and inflation rates fell significantly from earlier levels.

In light of this experience, the likely effects of the proposed treatment of capital gains on the supply of venture capital and "high technology" industries are of particular interest. Taxing real (indexed) capital gains at a maximum ordinary income rate of 35 percent will result in a greater tax burden on the most successful investments made by venture capitalists. If one assumes sufficiently high rates of return and moderate rates of inflation, indexing for inflation, even over the approximately 7 to 10-year life of the average venture capital investment, will not be as generous as the 60 percent exclusion. Some argue that this treatment, even if desirable on equity grounds, will unduly inhibit investment in the high technology industries typically funded by venture capitalists.

The basic principle underlying the Treasury Department proposals -- that all income should be taxed equally -- suggests that the taxation of real capital gains as ordinary income is the appropriate policy for all industries, including the venture capital industry. Perhaps more importantly, the Treasury Department believes the proposed treatment of capital gains is unlikely to have significantly negative effects on these industries. Several arguments can be made to support this position. More accurate measurement of economic losses and reduced variation in effective tax rates resulting from inflation will stimulate all investment, including investment in the venture capital and high technology industries.

Moreover, a maximum marginal tax rate of 35 percent on indexed capital gains will produce effective rates that are not substantially above those experienced during the last two venture capital booms. (Rates of 25 percent during the 1960s and 28 percent from 1978-81 on nominal gains were actually higher effective rates due to inflation.) Such an environment should be favorable to risky venture capital investments.

Also, the increase in saving stimulated by reductions in individual marginal rates and expansion of IRAs, as well as the elimination of many industry-specific tax preferences coupled with the enactment of measures to reduce the advantages of investment in unproductive tax shelters, should increase the supply of capital available to high technology industries. Finally, roughly one-half of the funds committed to so-called venture capital firms come from tax-exempt entities, such as pension funds, endowments, and foundations, or from foreign investors. To the extent that these are equity funds, their supply will not be affected by changes in the tax treatment of capital gains. For these reasons, the Treasury Department believes that taxation of indexed capital gains as ordinary income is unlikely to have significantly negative effects on the supply of venture capital to high-technology industries.

Other issues. Implementation of the Treasury Department proposal will have little effect on effective capital gains tax rates at moderate rates of inflation, and will significantly reduce effective rates at high rates of inflation. While the proposed treatment will have little effect on lock-in and bunching problems at moderate rates of inflation, it will mitigate them considerably at high rates of inflation, when they are most serious.

Simplification. Taxing real (inflation-adjusted) capital gains as ordinary income will complicate the tax system in some respects but, on balance, should result in simplification. Adjusting the basis of assets for inflation will result in some complexity, but taxpayers will not need to perform overly complex calculations since they will derive the applicable adjustment from a table. On the other hand, significant simplification will result from eliminating the distinction between capital gains and ordinary income, including repeal of recapture rules as well as the extremely complicated collapsible partnership and corporation provisions. Real gains from the sale of most assets will simply be taxed in the same way as all other income. Many elaborate schemes designed to obtain capital gains treatment for ordinary income will lose much of their attraction; as a result, fewer resources will be wasted in tax planning activities as well as in auditing returns with questionable conversion schemes. Once the proposed new tax treatment of business income is fully phased-in and all (or most) grandfathered assets are out of the system, the corporate minimum tax could be repealed.

B. Capital Consumption Allowances

The investment tax credit (ITC) and the accelerated cost recovery system (ACRS) were introduced during a period of rapid inflation to stimulate investment by preventing capital consumption allowances based on historical cost from being eroded by inflation. Without explicit indexing of depreciation allowances, the effects of rapid inflation on the return to investment in depreciable assets are so deleterious that something like ACRS and the ITC was essential to prevent confiscatory taxation of income from capital. Under the Treasury Department proposal, ad hoc accelerated capital recovery allowances like the combination of ITC and ACRS would be unnecessary; explicit indexing for inflation would ensure that future depreciation allowances would maintain their real value, regardless of the rate of inflation.

Since current rates of inflation are significantly lower than those prevailing when the ITC and ACRS were enacted, current law allows investment in depreciable assets to be recovered far more rapidly than under a neutral system of income taxation. Table 6-2 indicates the effective tax rates applied to income from various types of assets under current law; the figures apply to equity-financed investments by corporate taxpayers subject to the 46 percent statutory rate, for inflation rates between 0 and 10 percent.

As shown dramatically in Table 6-2, the combination of ACRS and the ITC results in a system where, at the rates of inflation covered by the table, effective tax rates are lower than statutory rates but vary, often significantly, with the rate of inflation. For example, at an inflation rate of 5 percent, the effective tax rates paid by a taxpayer subject to a 46 percent statutory rate vary from -8 percent for equipment with a 3 year ACRS life to 40 percent for a structure with an 18 year ACRS life. (A negative tax rate is the equivalent of the Federal Government paying a business to buy the asset and earn income tax-free.) Effective tax rates are lower, (that is, even more negative), for short-lived assets with lower inflation rates. At higher inflation rates such as those prevailing at the time of enactment of ACRS, effective tax rates are somewhat closer to the statutory tax rate, especially for longer-lived asset. (See Table 6-2 for effective tax rates under an inflation rate of 10 percent.) The current system is obviously deeply flawed, since effective tax rates vary tremendously among asset types and with inflation. Moreover, by reducing effective tax rates below the statutory rate, the tax system favors investment in depreciable assets such as equipment and real estate over investments in labor and in inventories. This results in effective tax rates which vary widely among industries, as demonstrated in Table 6-3.

Nevertheless, returning to the non-indexed economic depreciation of the pre-ACRS period is clearly unacceptable; the high effective tax rates on business plant and equipment during the 1970s that resulted from the failure to allow tax-free recovery of the real cost of capital reduced investment and economic growth. Instead, the Treasury Department proposes that the investment tax credit be repealed, that the basis of depreciable assets be indexed for inflation, and that depreciation allowances for tax purposes be set to approximate real economic depreciation. A combination of indexing for inflation and economic depreciation -- a Real Cost Recovery System, or RCRS -- will retain, and even reduce, the effective tax rates for depreciable assets that are present in the ACRS system, reduce the uncertainty about future changes in effective tax rates that occur without indexed depreciation, and eliminate the current tax bias toward investment in depreciable assets.

The enactment of the Treasury Department proposal will have four very significant advantages over current law. First, the benefits of economic neutrality will be realized. Effective tax rates on depreciable assets will no longer vary according to asset life, as depreciation allowances will be approximately equal to the real economic depreciation of assets. Effective tax rates will also no longer vary across industries, as investment in all industries will face the same reduced corporate tax rate. As a result of tax treatment which is economically neutral, the allocation of the nation's scarce resources will be greatly improved.

Table 6-2

Effective Tax Rates on Equity-Financed Investments
with Various Rates of Inflation for a 46 Percent Taxpayer
Under Current Law 1/

Asset class (years)		Inflation Rate (percent) 0	5	10
3	Equipment	-90	-8	22
5	Equipment	-51	-3	19
10	Equipment	-5	20	32
15	Structures	9	35	45
18	Structures	28	40	45

1/ Assumptions: Real return after tax is 4 percent. The investment credit rate selected is the maximum allowable (6 percent on 3-year equipment and 10 percent on 5-, 10-, and 15-year equipment). Effective tax rates are the difference between the real before tax rate of return and the real after-tax rate of return divided by the before-tax rate of return.

Table 6-3

Effective Tax Rates on Equity Financed Investments in Equipment and Structures by Industry with Various Rates of Inflation for a 46 Percent Taxpayer Under Current Law

Industry	Inflation Rate (percent) 5	10
Agriculture	29	37
Mining	13	31
Logging	21	34
Wood products and furniture	28	38
Glass, cement and clay	20	31
Primary metals	16	28
Fabricated metals	28	38
Machinery and instruments	26	36
Electrical equipment	26	38
Motor vehicles	8	26
Transportation equipment	25	36
Food	25	35
Tobacco	18	30
Textiles	19	32
Apparel	28	38
Pulp and paper	12	26
Printing and publishing	22	34
Chemicals	19	32
Petroleum refining	12	26
Rubber	18	30
Leather	30	40
Transport services	9	26
Utilities	28	38
Communications	19	33
Service and trade	31	40

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Second, effective tax rates will no longer vary with the rate of inflation. Businesses planning investments will be assured that the value of future depreciation allowances will be automatically corrected for inflation; they will not have to depend on Congress for periodic ad hoc and imperfect adjustments in tax laws to accomplish this correction. The reduced uncertainty implied by enactment of the Treasury Department proposals should stimulate investment in all industries.

Third, capital recovery allowances will no longer be "front-loaded," or accelerated to the early years of the productive life of an investment. Because the advantages of the ITC and ACRS are front-loaded, these provisions are of relatively little value to new and rapidly growing firms or to firms in ailing industries, neither of which can fully utilize their benefits. The Treasury Department proposal would thus eliminate a tax penalty faced by new firms and would eliminate incentives for tax-motivated mergers. The result will be increased competitiveness and more incentive for innovation. Also, elimination of front-loading of tax benefits will reduce the advantages of tax shelters, many of which are abusive and create severe administrative burdens for the Internal Revenue Service.

Fourth, these reforms will broaden the corporate tax base, just as many reforms in the individual income taxation area broaden the individual tax base. The most important effect in the corporate area is that the maximum corporate tax rate will be reduced from 46 to 33 percent.

The new method for taxing business income proposed by the Treasury Department is best appraised by examining the combined tax burden at the corporate and individual levels, in order to reflect the benefits of the dividend-paid deduction. Table 6-4 presents combined effective tax rates for a variety of alternative ways of taxing income from depreciable assets and inventories. Under the Treasury Department proposal the combined effective tax rate is 44 percent, regardless of the rate of inflation. This is substantially more generous than the tax treatment under ACRS, without the ITC or dividend relief, which at an inflation rate of 5 percent, produces a combined effective tax rate of about 58 percent. At an inflation rate of 10 percent the Treasury Department proposal is more generous than ACRS, even with the ITC. Even at an inflation rate of 5 percent, it is more favorable than current law, except for investment in equipment.

Table 6-5 shows effective tax rates at only the corporate level. The Treasury Department proposal for a Real Cost Recovery System produces approximately the same effective tax rate on income from all forms of investment, while the alternative approaches produce widely varying effective rates that depend on the rate of inflation.

C. Inventories

Under current law, taxpayers are allowed two basic options in calculating the cost of goods sold from inventories. They can either

Table 6-4

Effective Corporate and Personal Income Tax Rates on Equity Financed Investments
—Returns to Capital Distributed Equally Between Dividends and Capital Gains—1/

	All Capital 2/	Equipment and Structures	Equipment	Structures	Inventories 3/
Pre-1981 law 4/					
at 10 percent inflation	63	63	51	66	61
ACRS 5/					
With investment tax credit					
at 10 percent inflation	58	57	43	61	61
at 5 percent inflation	53	50	26	56	61
Without investment tax credit					
at 5 percent inflation	58	57	57	56	61
Real economic depreciation 6/					
Without dividend relief 7/	49	49	49	49	49
With dividend relief 8/	44	44	44	44	44

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1/ Assumes a 4 percent real return after corporate tax. Assumes two-thirds of capital gains deferred indefinitely, and the remaining third taxed at the same effective tax rate (35%) on real gain in order to eliminate any possible bias against current law, because the effective tax rate on capital gains under current law depends on the interrelationship between inflation, real appreciation, and the holding period.

2/ All capital includes equipment, structures and inventories.

3/ Assumes LIFO accounting with no reduction in inventories and inventory prices rising with the general price level.

4/ Assumes 46 percent corporate statutory tax rate and 45 percent personal tax rate under current law. Assumes sum of years digits depreciation over 9 years and 10 percent investment credit for equipment and 150 percent declining balance over a 34.4 year average life for structures.

5/ Assumes 46 percent corporate tax rate and 45 percent personal tax rate. Assumes 5-year depreciation schedule with half-basis adjustment for equipment and 18-year schedule for structures.

6/ Assumes 33 percent corporate rate and 35 percent personal rate under reform. Tax depreciation rates assumed equal to economic depreciation rates. Deviations may slightly alter tax rates.

7/ Effective tax rates are overstated. In a revenue neutral proposal, elimination of dividend relief would imply lower statutory tax rates.

8/ Assumes 50 percent corporate deduction for net dividends paid.

assume that the first goods put into inventory are the first ones out (FIFO), or they can assume that the last goods in are the first ones out (LIFO). Roughly 95 percent of firms with inventories use FIFO accounting for tax purposes. In an inflationary period the use of FIFO overstates current taxable income, because the deduction for cost of goods sold is based on lower prices that prevailed earlier. Nonetheless, many firms are dissuaded from switching to LIFO by, among other considerations, the "LIFO conformity requirement," which specifies that if LIFO is used for tax purposes it also must also be used for financial accounting. The overstatement of taxable income that results from the use of FIFO under inflationary conditions implies that the tax system imposes a penalty on inventory-intensive activities.

The important role of inventories in the economy is often overlooked. Inventories account for approximately one-fifth of corporate non-financial assets, and more than one-third of corporate depreciable assets. For many types of industries, particularly the wholesale and retail trade and service industries, inventories are more important than depreciable assets. (See Table 6-6.) Thus, in a system which indexes depreciation allowances and capital gains, indexing inventories is essential for economic neutrality across types of business assets and across industries.

The Treasury Department suggests repeal of the LIFO conformity requirement since it induces many firms to use accounting practices in calculating taxable income that seriously mismeasure income during inflationary periods; it is an anachronism that has no counterpart in other parts of the tax law.

In addition, the Treasury Department proposes that firms be given the option of employing indexed FIFO, instead of either LIFO or unindexed FIFO. Under indexed FIFO, the value of all goods in inventory will be adjusted (written up or down) for the amount of inflation that has occurred since their acquisition. Thus, since inflationary gains are permanently removed from the tax base, indexed FIFO measures income more accurately than does LIFO, where inflationary gains are only deferred until the firm reduces its inventory or liquidates. Also, indexed FIFO is thought to be somewhat simpler than LIFO. Adoption of indexed FIFO will not be mandatory, however.

D. Indexing Interest

Nominal interest rates include an inflation premium that compensates lenders for the loss of principal. Under current law, interest income and expense are overstated during a time of inflation, since nominal interest receipts are fully taxable and nominal interest payments are fully deductible. As a result, interest income is overtaxed during an inflationary period, and saving is discouraged; similarly, borrowing and debt finance are encouraged. A completely inflation-adjusted tax system would exclude the inflationary component of nominal interest rates from taxation.

Table 6-5

Effective Corporate Income Tax Rates
—Returns to Capital Distributed Equally Between Dividends and Capital Gains— 1/

	All Capital 2/	Equipment and Structures	Equipment	Structures	Inventories 3/
Pre-1981 law 4/					
at 10 percent inflation	48	48	31	53	46
ACRS 5/					
With investment tax credit					
at 10 percent inflation	41	39	20	45	46
at 5 percent inflation	35	31	-4	39	46
Without investment tax credit					
at 5 percent inflation	41	39	41	39	46
Real economic depreciation 6/					
Without dividend relief 7/	33	33	33	33	33
With dividend relief 8/	27	27	27	27	27

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See Footnotes for Table 6-4.

Table 6-6

Inventories as Percent of Total Physical Assets and Depreciable Assets

Industry	Inventories as Percent of Total: Physical Assets 1/	Net Depreciable Assets
Agriculture	14.3 %	31.7%
Mining	9.1	18.1
Construction	34.8	87.5
Manufacturing	29.2	54.3
Transportation	5.1	5.6
Wholesale Trade	61.2	216.5
Retail Trade	50.9	135.3
Finance, Real Estate	3.8	11.7
Services	10.1	14.5
Total	22.4%	39.3%

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1/ Physical assets include inventories, net depreciable, depletable, and intangible assets, land and other non-financial assets.

Source: 1981 Statistics of Income Corporate Income Tax Returns.

Perfect adjustment of debt or interest for inflation would require that lenders receive an annual deduction for each outstanding loan equal to the product of the inflation rate and the principal of the loan; borrowers would report an offsetting amount of taxable income on each loan. Such an approach would be extremely complicated, and thus is not recommended. The Treasury Department does, however, propose a rough surrogate for an exact inflation adjustment. Under this proposal a given fraction of interest income will be excluded from tax, and the deduction of interest expense (in excess of the sum of mortgage interest attributable to the principal residence of an individual taxpayer and $5,000) will be reduced by the same fraction. Corporations will also exclude this fraction of interest income or expense.

The fraction of interest income and expense to be excluded will be set to reflect the approximate relationship between the current inflation rate and the long-run real interest rate. In an ideal world, the exclusion rate that would result in accurate measurement of real interest income and expense would equal the ratio of the inflation rate to the nominal rate. This relationship was used in calculating Table 6-7, which provides the proposed relationship between inflation and the exclusion rate; these results are based on the conservative assumption of a 6 percent real interest rate (a lower real interest rate would result in higher exclusion rates). The exclusion rate to be used in calculating interest income and expense will be announced each year. Inflation will be measured by the percentage increase in the consumer price index (CPI) over the previous twelve months. If, for example, the CPI increases by 4 percent, 40 percent of nominal net interest income will not be taxed.

The proposed approach provides only a rough adjustment for inflation. Although the inflation adjustment will not be exact most of the time, it will clearly be more appropriate than the zero-inflation assumption implicit in the current law's treatment of all nominal interest as taxable income or deductible expense.

As long as neither interest receipts nor interest payments are indexed, lenders will be taxed too heavily and borrowers too lightly. This tax treatment accentuates the incentive under the current progressive rate structure for low-bracket taxpayers to acquire interest-bearing assets and avoid borrowing, while high-bracket taxpayers borrow and avoid interest-bearing assets. Moreover, these undesirable distortions of behavior would be accentuated if depreciation deductions and capital gains are indexed but interest receipts and payments are not. Investors in high tax brackets would have a strong incentive to out-bid other investors for borrowed funds in order to finance the acquisition of depreciable assets and assets expected to yield indexed capital gains. These incentives will be mitigated under a system with fractional exclusion of interest receipts and expenses. As a result, high-bracket investors will have less incentive to borrow and a stronger incentive to equity-finance their acquisition of assets. In addition, interest indexing will

Table 6-7

Fractional Exclusion Rate Table

Constant Real Before Tax Rate of Return of 6 Percent

Inflation Rate (%)	Nominal Interest Rate (%)	Optimal Exclusion Rate (%)
0	6	0
1	7	14
2	8	25
3	9	33
4	10	40
5	11	45
6	12	50
7	13	54
8	14	57
9	15	60
10	16	62
11	17	65
12	18	67

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reduce the tax disadvantage of taxable debt relative to tax-exempt bonds. This in turn will make it easier and cheaper for other investors to obtain borrowed funds.

IV. Retirement Savings

By encouraging taxpayers to save for retirement, the tax-preferred treatment of retirement plans serves two important public purposes. It helps retirees accumulate funds so they can live out their lives in dignity without becoming wards of society, and it produces saving that can be made available for capital formation. In the latter sense, tax-preferred retirement plans have much the same benefits as a consumed income tax, but without its other disadvantages (discussed more fully in chapter 9). The Treasury Department believes that the present tax incentives for such retirement plans should be retained but made more consistent. The retirement saving proposals should increase saving, provide greater protection for spouses, and simplify compliance and administration.

Under current law, individual retirement plans (IRAs) are fully available only to those who are employed. Whereas an employee can contribute up to $2,000 per year tax-free on his or her own behalf, only an additional $250 can be contributed to a "spousal" IRA. The Treasury Department supports the Administration's proposal that IRAs be available on equal terms to spouses working in the home and in the market. Further, the Treasury Department proposes that the limits on an IRA be raised to $2,500 for both employees and those working at home, that is, to $5,000 for husband and wife. With the present limits, over one-half of tax returns with payments to IRAs showed maximum contributions; thus the availability of IRAS provided little incentive at the margin for additional saving. Increasing the limits will make this general saving incentive more effective.

Employees of employers that maintain qualified cash or deferred arrangements (401(k) plans) effectively can avoid the IRA limitations of current law by making additional deductible contributions to these plans. The Treasury Department believes that this disparity among individuals is inappropriate and thus, coupled with increasing the limits on IRAs, proposes to repeal the current provisons that accord cash or deferred arrangements preferential tax treatment. Employers will be able to set up IRA plans for their employees, as under current law.

Other revisions are required to provide consistent treatment of various types of retirement plans. Under current law the tax treatment of both contributions to retirement plans and subsequent distributions may be different, depending upon the particular type of plan. The Treasury Department proposes to establish a consistent and uniform policy that will apply to all retirement plans. Certain early distributions to finance first-time purchases of homes and college education will be subject to a 10 percent tax; the tax will be raised to 20 percent for other early distributions.

Current law contains annual limits on contributions and benefits that may be provided to an individual under an employer's tax-favored retirement plans. There are separate rules limiting contributions to two types of pension plans, those where a fixed contribution is required (defined contribution plans) and those that promise a fixed benefit (defined benefit plans). The defined contribution plan dollar limit, at $30,000 per year, is much more generous than the defined benefit limit, which allows deductions to finance future benefits of up to $90,000 per year. In addition, complex rules are required to limit contributions and benefits on behalf of employees who participate in both types of plans.

The Treasury Department proposes to eliminate the overall limit for individuals participating in both defined contribution and defined benefit plans that provide significant benefits to rank-and-file employees. To replace the overall limit, and to limit the ability of an individual to accrue excessive benefits by working for separate employers, the Treasury Department proposes to apply an excise tax on extraordinary withdrawals made in any year from either type of plan. This and more specific reforms will both simplify considerably the task of employers who must deal with the present complex rules and provide greater rationality and consistency in this area.

V. Neutrality Toward the Form of Business Organization

Under present law, equity income originating in the corporate sector is taxed twice -- first as corporate profits and then as dividends. This double taxation of dividends, coupled with the deductibility of interest payments, discourages the use of equity finance and favors debt finance. Double taxation of dividends also discourages saving and discriminates against investment in the corporate sector. By comparison, opportunities for tax shelters, the benefits of which are usually most easily available through partnerships, artificially encourage the use of that form of business organization.

Between 1963 and 1982 the value of all partnership assets increased almost twelve-fold, from an estimated $71.8 billion in 1963 to $845 billion in 1982. Assets owned by partnerships in the two most important and popular tax shelter industries, oil and gas drilling and real estate, grew even more rapidly, increasing roughly sixteen-fold during the same period. By comparison, between 1963 and 1982 the value of corporate assets increased slightly more than six-fold, from $1.48 trillion to $9.1 trillion.

The Treasury Department proposes several fundamental changes that will foster neutrality in the selection of organizational form, and in the choice among alternative methods of finance. Without these changes, both corporations and partnerships would continue to rely too heavily on debt finance, the recent tax-induced shift of assets away from the corporate sector would continue, and tax administration would be needlessly difficult.

A. Relief for Double Taxation of Dividends

With a comprehensive corporate income tax base, income derived from equity investment in the corporate sector would be taxed twice -- once when earned by a corporation and again when distributed to shareholders. The double taxation of dividends has several undesirable effects. It encourages corporations to rely too heavily on debt rather than equity finance. By increasing the risk of bankruptcy, this artificial inducement for debt finance increases the incidence of bankruptcies during business downturns.

The double taxation of dividends also creates an inducement for firms to retain earnings, rather than pay them out as dividends. There is, however, no reason to believe that firms with retained earnings are necessarily those with the best investment opportunities. Instead, they may have more funds than they can invest productively, while new enterprises lack capital. If retained earnings are used to finance relatively low productivity investments, including uneconomic acquisitions of other firms, the quality of investment suffers. In addition, both corporate investment and aggregate saving are discouraged, because the double taxation of dividends increases the cost of capital to corporations and reduces the return to individual investors.

These problems cannot be solved by simply eliminating the corporate income tax. If there were no corporate tax, dividends would be taxed properly, at the tax rates of the shareholders who receive them, but earnings retained by corporations would not be taxed until distributed, and thus would be allowed to accumulate tax-free. As a result, there would be a substantial incentive to conduct business in corporate form, in order to take advantage of these benefits of tax exemption and deferral.

Nor can the corporate and individual income taxes be fully integrated by treating the corporation as a partnership for tax purposes. Technical difficulties such as those described below preclude adoption of this approach. The Treasury Department thus proposes that the United States, following the practice of many other developed countries, continue to levy the corporate income tax on earnings that are retained, but provide partial relief from double taxation of dividends.

There are two alternative ways to provide dividend relief. The approach more commonly employed in other countries is to allow shareholders a credit for a portion of the corporate tax attributable to the dividends they receive. The credit is generally available only to residents, although it is sometimes extended to foreigners by treaty. The credit can be denied tax-exempt organizations, if that is desired.

The simpler method, and the one proposed by the Treasury Department, will allow corporations a deduction for dividends paid similar to the deduction for interest expense. Dividends paid to nonresident shareholders will be subject to a compensatory withholding tax, equivalent to the reduction in tax at the corporate level. The proposal will not impose such a compensatory tax where it would be contrary to a U.S. tax treaty; nor will the compensatory tax apply to dividends paid to U.S. tax-exempt organizations. However, the initial decision to extend the benefits of dividend relief to these two groups of shareholders will be subject to continuing review.

Despite the advantages of full relief from double taxation of dividends, the Treasury Department proposal would provide a deduction of only one-half of dividends paid from income taxed to the corporation. This decision is based primarily on considerations of revenue loss, and can be reconsidered once the proposal is fully phased in.

The deduction will not be allowed for dividends paid from income that had not been subject to corporate tax; firms wishing to pay out tax-preferred income will not receive a deduction, but dividends will be presumed to be paid first from fully taxed income. For this purpose, income that did not bear a corporate tax because of allowable credits, including foreign tax credits, will not be eligible for the deduction.

Reduction of the double taxation of corporate equity income will tend to increase initially the market value of existing corporate shares of companies that distribute an above-average proportion of current earnings as dividends. It will reduce the current tax bias against equity finance in the corporate sector and make equity securities more competitive with debt. Because dividend relief will also reduce the tax bias against distributing earnings, corporations will be likely to pay greater dividends and to seek new funds in financial markets. Corporations will therefore, be more subject to the discipline of the marketplace and less likely to make relatively unproductive investments simply because they have available funds. Similarly, the pool of funds available to new firms with relatively high productivity investment opportunities will be larger. As a result, the productivity of investment should be improved substantially.

Dividend relief will be phased in gradually in order to match the phase-in of the correct rules for measurement of corporate income and to minimize unjustified windfall profits to current shareholders. Moreover, phasing in dividend relief will prevent a large loss of tax revenue and any associated reduction in the tax burden of high-income shareholders.

The current exclusion from individual income taxation of $100 of dividends received serves no useful purpose and will be repealed immediately. It loses considerable revenue without stimulating significant investment in corporate equities. It would have no justification in a system that allows dividend relief.

B. Tax Treatment of Large Partnerships

Large modern partnerships have many of the attributes commonly associated with corporations, especially when there is limited liability for most partners in the enterprise. The interests in some large partnerships are even traded on organized stock exchanges. Yet partnerships still benefit from preferential tax treatment that was more fitting in a simpler world in which partnerships were typically comprised of small groups of individuals, each of whom was responsible for the liabilities of the business.

The main tax advantage of the partnership form is that gains, losses and tax credits pass through to partners, rather than being taxed to the entity. Thus, unlike corporations who cannot benefit fully from tax credits, deductions for recovery of capital costs , and interest expense if taxable income becomes negative, partnerships are able to pass any net operating losses through to partners, who can use the losses to shelter other income from tax. As a result, partnerships are an attractive vehicle for investment in tax shelter activities that initially may produce positive cash flow but result in losses for tax purposes; once the venture begins to show a profit for tax purposes, it is converted to corporate form or is sold so that deferred income is realized as tax-preferred long-term capital gains. Moreover, since debt finance magnifies the benefits of tax preferences, the tax Code encourages partnerships, as well as corporations, to rely too heavily on debt finance.

Until the mid-1960s, the corporate form of ownership was often considered the optimal way in which to hold large aggregations of assets. The corporation presented the advantages of both limited liability and a simple administrative vehicle for business transactions when large numbers of owners were involved. Because of the recent shift to the use of partnerships as tax shelters, however, ownership of more and more assets has been switched to partnership form. In many cases, the assets are actually transferred from corporations, while in other cases, new businesses that normally would be formed as corporations are now established as partnerships.

Pass-through treatment of large limited partnerships creates enormous administrative and compliance burdens for the Internal Revenue Service. Any time a partnership is audited and an adjustment is made, the tax liability of each partner must be adjusted. This process can be time consuming and expensive, as collection of additional tax can be required from hundreds of individual taxpayers, many of whom may have moved, died, or suffered substantial declines in income since the original partnership return was filed. Administrative problems such as these are among the reasons why the corporate and individual income taxes cannot be fully integrated by according corporations the pass-through treatment used for partnerships. In view of the problems encountered in applying pass-through treatment to large partnerships with many partners, it is especially appropriate to tax large partnerships as corporations where they possess important characteristics of corporations, particularly the limited liability of partners. The recent proliferation of many such large partnerships suggests that the implications for tax administration of not doing so could be serious indeed.

In order to restore competitive balance between the corporate and partnership forms of business organization, and to avoid these administrative problems, the Treasury Department proposes that large limited liability partnerships be subject to taxation as corporations. Losses of such entities will not pass through to partners, earnings retained by the partnership will be subject to tax at the entity level, and distributions of partnership earnings will qualify for dividend relief. This proposal will reduce the interference of the tax law in the decision of whether to use the partnership or corporate form for ventures in which many owners are involved. Current pass-through treatment is appropriate for those corporations and partnerships that are truly mere economic extensions of their owners. Accordingly, so-called S corporations, limited partnerships with 35 or fewer limited partners, and general partnerships, including those with more than 35 partners, will continue to be accorded pass-through treatment.

The Treasury Department's proposals would promote greater neutrality in the choice of business organizational form. Additional study should be devoted to the continuing differences in the taxation of corporations and partnerships of all sizes, and of ways to make the taxation of both forms of business organization as consistent as possible. Such study also should consider the tax treatment of the trust entity and how to ensure that the use of trusts is limited to their traditional non-business functions.

APPENDIX 6-A

LIST OF PROPOSED REFORMS

BASIC TAXATION OF CAPITAL AND BUSINESS INCOME

A. Lower Corporate Tax Rates

1. Reduce maximum corporate rate to 33%.

2. Repeal graduated corporate rate structure.

3. Repeal personal holding company tax.

B. Taxing Real Economic Income

1. Index basis (cost) of assets and tax real gains as ordinary income.

2. Index depreciation for inflation and set depreciation allowances to approximate economic depreciation.

3. Repeal investment tax credit.

4. Repeal collapsible corporation rules.

5. Allow expensing of the first $5,000 of depreciable business property, but repeal currently scheduled increases in that dollar limit.

6. Allow indexed FIFO and repeal LIFO conformity requirement.

7. Index interest receipts and payments in excess of mortgage interest plus $5,000.

C. Retirement Savings

1. Raise IRA limits to $2,500.

2. Make IRA's available to both employees and spouses working in the home.

3. Subject all tax-favored retirement plans to uniform distribution rules.

   a. Subject all pre-retirement distributions from tax-favored retirement plans to a 20 percent premature distributions tax generally, (but 10 percent if used for tuition or first-home purchase).
   b. Subject all tax-favored retirement plans to uniform minimum distribution rules.
   c. Repeal 10-year averaging for lump-sum distributions.
   d. Eliminate special recovery rules for qualified plan distributions.
   e. Repeal special treatment for distributions of employer securities.

4. Simplify the deduction, contribution, and benefit limits for tax-favored retirement plans.

   a. Repeal aggregate-based deduction limit for profit-sharing and stock bonus plans.
   b. Subject excess contributions to a 6 percent excise tax to recapture excessive tax benefits.
   c. Repeal combined plan limit for non-top-heavy plans.
   d. Subject all distributions in excess of $112,500 per year to a 10 percent excise tax.

5. Miscellaneous changes.

   a. Extend deduction limits for tax-favored retirement plans to employee stock ownership plan and repeal the employee stock ownership plan credit.
   b. Repeal "cash or deferred arrangements."
   c. Subject reversions of funds from tax-favored retirement plans to employers to a 10 percent excise tax.

D. Neutrality Toward the Form of Business Organization

1. Reduce double taxation of distributed corporate earnings by allowing 50% dividends paid deduction. (Allow 50% dividends-received deduction for intercorporate dividends).

2. Repeal $100/$200 exclusion of dividend income.

3. Require that all limited partnerships with more than 35 limited partners be taxed as corporations.

Chapter 7

INDUSTRY-SPECIFIC SUBSIDIES, TAX SHELTERS, AND OTHER TAX ISSUES

I. Introduction

Over the course of the last 70 years, the income tax has been riddled by special tax preferences and subsidies for certain industries and activities. These special rules have no place in a comprehensive income tax. This chapter discusses the Treasury Department's proposals to modify or eliminate most of these subsidies. In addition, this chapter discusses proposals that will improve the rules for measuring income, require more consistent accounting of receipts and expenses, and further reduce the opportunities for tax shelters.

Two large sectors of the economy -- natural resources and financial institutions -- have special tax rules that are inconsistent with both a comprehensive income tax and the goal of increased reliance on the market allocation of investment and saving. To ensure that saving and investment in the economy are channeled to their most productive uses, these sectors should be accorded tax treatment similar to that of other businesses.

The tax exemption of interest on debt of state and local governments is inconsistent with a comprehensive income tax. Nonetheless, to the extent that the exemption is confined to governmental activity, it has come to be an accepted part of the fiscal landscape. In recent years, however, state and local governments have expanded the use of tax-exempt bonds in ways which are often abusive and which compete directly with both government purpose issues of State and local governments and private financial intermediation. The proposal will repeal the use of tax-exempt bonds for nongovernmental purposes and tighten restrictions that prevent state and local governments from earning arbitrage profits.

The general income measurement rules proposed will greatly reduce the attractiveness of existing tax shelters. Yet opportunities for tax shelters may remain, and the Treasury Department proposes tightening provisions designed to prevent taxpayers from borrowing to invest in tax-preferred assets or from taking deductions that exceed the amount of funds "at risk."

The Treasury Department proposals will retain the basic system of U.S. taxation of international transactions. The reduction in the corporate tax rate necessitates changing the foreign tax credit to apply on a country-by-country basis. Source rules should be modified to reflect more closely the economic substance of transactions. The possessions tax credit will be revised to direct the credit to employment-producing investment by U.S. corporations.

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Finally, the Treasury Department proposals will unify and simplify the taxation of estates and gifts, simplify the adminstration of penalty provisions, and allow certain provisions to expire. In addition, the proposals would have beneficial indirect effects on the financial solvency of the social security system.

II. General Issues of Income Measurement

The current tax law does not account satisfactorily for the timing of many receipts and expenses. Too frequently, taxable receipts can be deferred until later years and deductible expenses can be accelerated. This mismatching of receipts and expenses results in tax deferral, and the Federal Government effectively provides to the taxpayer an interest-free loan equal to the deferred tax liability. The value of tax deferral is greater, the longer the deferral and the higher the taxpayer's marginal tax rate. Table 7-1 indicates how much tax deferral reduces effective tax rates. For example, at an 8 percent after-tax interest rate, a 10-year tax deferral effectively reduces a 50 percent marginal tax rate to only 23 percent.

Several general income measurement rules in current law require modification in order to eliminate opportunities for tax deferral. The matching of receipts and expenses for activities extending over several years (multiperiod production) requires more comprehensive and more uniform cost capitalization rules. The use of the cash method of accounting should be available only to businesses that do not use the accrual method for financial accounting purposes, carry no inventories, and are too small to have access to professional accounting expertise. Vendors should not be permitted to report sales income on the installment method when their receivables are effectively converted into cash. The deduction for bad debt losses should be restricted to the actual losses experienced in the current year. Once these and other income measurement changes have been fully implemented, the retention of the corporate minimum tax will be unnecessary because the underlying tax preferences will have been eliminated.

A. Multiperiod Production

Activities that involve multiperiod production, or sales that occur in years after expenses are incurred, often benefit from the mismatching of expenses and receipts. For instance, most of the expenses involved in growing timber are deducted long before the timber is sold and payments are received. Any acceleration of deductions effectively shelters other income from current taxation. Matching of receipts and expenses is achieved if the costs of producing long-lived assets are capitalized, that is, included in the basis of the asset, and recovered when the asset is sold or depreciated.

Under current law, certain indirect costs, such as fringe benefits and the cost of borrowing to carry multiperiod production to completion, generally are not capitalized. In addition, the

Table 7-1

Effective Tax Rate Per Dollar of Income Deferred by a
50 Percent Taxpayer
for Different Deferral Periods and Interest Rates

Interest rate	Deferral period (in years) 1	3	5	10	20	30
4 percent	48.1	44.4	41.1	33.8	22.8	15.4
6 percent	47.2	41.0	37.4	27.9	15.6	8.7
8 percent	46.3	39.7	34.0	23.2	10.7	5.0
10 percent	45.4	37.6	31.0	19.3	7.4	2.9
12 percent	44.6	35.6	28.4	16.1	5.2	1.7

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capitalization rules do not apply uniformly to all activities, and they vary depending on whether the output is sold or used in the producer's own business. Long-term contracts, self-constructed assets, inventories, minerals, and timber all have different cost capitalization rules. The Treasury Department proposals will make the cost capitalization rules more comprehensive and apply a uniform rule to all multiperiod production activities.

Making cost capitalization rules more uniform would ensure neutrality across types of businesses, reduce tax shelters, and improve equity. Uniform rules would eliminate the current tax incentive for businesses to construct their own plant and equipment, even when they are not the most efficient producers. In addition, due to the incomplete capitalization rules, industries with long production processes -- the so-called "natural deferral" industries, such as timber and minerals -- are dominated by tax shelter investors. Thus, current law results in serious dislocations and inequities. Among the many consequences, shelter investors bid up land prices and drive down product prices in these tax-favored industries; as a result, low-bracket individuals and businesses with little taxable income to shelter can no longer earn a sufficient after-tax rate of return from investments in these activities.

B. Use of Cash Method of Accounting

Allowing taxpayers to choose between cash and accrual accounting methods results in significant mismatching of taxable receipts and deductions. For instance, mismatching occurs in the case of prepayments of expenses when the buyer uses the cash method and deducts payments currently, but the seller uses a method of accounting that defers income until a later period.

The use of the cash method of accounting is not in accord with generally accepted accounting principles and, therefore, is not permissible for financial accounting purposes. Yet, many taxpayers that use an accrual method for financial accounting purposes choose to use the cash method for tax purposes solely because this method defers taxable income by accelerating deductions. The proposal will restrict the use of the cash method to businesses that do not use the accrual method for financial accounting purposes, carry no inventories, and have gross receipts of less than $5 million.

The restriction on the use of the cash method would only affect businesses that are already using accrual accounting in some part of their business or are sufficiently large to have access to professional accounting expertise. The taxpayers that would be most affected by the proposal would be banks that use accrual accounting for financial reporting purposes, but the cash method for tax purposes, and large cash-method service organizations, such as accounting, engineering, law, and advertising firms.

C. Bad Debt Deductions

Taxpayers generally are not allowed to deduct the cost of future liabilities or losses. The deduction for bad debt reserves is an exception from the general realization principle that losses on an asset are not deducted until the sale or exchange of the asset. The current reserve deduction accelerates the timing of the deduction for bad debts, and thus allows businesses to defer tax on a portion of their income.

The current bad debt reserve rule allows taxpayers a deduction for actual bad debt losses in the current year plus any increase in the reserve. For example, a beginning firm with $150 of loan losses might deduct $250 in the first year: $150 for the actual loan losses plus $100 for an increase in the allowable reserve for future losses. As long as the firm's total loan losses never fell below $100, the excess deductions would never be recaptured. Because firms effectively deduct their current loan losses, the accumulated reserve for a growing firm is never brought into taxable income. Indefinite tax deferral is virtually equivalent to tax exemption. Only firms that have declining loan losses are taxed on their deferred income. Thus, the current rule mismeasures the timing of taxable income, and provides differential tax treatment across types of firms. In addition, the current treatment of bad debt losses encourages debt financing for risky projects by reducing the risk premium that lenders charge.

The proposal will restrict the deduction for bad debts to the actual loan losses in the current year. This will eliminate the preferential tax treatment of risky loans and treat bad debt losses consistently with other types of losses.

D. Installment Sales

The tax system is not neutral with respect to the form of financing of property sales. The current rules for taxation of installment sales allow taxpayers that can afford to provide seller financing to defer tax liability on the sale of property. In contrast, sellers that receive cash directly, or whose sales are financed by a third party, pay tax on the gain currently. Charging interest on the amount of the deferred tax liability for taxpayers electing the installment method would make the tax law neutral as to the financing of property sales and would end use of installment sales as a vehicle for tax deferral.

The Treasury Department does not propose charging interest on installment sales, however, because of the increased complexity and taxpayer perception problems that such an approach would create. Most taxpayers would not readily comprehend why they should pay interest on the deferred taxes when the taxes are only paid as installment payments are received.

The installment sale method originally was intended to alleviate the seller's liquidity problems. The method is now commonly used to defer tax liability on gain from sales by individuals and businesses that have no liquidity problems. For example, sales income may be reported on the installment method, even though the installment notes received are immediately pledged as collateral for loans. In such cases, the seller has received cash immediately, has no liquidity problem, and is simply using the installment method for tax deferral. The Treasury Department proposes to deny use of the installment sale method in such circumstances.

E. Corporate Minimum Tax

Minimum taxes reflect an attempt to maintain the equity and neutrality of a tax system that is riddled with special preferences. The corporate minimum tax would be necessary only if the underlying special preferences were retained. Because the Treasury Department's comprehensive tax reform package repeals almost all special preferences directly, eventual repeal of the corporate minimum tax would be possible. However, the minimum tax should not be repealed unless and until the basic reforms are fully implemented.

If, after enactment of tax reform, individuals and corporations with significant economic income still find mechanisms by which to pay little or no income tax, the Treasury Department would support the enactment of appropriate minimum taxes on the economic income of individuals and corporations.

III. Subsidies for Specific Industries

A. Energy and Other Minerals

Proper measurement of income in natural resource industries requires that costs of exploration and development be capitalized. Such expenses should then be recovered over the productive life of a natural resource property as resources are extracted and income is earned. The proper recovery of exploration and development costs is achieved through cost depletion; it is analogous to economic depreciation. Where only "dry holes" occur and an entire property is abandoned, the related costs should be written off at the time of abandonment.

Taxation of natural resources in general, and of oil and gas in particular, has long deviated from principles required for the accurate measurement of income. The energy industry is currently favored over other business activities through the tax system in two unique ways. First, "intangible drilling costs" -- the expenses of drilling, other than for the purchase of physical assets -- can be deducted currently even if drilling is fruitful. This acceleration of cost recovery produces several adverse effects. Investment in oil production is favored relative to other investments with higher pretax returns. Drilling is favored relative to less expensive means of exploration that are not tax-preferred. Investment in energy sources where capital costs are a relatively high share of total costs are favored relative to others. Tax burdens on energy corporations and on individuals investing in the energy sector are reduced, interfering significantly with tax equity. As a result, the perception of fairness of the tax system is tarnished.

Second, except for major integrated oil companies and certain large independent producers, cost depletion is not required for those costs of exploration and development that are not written off immediately. Instead, qualified producers of petroleum and all producers of certain other natural resources are allowed to deduct from taxable income a flat percentage of gross income (ranging from 5 to 22 percent, depending on the mineral), subject to a limitation that the deduction cannot exceed 50 percent of net income from the property. Deductions based on percentage depletion, plus previously deducted investment costs, generally exceed 100 percent of actual costs of exploration and development. Thus, percentage depletion is not merely an accelerated alternative to cost depletion as a means of recovering investments in natural resources; rather it is a subsidy to the exploitation of natural resources that is administered through the tax system. This subsidy increases with the prices of natural resources. Percentage depletion encourages over-production of scarce domestic resources, adds complexity to the tax system, unfairly benefits owners of those resources, and erodes the perception of fairness of the tax system.

The oil industry is also subject to the windfall profit tax, a special excise tax on revenues from crude oil produced domestically. Taxable crude oil is classified in three tiers. Generally, oil in tier one is oil that has been subject to price controls; oil in tier two consists of stripper well oil; and oil in tier three is newly discovered oil, incremental oil and heavey oil. The tax base is the difference between a statutory base price and the amount for which the oil is sold, less a severance tax adjustment. The tax rate is highest for tier one oil and is progressively reduced for tiers two and three (with a greater reduction for newly discovered oil).

The windfall profit tax was enacted in 1980 at a time when crude oil prices were rising rapidly. Its enactment was associated with decontrol of crude oil prices. Since that time crude oil prices have moderated and, in fact, have significantly declined from record high levels. Consequently, the perceived "windfall" for producers has generally vanished. Furthermore, the tax offset some of the additional stimulus to domestic production provided by oil decontrol.

The goal of increased reliance on free-market forces underlies this Administration's energy policy, as well as the Treasury Department study of fundamental tax reform. As stated in the Budget for Fiscal Year 1985:

> The Nation needs adequate supplies of economical energy. The most promising way to meet this need is to let market forces work ... The

> primary role of the Federal Government with respect to energy is to establish and maintain sound policies based on economic principles that promote efficient energy production and use. This strategy ... emphasizes the importance of allowing our market economy to function to ensure that these decisions are as productive and efficient as possible.

The Treasury Department therefore proposes that the windfall profit tax be repealed and that the option of expensing intangible drilling costs and percentage depletion be replaced by cost depletion. Repeal of expensing on intangible drilling costs and percentage depletion should not be viewed as penalizing or singling out the energy industry. The proposed rules are identical to proposed changes in the general rules for income measurement for all multiperiod production, which require cost capitalization in order to match deductions with taxable receipts.

Some will argue that these subsidies for the production of minerals provided by special tax treatment cannot be eliminated, because doing so would reduce domestic production and increase American dependence on foreign sources of oil and other minerals. Further, they will argue that enactment of the Treasury Department proposals would raise prices of minerals, even though the magnitude of this effect would probably be small because the prices of most minerals are set in international markets. While these effects may occur and might be burdensome in the short run, the proposed reforms would be beneficial in the long run because the capital and labor released from the energy and minerals sector as a result of a more neutral tax policy would be employed more productively in other industries. Higher prices for oil and gas, lower marginal tax rates, indexation of the basis against which depletion allowances are taken, and repeal of the windfall profit tax would partially offset the elimination of the subsidy, cushion any drop in domestic production, and encourage the development of alternative domestic energy sources. As the Administration's announced policy on energy makes clear, the public would gain from a more rational allocation of resources among competing energy modes. Prices more reflective of the actual replacement costs of energy would encourage greater conservation, and that, plus less rapid depletion of domestic resources, would, over the long run, reduce vulnerability to foreign supply disruptions.

B. Financial Institutions

Most types of financial institutions presently benefit from preferential tax treatment. Besides being unfair and distortionary relative to the taxation of the rest of the economy, these tax preferences create distortions within the financial sector that are inconsistent with the Administration's efforts to deregulate financial markets. Equity and neutrality demand that all financial institutions be taxed uniformly on all of their net income. These special preferences are especially inappropriate in a world in which the corporate tax rate is lowered and both individuals and other corporations are taxed on their economic income.

Banks and thrift institutions are allowed to deduct an arbitrary fraction of outstanding loans or otherwise taxable income as an addition to a reserve against bad debts, without regard to the actual losses they experience on bad debts. In theory, reserve accounting is consistent with accrual accounting; but in practice reserve accounting for banks and thrift institutions has borne little relation to expected losses, and therefore little relation to proper accrual accounting. The special bad debt deduction for thrift institutions is tied to specialization in residential mortgage lending, and only benefits profitable thrift institutions. The special rules are at variance with the general rules that are applied to non-depository institutions and the correct income measurement rule. This arbitrary deduction involves a tax subsidy for financial institutions that has no place in an income tax system; it should be repealed.

Taxpayers generally are prohibited from deducting interest on debt incurred to finance holdings of tax-exempt bonds. Banks benefit from an exception to this rule; they are able to deduct 80 percent of interest incurred to carry tax-exempt securities, and thus offset taxable income from other sources, in many cases totally eliminating income tax liability. Because of the special rule that allows banks to earn arbitrage profits, borrowing costs of state and local governments are subject to greater volatility because of the excessive demand created for their tax-preferred bonds. The Treasury Department proposes extending to banks the general rule that fully disallows interest deductions on debt incurred to carry tax-exempt securities.

Credit unions, which compete with banks and thrift institutions, currently are tax exempt. This exemption allows deferral of tax on members' interest income that is retained in the credit union. This tax break for their members gives credit unions a competitive advantage in attracting deposits from other financial institutions. The exemption should be repealed.

Life insurance companies traditionally have been allowed a deduction for increases in policy reserves that exceed the amount of policyholders' savings and interest income represented by the actual increase in the cash value of the policies they underwrite. In addition, they are allowed a special deduction for 20 percent of otherwise taxable income (60 percent for small companies). This extra deduction is equivalent to applying a lower tax rate to the income of life insurance companies. Deductions for increases in reserves should be limited to increases in cash value, and the special deduction should be repealed.

Amounts earned by policyholders on the cash value of life insurance (the "inside buildup") generally escape income tax under present law. As a result, income earned on investments in life insurance policies is treated substantially more favorably than interest on deposits in banks and thrift institutions, which is taxed currently. In addition, tax-deferred income from annuities can be earned in unlimited amounts. In order to make the taxation of income flowing through financial institutions more neutral, the Treasury Department proposes that the exclusion of the inside buildup in life insurance be repealed and that annuity interest income be subject to current taxation. Taxpayers will be allowed to treat the savings portion of life insurance premiums as deposits in an individual retirement account (IRA), subject to the overall IRA limitations. Income earned on these savings will be tax exempt until withdrawn from the IRA.

Property and casualty (P&C) insurance companies are allowed a deduction for additions to accounts for protection against losses that bears no relation to actual losses. In addition, P&C companies are allowed current deductions for losses expected to be incurred in the future, with no recognition that the future losses are worth substantially less, in present value terms, than the deductions being allowed currently. (Another way of saying this is that to meet future losses a much smaller amount can be set aside today because of the interest earned before the loss is incurred.) Both of these excessive deductions are inconsistent with a comprehensive income tax; the first should be repealed, and the second should be altered to reflect the value of an early deduction for future losses.

The proposed tax changes at both the individual and corporate levels would make the "playing field" for financial institutions more level and more comparable to that of nonfinancial institutions. These changes are consistent with and necessary for the deregulation of the financial sector. All financial institutions would be affected, but they would generally be compensated by the reduction in the corporate tax rate.

Banks would no longer find it advantageous to eliminate Federal tax liability by investing in tax-exempt bonds; the lower tax rate would make their after-tax return on taxable investments generally higher than the current tax-exempt yields. Eliminating the special rule that enables many banks to pay little, or no, Federal income tax would improve the perception of fairness of the tax system. Repeal of the special deductions of thrift institutions and life insurance companies will be offset by the lower tax rate. Credit unions will be taxed on the same basis as banks and other thrift institutions. Individuals would buy life insurance and annuity policies for the primary purpose of protecting against premature death or longevity, rather than as a tax shelter. And P&C insurance companies would have no tax advantage in selling casualty insurance compared with companies willing to self-insure against the risk of property loss.

The total amount of saving flowing through financial institutions would increase as rate reductions increase the after-tax return to saving. The proposed changes would remove the tax distortions that encourage saving to flow through life insurance companies at the expense of other financial institutions. The change in the bad debt deduction would remove the tax incentive for banks and thrift institutions to make risky loans.

C. Debt of State and Local Governments

Interest on debt issued by State and local governments for governmental purposes, such as schools, roads, and sewers ("governmental bonds"), has long been exempt from tax. The exemption of this interest is inconsistent with a comprehensive income tax. Moreover, the subsidy it provides to the borrowing of State and local governments is an inefficient one because much of its benefits are received by high-income bondholders, rather than producing cost savings for state and local governments. The exemption of interest on governmental bonds originated in earlier views about the fiscal relationship between the Federal and State and local governments under the Constitution. However outmoded that understanding of federalism may appear today, this exemption appears to be an accepted part of the fiscal landscape.

State and local governments have recently expanded the use of tax-exempt bonds in ways that should not be accepted. Proceeds from tax-exempt bonds have been used for non-governmental purposes: for economic development (via industrial development bonds or IDBs), for low-interest mortgages on owner-occupied housing, for student loans, and for private hospital and educational facilities. In addition, State and local governments have invested proceeds of tax-exempt bonds in higher-yielding taxable securities to earn arbitrage profits.

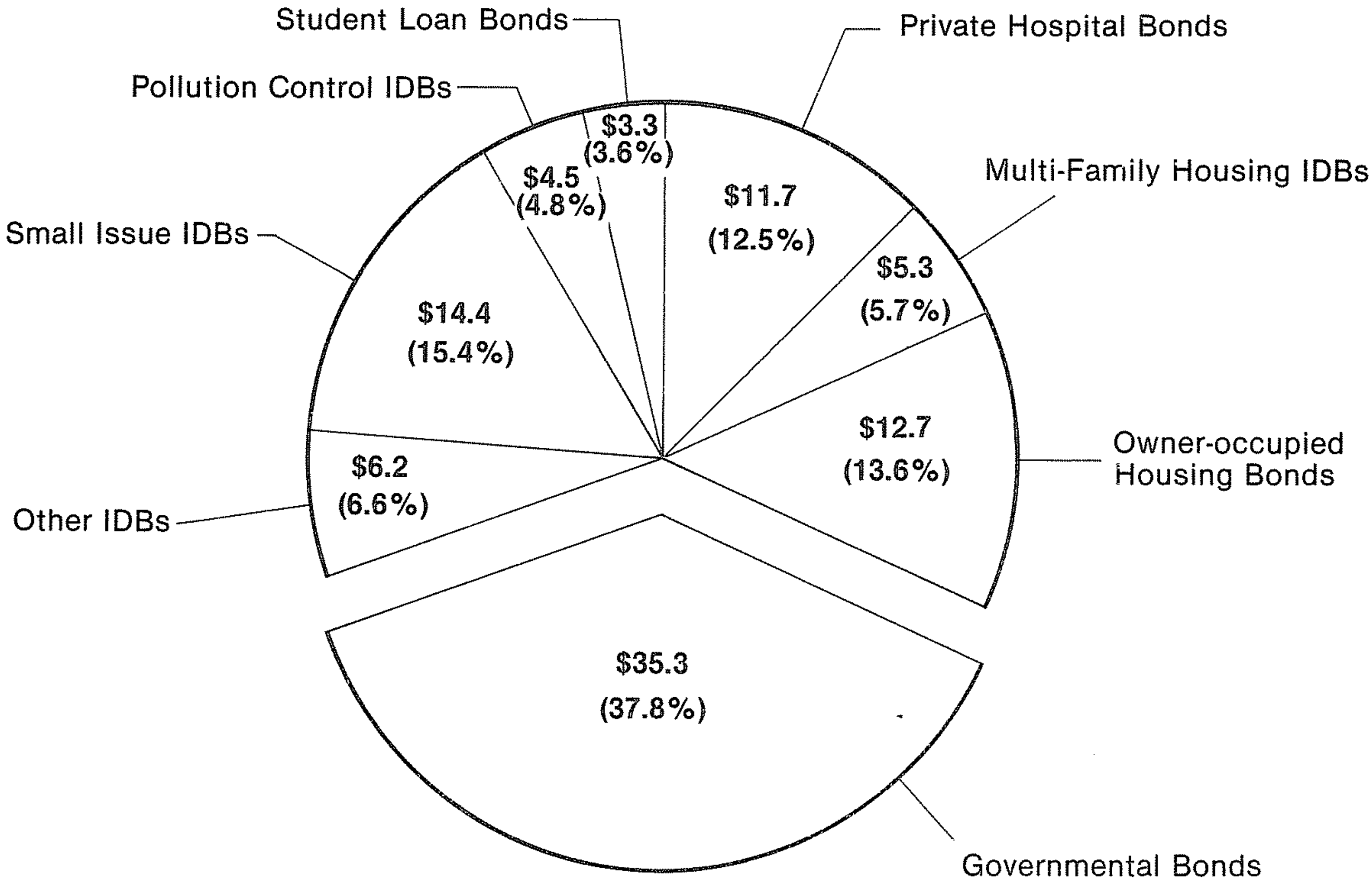
The use of State and local governments' tax-exempt borrowing privilege for the direct benefit of private businesses, nonprofit organizations, and individuals has increased rapidly in recent years. Non-governmental bonds issued in 1975 totaled only $9 billion, accounting for 30 percent of long-term tax-exempt bond volume. In 1983, non-governmental tax-exempt bonds totaled $58 billion and accounted for 62 percent all new long-term tax-exempt bond issues. (See Figure 7-1.) Despite recently enacted volume limitations on certain non-governmental bonds, their share of the total tax-exempt bond market will continue to increase in the future in the absence of further restrictions. This will bid up the interest rates that must be paid on debt of State and local governments issued for governmental purposes.

Seen from the perspective of any one State or local government, issuance of such non-governmental tax-exempt bonds appears attractive; a local business or resident obtains a Federal subsidy at no cost to the local government. In many cases the local government would not provide a direct subsidy to the same business or resident. From a national perspective, however, the subsidies provided through tax-exempt financing to private businesses and individuals are inefficient, costly and distortionary. If all of the States compete for economic development by issuing industrial development bonds, economic activity will not be significantly greater than in the

Figure 7-1

VOLUME OF LONG-TERM TAX-EXEMPT BONDS ISSUED IN 1983

(Amounts in $Billions)



absence of the bonds and it will probably not be located very differently. Firms not benefitting from IDBs are placed at a competitive disadvantage. Moreover, the loans are not allocated to their best use, but rather to those who best know how to manipulate an administrative or political process.

The primary effects of non-governmental tax-exempt bonds are a lower interest rate for the private business or individual benefitting from tax-exempt financing, tax savings for wealthy bondholders, higher borrowing costs on tax-exempt bonds issued for governmental purposes, less Federal revenues as a result of tax exemption of interest on the bonds, and correspondingly higher tax rates on wages and salaries and other forms of taxable income. If below-market mortgages or student loans benefitting local residents are thought to be worthy of local support, they should be financed locally, not through inefficient Federal subsidies to local borrowing that drive up tax rates throughout the country. The Treasury Department proposals will eliminate the future issuance of all tax-exempt bonds resulting in proceeds used by persons or organizations which are not governments, tighten the restrictions on arbitrage, rely on market forces to direct private investment to its most efficient use, expand the tax base, and lower tax rates.

The proposed elimination of non-governmental bonds should be of financial benefit to State and local governments. Reducing the volume of tax-exempt bonds will improve the market for bonds issued for government purposes, thus reducing interest costs to governments.

D. Special Rules

In addition to the industry-specific subsidies previously described, the tax law is littered with credits, exclusions, and special exceptions to general rules. These implicit subsidies should be repealed as part of tax reform designed to free markets from the intrusions of government via the tax system.

Land is not depreciable because its productive capacity is not expected to decline measurably over time. Yet certain capital expenditures have special recovery rules, even though some of these expenditures are for assets similar to land. For instance, companies are allowed to recover the cost of railroad grading and tunnel bores over 50 years, even though such improvements may have undiminished economic value for hundreds of years or even indefinitely.

Other special rules were intended to encourage a particular activity by allowing accelerated write-offs and the advantages of tax deferral. The current law allows 5-year write-off of certified pollution control facilities. This provision was intended to reduce the cost of businesses complying with regulatory requirements. Since the enactment of ACRS in 1981, this provision has not been used, because accelerated cost recovery over 5 years is more generous than straight-line recovery over the same period. However, compared with the indexing and recovery over economic lives proposed for all other assets, this special provision would be extremely advantageous. As part of comprehensive tax reform, these special rules that mismeasure economic income and benefit specific industries should be repealed.

The Merchant Marine Capital Construction Fund is an example of a tax subsidy program that has become outdated and distorted from its original purpose. In 1936, special tax treatment, along with direct appropriations programs, were provided for U.S. citizens owning or leasing U.S.-flag vessels to assure an adequate shipping capacity in the event of war. The direct appropriations programs have been phased out because an adequate number of vessels are owned or controlled by U.S. citizens, though perhaps registered elsewhere. The tax subsidy, on the other hand, has been expanded to fishing vessels and ships plying the inland waterways -- a result inconsistent even with the original, but antiquated, purpose for the Fund. This tax subsidy program should be repealed.

The R&E credit, which is designed to encourage businesses to undertake additional private research activities, will be extended. To improve the effectiveness of the credit, however, the scope of qualifying expenses will be focused so that the credit is available only for private research activities that are likely to lead to technological innovations. A revised definition of eligible expenses will target the credit more narrowly and provide a greater incentive for business to undertake research efforts which will lead to productivity-enhancing innovations.

The tax Code also contains a number of credits that should be repealed. Rehabilitation tax credits provide Federal subsidies for the renovation of older buildings and historic property. These tax credits were intended to match the favorable tax treatment of new buildings resulting from accelerated depreciation and investment tax credits. With repeal of the investment tax credit and the use of indexed, economic depreciation, the rehabilitation tax credits should be repealed. The subsidization of historic preservation expenditures, if believed to be desirable, should be provided through direct appropriations, rather than through the tax system.

IV. Further Curtailment of Tax Shelters

Participation in a variety of tax shelter investments has increased steadily since the 1960s. One indication is the growth in the number of individual tax returns claiming partnership losses, as partnerships are the most common vehicle for investing in tax shelters. Between 1963 and 1982 the number of taxpayers claiming partnership losses increased almost five-fold to 2.1 million. By comparison, the total number of tax returns filed during the same period increased by only 50 percent.

In 1981 and 1982, U.S. partnerships actually reported aggregate net losses for tax purposes. Over one-half of all partnership losses were concentrated in three broad areas: farming, mining and other extractive industries, and real estate. These industries benefit especially from opportunities for sheltering created by the combination of deferral of taxes, preferential treatment of long-term capital gains, and the deductibility of interest.

Tax deferral arises whenever investors are able to accelerate deductions or defer reporting of taxable receipts. Opportunities for such deferral are created by a variety of tax rules. In the case of farms, current deductions are allowed for costs incurred to earn income which is not reported until a later taxable year; in the case of oil and gas drilling, intangible drilling costs may be expensed in the current taxable year, rather than capitalized and recovered over a number of years; in the case of real estate, deferral is made possible by tax depreciation rules which permit deductions in excess of true economic depreciation to be taken in the early years of the investment.

A second aspect of tax shelters is the conversion of ordinary income to tax-preferred capital gains. Tax deferral and conversion of ordinary income to capital gains occur together when accelerated depreciation deductions are used to offset ordinary wage and salary income, while a significant portion of the annual return on the investment is realized as preferentially taxed long-term capital gain at some future date.

Moreover, when taxation of income from an asset can be deferred or converted into tax-preferred income, investors will often have a strong incentive to finance the acquisition of the asset by means of borrowing, as this allows the investor to engage in interest-related tax arbitrage. Interest-related tax arbitrage transactions occur when an investor borrows funds, fully deducts the interest expenses incurred to borrow those funds, and then uses the funds to purchase investments which earn either partially or entirely tax-exempt or tax-deferred income.

It is the combination of tax deferral and leveraged financing which is the principal cause of the substantial losses reported by tax shelter partnerships in the aforementioned three industries -- some $33 billion in 1982. Yet for reasons just mentioned, these "losses" overstate true economic losses incurred by those partnerships. A substantial portion of the accounting losses simply reflect preferential tax treatment of certain sources and uses of income.

As a consequence of these tax accounting losses, affluent investors are able to shelter other income from tax. This is undesirable primarily because preferential treatment of particular activities interferes with the market-determined allocation of resources and unfairly benefits investors in tax shelters.

The proliferation of tax shelters has other undesirable consequences. Auditing tax shelters absorbs valuable resources of the Internal Revenue Service that could better be devoted to other tasks. Beyond that, the widespread existence of legitimate shelters makes it far more difficult for the Internal Revenue Service to identify and control abusive shelters involving tax fraud. Perhaps worse, unsophisticated taxpayers who cannot afford legal advice also cannot distinguish between legitimate and abusive shelters and thus increasingly invest in the latter with disastrous results. To lower and middle-income taxpayers who cannot benefit from tax shelters, the distinction between legal tax avoidance and illegal evasion may be too subtle to prevent a widespread impression that the tax system is unfair because high-income taxpayers are escaping taxation. This impression of unfairness lies at the root of many complaints about the tax system and undermines voluntary compliance with the tax law. Of course, this perception is accentuated by widely publicized stories about abusive shelters.

Growth in tax shelter activity has also played a significant role in the erosion of the Federal income tax base, particularly among affluent taxpayers. Estimates from the 1983 Treasury individual tax model indicated that total partnership losses (losses claimed by individuals -- as distinct from corporations, who also own partnership interests) may have sheltered as much as $35 billion of all individual income from taxation. Roughly $28.6 billion or 82 percent of total partnership losses claimed on individual tax returns were reported by taxpayers with gross incomes (before losses) of $100,000 or more, and 60 percent, or $21.0 billion, were reported by taxpayers with gross income (before losses) in excess of $250,000. By comparison, these groups reported considerably smaller shares of all gross income before losses -- 9 percent and 4 percent, respectively.

Several of the Treasury Department's proposals -- for example, lower tax rates, taxation of real capital gains as ordinary income, capital consumption allowances that approximate economic depreciation, indexing of interest expense, matching expenses and receipts from multiperiod production, and tax treatment of certain large partnerships as corporations -- will greatly reduce the attractiveness of tax shelters. Yet opportunities for tax shelters will remain. The proposals in this section will further reduce these opportunities.

A. Limiting Interest Deductions

Under the present income tax, certain forms of investment income are not fully taxed. Notable examples include interest from State and local securities, long-term capital gains, and the earnings on many insurance and retirement accounts. Moreover, certain expenditures give rise to deductions and credits that can be used to offset tax that would otherwise be due on other income. The most important of these are accelerated depreciation, the investment tax credit, and the immediate deduction for intangible drilling costs.

When investments benefitting from tax preferences are debt-financed, the preferences generally are magnified. This problem has long been recognized, and since 1921 deduction of interest incurred to carry tax-exempt securities has been disallowed. Because it is difficult for the Internal Revenue Service to associate a particular debt with investment in tax-exempt securities or other tax-preferred investments, this type of restriction is not fully effective. More recently, the deduction for investment interest expense was limited to the sum of investment income plus $10,000, in order to prevent taxpayers from taking large deductions for interest expense incurred to earn tax-preferred income. However, the limitation does not adequately take into account interest incurred to finance investments in many tax-preferred activities.

The Treasury Department proposes tightening the interest limitation rules. Individuals would be allowed no current deduction for investment interest expense in excess of the sum of passive investment income, mortgage interest on the taxpayer's principal residence, and $5,000. For this purpose, passive investment income will not include business and investment income from general partnerships interests, sole proprietorships, S corporations actively managed by the taxpayer, and farms, but will include dividends, interest, and income from limited partnership interests. Similarly, investment interest subject to the limitation will include all interest now deducted as an itemized deduction (other than interest on the taxpayer's principal residence) plus the taxpayer's allocable share of interest incurred through any limited partnership interest and any S corporation in which the taxpayer is a passive investor. This limitation will not prevent the deduction of mortgage interest on the principal residence of the taxpayer, nor the deduction of interest incurred in the conduct of a trade or business. The $5,000 allowance would prevent the limitation from affecting most taxpayers.

As long as high-income investors are able to borrow funds to acquire investments which pay tax-preferred income, and deduct currently the interest expenses incurred to borrow those funds, tax equity will suffer and the marginal tax rate needed to raise a given amount of tax revenue will be higher than would otherwise be required. Moreover, the arbitrage availability encourages high-income investors to compete aggressively for borrowed funds in capital markets, reducing the supply of capital available for low-income borrowers, including prospective homeowners and new businesses. The proposed limitation on interest expense would reduce the extent to which high-income investors engage in tax-motivated borrowing, but would not discourage borrowing for active business pursuits. This would both lower marginal tax rates, and make it easier for moderate-income investors to compete for borrowed funds with high-income investors.

B. At-Risk Rules

Current law contains rules to prevent a taxpayer from taking deductions that exceed the amount he or she has "at risk" in a given investment. The at-risk rules apply primarily when the taxpayer is taking deductions related to assets that are heavily financed by non-recourse debt -- debt for which the taxpayer is not personally liable. Non-recourse debt often plays an important role in tax shelters, as it permits taxpayers to report deductions in excess of the amount of the taxpayer's actual investment. The tax losses that these deductions produce for the investor are clearly artificial, since an investor cannot possibly lose more than he or she has at risk in an investment.

Because the at-risk rules are complicated, it is tempting to propose that they be eliminated in the interest of simplification. But the at-risk rules could not be repealed without replacing them with an equally effective solution, such as a reduction in the basis used in calculating depreciation allowances by the amount of non-recourse debt. Such a radical departure from current law would have an uncertain and perhaps severe economic impact. Thus despite the logic of such an approach, the Treasury Department does not propose it. Rather, the at-risk rules should be retained and applied to all investments.

In the case of activities to which the at-risk rules do not currently apply, such as real estate and leasing, the tax benefits of the investment are so magnified that the true economic return of the investment property is often a minor consideration in the ultimate decision of whether to invest. As a result, resources are allocated without due regard to the true (pre-tax) profitability of such ventures. Since pre-tax profitability can generally be trusted to guide the nation's resources to their best uses, this emphasis on after-tax profits, to the neglect of pre-tax profits, interferes with the market allocation of resources to their most productive uses.

Extending the at-risk rules to cover all activities would allow deductions only to the extent of the investor's actual liability for potential losses in that activity. As a result, investors in tax shelter activities could still claim sizable depreciation and interest deductions, provided that they were accountable for a commensurate share of the business risk associated with the investment. This would cause investors to pay more attention to the potential economic gain or loss from investments, rather than focusing on their tax consequences, and thereby promote greater efficiency in the allocation of the nation's capital among competing activities. With investments based on economic realities, there would be less tendency for real estate prices to spiral upwards, driven by investors in tax shelters.

V. International Issues

In taxing the foreign income of U.S. taxpayers, the United States has sought a balanced treatment of foreign and domestic investment, tempered by concern for international competitiveness. U.S. taxpayers are subject to tax on their worldwide income. However, in order to avoid double taxation of foreign income also taxed by host countries, a credit is allowed for foreign income taxes paid. In the interest of competitiveness, U.S. tax on income earned by foreign subsidiary corporations is generally deferred until that income is remitted to U.S. shareholders. (This tax deferral is not available with respect to tax haven income.) In addition, the Foreign Sales Corporation ("FSC") provisions and the exclusion of individuals' foreign earned income provide special rules to promote exports. Other special rules are designed to promote investment in the U.S. possessions.

The Treasury Department proposals will retain this basic system of U.S. taxation of international transactions. For example, the foreign tax credit, the deferral of tax on undistributed foreign subsidiary earnings, the FSC provisions, and the foreign earned income exclusion would be retained. The present system of current taxation of certain tax haven earnings of foreign subsidiaries also would be continued, but consideration should be given to coordinating the various rules. Changes would be made in the foreign tax credit limitation and in certain source provisions to make those rules work more efficiently and equitably. The taxation of income from the possessions and territories would be revised. Other more technical changes would rationalize the taxation of U.S. branches of foreign corporations and the translation of certain foreign exchange transactions.

The foreign tax credit is intended to prevent the U.S. tax from resulting in double taxation of foreign income. It is not intended to reduce the U.S. tax on U.S. income. To prevent credits for high foreign taxes from offsetting the U.S. tax on domestic income, a limit is placed on the amount of foreign tax credit which may be used in any given year (with provision for carryover of excess credits). Current law generally limits the allowable foreign tax credit to the U.S. tax on the taxpayer's aggregate foreign source income. Under this "overall" limitation, foreign income taxes paid to different countries are averaged together; high foreign taxes paid to one country may be used by the taxpayer to offset the U.S. tax on income earned in a low tax country.

Such an approach distorts investment decisions. A taxpayer has an incentive to generate low-taxed foreign income to utilize excess foreign tax credits. As a consequence, investments may be shifted from the United States to low tax countries. The U.S. tax base is eroded and capital may be allocated to less productive uses for tax reasons. Low-taxed foreign income also may be generated by using the existing source rules simply to shift income to low-tax jurisdictions. For example, income from certain sales may be sourced in any country by having the title pass there.

The proposed reduction in the U.S. corporate tax rate will greatly increase excess foreign tax credits. This will correspondingly increase the incentives to divert investment and income to low-tax countries, if the overall limitation is left intact. It is therefore proposed that the foreign tax credit limitation be changed to apply country by country, and that certain source rules be modified to reflect more closely the economic substance of the transaction.

There are those who will argue that the Treasury Department proposal will only aggravate the problem of excess foreign tax credits. But this defense of the overall limit on the credit is based on a misunderstanding of the purpose of the credit. The purpose of the credit is to avoid double taxation of foreign source income. The per-country limit achieves that. Relief from taxes in excess of U.S. taxes on the same income must be sought elsewhere.

A "per country" limitation is used by most other countries that allow a foreign tax credit, and it was long used in the United States, either with the overall limitation or alone. It was repealed in 1976 because large tax accounting losses in certain countries were offsetting U.S. income and reducing revenues. Proposed changes in accounting for depreciation and for multiperiod production will largely eliminate the reasons for repealing the per country limitation. The treatment of economic losses will be addressed directly by allowing them to offset the pool of profits from all other countries, with an appropriate provision for recapture.

In combination with the reduced rate of corporate tax, the proposed changes in the foreign tax credit limitation and source rules will result in a substantial net reduction in the U.S. tax on foreign income. In effect, the combination will make the foreign tax credit operate more efficiently and equitably without penalizing foreign investment.

Another proposed change in international taxation affects the credit for income from U.S. possessions. The tax benefit of the existing credit rewards the shifting of income to the possessions, whether or not the income generated creates real economic activity there. The revenue cost of the credit is very high, and the tax saved per worker employed greatly exceeds the cost of employing that individual. In the long run, with a low-rate, broad-based tax, and the deferral of U.S. tax on the earnings of foreign corporations, the special tax preference for income from the possessions should be phased out. In the meanwhile, the credit would be revised to relate it directly to the minimum wage for employees engaged in manufacturing activities in the possessions, and to allow the credit to be used against income from any source, not only possessions source income. These proposed changes are intended to bring the incentive more into line with its purpose, as stated by the Joint Committee on Taxation, to "assist the U.S. possessions in obtaining employment-producing investments by U.S. corporations." The existing systems of taxation in effect in the U.S. territories also would be modified to resolve the inconsistencies and problems which have developed.

Finally, the taxation of income earned by foreign corporations through U.S. branches would be rationalized to bring it more into line with the taxation of income earned through U.S. subsidiaries, and certain rules concerning foreign currency transactions would be clarified.

VI. Other Tax Issues

A. Transfer Taxation

Transfers of wealth are subject to tax at the Federal level under an estate tax, a gift tax and a generation-skipping transfer (GST) tax. Transfers of wealth at death are subject to the estate tax, which is imposed at slightly progressive rates (with a large exemption level). The gift tax and the GST tax are designed on the whole to ensure that taxpayers cannot easily avoid the estate tax through lifetime gifts, multigenerational trusts, and similar arrangements.

Ideally, the Federal transfer tax system should have as little impact as possible on the ways that individuals hold and transfer their wealth. In order to achieve this goal, the transfer tax system must be designed so that the amount of wealth that can be transferred from one individual to another net of tax does not depend on the form or timing of the transfer. This requires close coordination among the three transfer taxes as well as attention to their interaction with the income tax.

Major steps toward this goal were taken in 1976 with the unification of the estate and gift taxes and the enactment of the GST tax. Significant inequities and loopholes remain, however, leaving substantial opportunities for tax avoidance and, in some cases, resulting in double taxation. The principal thrust of the Treasury Department proposals for reform of the transfer tax system is to eliminate these inequities, thereby improving the fairness and neutrality of the system.

Perhaps the most significant of these proposals is to complete the unification of the estate and gift tax systems by conforming the computation of the gift tax base to that of the estate tax. Also of major importance is the proposal to replace the present GST tax with a new GST tax along the lines of Treasury Department's proposal of April 1983. Together, these changes will assure that the form of ownership and transfer of assets within a family will play a greatly reduced role in determining the transfer taxes paid by that family.

These proposals are approximately revenue-neutral, even though they will result in a broader transfer tax base over the longer run. However, since transfer taxes are imposed on accumulations of wealth only once in each generation, the revenue effects of the base broadening will be felt only gradually. Hence, it is not possible to propose any reduction in transfer tax rates at the present time. Once the new rules are in place and the effects of the transition rules have been phased out, rate reductions may be possible. These will make the transfer tax system an even less obtrusive factor in taxpayers' decisions as to how to hold and transfer their wealth and will furher increase productivity and invention.

These proposals also permit a number of simplifications in the transfer tax system. In particular, the rules relating to when a transfer is treated as complete, when a prior gift is included in the transferor's estate, and the power-of-appointment rules can be greatly simplified. Under the proposed rules, most transfers would be subject to the transfer tax system only once in each generation, and the number of occasions when a transfer would have to be valued on the basis of actuarial tables would be significantly reduced.

One final major aspect of the transfer tax proposal relates to the timing of the payment of the estate tax. Under current law, many estates that have adequate cash to pay the Federal estate tax are nevertheless entitled to pay the tax in installments, with a preferred interest rate applicable to part of the deferred payment. On the other hand, some truly illiquid estates are denied the right to deferred payment. The proposal would alleviate this inequity by replacing the complex test of current law with a relatively simple test allowing an estate to pay its estate tax liability in installments based on its relative holding of liquid and illiquid assets. A market rate of interest on any deferred tax payments would be charged to ensure that the expanded liquidity relief provision is fair and revenue neutral.

B. Penalties

The numerous civil penalties imposed under current law for the violation of reporting and payment provisions are complex and often inconsistent in the treatment of similar violations. Moreover, because interest is not charged, current law provides no incentive for the timely payment of penalties. The proposal consolidates many of the information-reporting penalties into one provision with uniform penalty amounts. This would simplify administration of the penalty provisions and ensure their fair application. The proposal also assesses interest on delinquent penalty amounts in order to encourage timely payment.

C. Expiring Provisions

The following special tax provisions are scheduled to expire by 1988: residential and business energy credits, the targeted jobs credit, the credit for testing orphan drugs, the special expensing rule for expenditures to remove architectural barriers to the elderly and handicapped, the exclusions of employer-provided legal services, educational assistance, and van-pooling, and the special treatment of dividends reinvested in public utility stock. The Treasury Department proposes that these provisions be allowed to expire as scheduled.

Several of these expiring provisions give preferred treatment to specific sectors, contrary to the spirit of neutrality. Others have outlived their usefulness. Most are believed to have had little effect on behavior or to provide only a weak incentive for the preferred activity. The credit for research and experimentation expenditures, however, would be extended for three years and targeted more effectively toward productivity-enhancing innovations.

D. Social Security Issues

Although the tax proposals presented by the Treasury Department deal primarily with the individual income tax, they would also have beneficial effects on the social security system. Within a few years after enactment, social security revenues would rise by about $5 billion. The longer run impact, while harder to measure, will ultimately prove to be much more important. The increasing use of fringe benefits over the past few decades has led social security forecasters to predict continual declines in the taxable wage base relative to total compensation paid to workers. The long-run impact on the Social Security and Disability Trust Funds (which are now nearly in long-run blance) will be minor since benefits, as well as revenues, will be increased. However, the long-run impact on the Medicare Trust Fund will be measurable, since revenues will be increased without creating additional liabilities. Moreover, the cap on the exclusion of employer-provided health insurance will help stop the upward spiral of the cost of health care. This, too, will help reduce the cost of Medicare and other government-provided health programs.

E. Items Not Included in the Tax Reform Proposal

Despite its comprehensive nature, this study proposes no change in many sections of the tax Code. In some cases, this reflects the belief that current law is appropriate. In other cases, however, changes may be desirable, but specifying the appropriate changes will require more time for detailed analysis. Therefore, the fact that no change is proposed in a particular area should not be interpreted as Treasury endorsement of current law.

This Report proposes no change in the itemized deductions for mortgage interest on the taxpayer's principal residence, medical expenses, and casualty losses. In addition, extraordinary charitable contributions would remain deductible. No change is proposed in the current provisions which exclude all or part of each of the following from tax: social security benefits; income-conditioned transfers; in-kind benefits; certain hard-to-value fringe benefits; employer-provided meals and lodging; personal injury awards; capital gains on appreciated assets transferred at death or by gift; capital gains on owner-occupied housing; earned income of U.S. citizens working abroad; and interest on state and local government bonds for "governmental" purposes. In addition, preferential tax treatment of IRAs and most retirement plans would be expanded, most employer-provided health insurance and most scholarships would remain untaxed, the earned income tax credit would be maintained and indexed, the credit for the elderly and disabled would be expanded and made available to the blind, and income averaging would still be available for most taxpayers.

Other provisions for which no changes are proposed include the following: subchapter S; corporate mergers, acquisitions, liquidations and reorganizations; export incentives (including FSC); deferral of tax on earnings of foreign corporations; rules for net operating losses; rules for pooled passive investment trusts; the accumulated earnings tax; rules for determining eligibility for the dependency exemption, marital status, and head-of-household status; related-party and attribution rules; rules governing the exemption of certain organizations from tax; and the tax treatment of cooperatives and their patrons and of partners and partnerships (except for limited partnerships with more than 35 partners).

APPENDIX 7-A

LIST OF PROPOSED REFORMS

INDUSTRY-SPECIFIC SUBSIDIES, TAX SHELTERS, AND OTHER TAX ISSUES

A. General Issues of Income Measurement

1. Match expenses and receipts from multiperiod production.
2. Restrict use of cash accounting method.
3. Limit bad debt deductions to actual loan losses.
4. Disallow installment sales treatment when receivables are pledged.
5. Repeal corporate minimum tax (only if basic reforms are fully implemented).

B. Subsidies for Specific Industries

1. Energy and Natural Resource Subsidies

   a. Repeal windfall profits tax.
   b. Repeal percentage depletion; use cost depletion, adjusted for inflation.
   c. Repeal expensing of intangible drilling costs.
   d. Repeal expensing of qualified tertiary injectant expenses.
   e. Repeal expensing of hard mineral exploration and development costs.
   f. Repeal special treatment of royalty income.
   g. Repeal special rules for mining reclamation reserves.
   h. Repeal non-conventional fuel production tax credit, alcohol fuels credit and excise tax exemption.

2. Special Rules of Financial Institutions

   a. Commercial banks and thrift institutions

      1. Repeal special bad debt deductions for banks and thrift institutions.
      2. Disallow 100% of interest incurred to carry tax-exempt bonds by depository institutions.
      3. Repeal tax exemption of credit unions.
      4. Repeal special carryover rules, and repeal special merger rules for thrift institutions.

   b. Life Insurance Companies

      1. Limit life insurance reserve deductions to the increase in policyholders' cash surrender value.
      2. Repeal special deduction of percentage of taxable income of life insurance companies.

3. Repeal tax exemption for certain insurance companies.

c. Property and Casualty (P&C) Insurance Companies

1. Limit P&C reserves to the discounted present value of future liabilities.
2. Repeal mutual P&C insurance companies' deduction for additions to protection against loss account.
3. Limit deductibility of P&C policyholder dividends.
4. Repeal special tax exemption, rate reductions, and deductions of small mutual P&C insurance companies.

3. Insurance Investment Income

a. Repeal exclusion of investment income on life insurance policies.
b. Treat policyholder loans as coming first from any tax-exempt inside buildup.
c. Repeal exclusion of current annuity income.

4. State and Local Government Debt and Investments

a. Repeal the tax exemption of nongovernmental purpose tax-exempt bonds.
b. Tighten restrictions on tax arbitrage and advance refunding for tax-exempt bonds.

5. Special Expensing and Amortization Rules

a. Repeal expensing of soil and water conservation expenditures, expenditures by farmers for fertilizer and for clearing fields.
b. Repeal 5-year amortization of expenditures for rehabilitation of low income rental housing.
c. Repeal 5-year amortization of certified pollution control facilities.
d. Repeal 50-year amortization of railroad grading and tunnel bores.
e. Repeal 5-year amortization of trademark expenses.
f. Repeal 84-month amortization of reforestation expenditures and 10% tax credit for such expenditures.

6. Other Specific Subsidies

a. Repeal rehabilitation tax credits.
b. Repeal special rules for returns of magazines and paperback books and for qualified discount coupons.
c. Repeal exclusion relating to Merchant Marine Capital Constuction Fund.
d. Rationalize credit for research and experimentation.

C. Further Curtailment of Tax Shelters

1. Disallow most current interest deductions (with carryforward) in excess of the sum of mortgage interest on the taxpayer's principal residence, investment income, income from limited partnerships and S corporations, and $5,000.

2. Extend at risk limitations to real estate and equipment leasing.

D. International Issues

1. Change foreign tax credit limitation to a separate per country limitation.

2. Modify rules defining source of income derived from sales of inventory-type property and intangible property.

3. Repeal the secondary dividend rule and replace with a branch profits tax.

4. Repeal special preference for 80/20 corporations.

5. Repeal possessions tax credit and replace with phased out wage credit.

6. Clarify treatment of certain transactions in foreign currency.

E. Other Tax Issues

1. Transfer Taxation

   a. Unify estate and gift tax structure by grossing up the tax on gifts, and simplify rules for determining when a transfer is complete for gift tax purposes.
   b. Simplify taxation of generation-skipping transfers, and modify credit for tax on prior transfers to a lower generation.
   c. Impose a rule to prevent abuse of minority discounts.
   d. Replace the rules governing payment of estate tax in installments with simplified rules based on estate liquidity, but make interest incurred by an estate nondeductible for estate tax purposes.
   e. Reduce estate tax deduction for claims against an estate by the amount of income tax savings from payment of the expense.
   f. Simplify state death tax credit by making it a flat percentage of federal estate tax collected.
   g. Repeal special tax rules for redemption of stock to pay death taxes.
   h. Tighten rules regarding powers of appointment.

2. Penalties

   a. Simplify information return penalties.
   b. Repeal maximum limits on penalties.
   c. Replace failure-to-pay penalty with a cost-of-collection charges.

3. Expiring Provisions

   a. Residential and certain business energy tax credits.
   b. Targeted jobs tax credit.
   c. Expensing of expenditures to remove architectural barriers to the elderly and handicapped.
   d. Credit for testing orphan drugs.
   e. Special treatment for dividend reinvestment in public utility stock.
   f. Exclusion of employer-provided legal service.
   g. Exclusion of employer-provided educational assistance.
   h. Exclusion of employer-provided van-pooling.

Chapter 8

COMPARISON WITH OTHER TAX REFORM PLANS

Over the past several years many proposals for tax reform have been advanced by members of the U.S. Congress. These include proposals for a pure flat tax, a modified flat tax, a tax on consumed income, and a value-added tax. All of these plans share common objectives: to broaden the tax base and lower rates and thereby make the tax system fairer, simpler, and more neutral in its impact on the private economy. The same objectives motivated the Treasury Department study.

The Treasury Department proposals for tax simplification and reform combine many of the best features of these Congressional plans for tax reform. They go further in measuring taxable income comprehensively and consistently at both the corporate and individual levels. They deal more completely with problems of tax shelters and abuses -- a growing threat to the tax system -- and address in greater detail the need to simplify the income tax. In short, though the Treasury Department plan draws heavily on the pioneering efforts by many members of Congress and by others, it goes further in achieving the mandate to design a tax system that is broad-based, simple, and fair.

Two of the earliest and most detailed of the congressional proposals are those by Representative Jack Kemp and Senator Robert Kasten for a "Fair and Simple Tax" (S. 2948; H.R. 6165) and by Senator Bill Bradley and Representative Richard Gephardt for a "Fair Tax" (S. 1472; H.R. 3271). These bills include most of the specific proposals for reform contained in the other bills offered by members of Congress. This chapter compares the most important features of the Treasury Department proposals with those of the Kemp-Kasten and Bradley-Gephardt plans. More detailed and more comprehensive comparisons with these and other congressional plans are provided in the appendices to this chapter.

Like the discussion of tax reform proposals in chapters 5, 6, and 7, the comparison of the Treasury Department, Bradley-Gephardt, and Kemp-Kasten proposals is divided into provisions that affect virtually all individuals, regardless of whether they have important amounts of capital or business income (section I), those that pertain almost exclusively to the basic taxation of capital and business income, including the tax treatment of retirement savings and the taxation of corporations and partnerships (section II), and those that pertain to specific industries and tax shelters (section III), and those that pertain to other tax issues, including the taxation of transfers and provisions that are currently planned to expire (section IV).

I. Individual Income Tax

A. Income Tax Rates

One of the primary objectives of the Treasury Department study of tax simplification and reform has been to broaden the income tax base enough that a given amount of revenue can be raised with substantially lower tax rates than under current law. This important objective is shared by the Kemp-Kasten and Bradley-Gephardt proposals, and, indeed, by all of the proposals for fundamental tax reform that have been introduced in the Congress.

Under the Treasury Department proposals all income of individuals above the tax-free amount will be taxed at three rates, 15 percent, 25 percent, and 35 percent. Real capital gains -- that is, gains after adjustment for inflation -- will be taxed as ordinary income. By comparison, the Bradley-Gephardt proposal will impose three tax rates, 14 percent, 26 percent, and 30 percent. This rate graduation will be achieved by levying the 14 percent rate on all income and surtaxes of 12 and 16 percent on incomes above certain levels. Nominal capital gains will be taxed as ordinary income, without adjustment for inflation.

The Kemp-Kasten proposal contains only one statutory rate, 25 percent. However, 20 percent of "earned income" -- wage and salary income and income from sole proprietorships and farms -- up to the social security ceiling ($39,600 in 1985), will be exempt from tax. (For this purpose the first $10,000 of income of single taxpayers and $15,000 of income of a married couple with income below those levels is assumed to be earned income, even if it is from capital or business. These amounts are indexed for inflation.) That exemption is then phased out (at an income level of $102,960). Because this exemption is phased out, there is, in effect, a 20 percent rate on earned income up to the social security ceiling, a 28 percent rate over the phase-out range of income, and then a flat rate of 25 percent on income above the phase-out range.

B. Fairness for Families

Under current law, the personal exemption for taxpayers and dependents for 1985 will be $1,040 per person (allowing for indexation, which begins January, 1985); the elderly and the blind receive an additional $1,040 exemption. Under the Treasury Department proposals the taxpayer and dependent exemptions will be increased to $2,000 per person in 1986. The extra exemptions for the elderly and the blind will be folded into an expanded credit for the elderly, blind, and disabled, so that the tax-free amount for the elderly will be increased slightly. The Kemp-Kasten proposal follows a similar approach, raising the taxpayer and dependent exemptions to $2,000; it will also increase the additional exemptions for the elderly and the blind to $2,000. The Bradley-Gephardt proposal distinguishes between personal exemptions for the taxpayer and spouse, which it sets at $1,600 (or $1,800 for a head of household), and those for dependents, the elderly, and the blind; the latter are set at $1,000. The Bradley-Gephardt plan allows personal exemptions to be deducted in computing income taxed at the 14 percent rate, but not for computing income subject to the 12 percent and 16 percent surtaxes.

Under current law the zero-bracket amount in 1986 is estimated to be $2,510 for individuals, $2,510 for heads of households, and $3,710 for joint returns. Under the Treasury Department proposals these amounts will be increased to $2,800, $3,500, and $3,800, respectively. By comparison, the Kemp-Kasten proposal (after indexing to 1986 levels) increases them to $2,950, $2,950, and $3,820, respectively, and the Bradley-Gephardt proposal increases them to $3,000, $3,000, and $6,000. *For a family of four filing a joint return and receiving* only income from employment, the tax-free amount -- the level of income at which tax liability begins (including the earned income credit) -- would be $11,800 under the Treasury proposal, $11,200 under the Bradley-Gephardt proposal, and $15,675 under the Kemp-Kasten approach. Under current law a family of four will incur no income tax liability until adjusted gross income exceeds $9,613 (after indexing for the increase in prices projected for 1985).

The Treasury Department proposals retain the indexation of the zero-bracket amount, personal exemptions, and rate brackets that becomes effective on January 1, 1985. Without indexation inflation will continue to give rise to "bracket creep" that causes taxpayers with unchanged real incomes to pay increasingly higher rates of tax. Lack of indexation also allows inflation to lower real tax-exempt levels of income and impose taxes on persons in poverty. Whereas the Kemp-Kasten proposal also retains indexation, the Bradley-Gephardt proposal will repeal it. The Treasury Department and Kemp-Kasten proposals will also extend indexation to the dollar limits of the earned income tax credit.

The choice of personal exemptions and zero-bracket amounts involves conflict between several competing goals. First are revenue considerations. Higher tax-exempt levels reduce revenues and require higher tax rates to reach a given revenue goal. In some proposals there is a tendency to raise taxes more for middle-income taxpayers to accomplish greater reduction at lower income levels.

Second, if personal exemptions and the ZBA are set in such a way that the tax threshold closely resembles the poverty level of income for taxpaying units of various types, a marriage penalty is produced. The marriage penalty occurs because at any level of income two persons living together have lower expenses than two single persons living alone. Thus two single persons living alone at the poverty level have an aggregate tax-free amount greater than a married couple at the poverty level, if the tax-free amount tracks the poverty level. If, on the other hand, the tax threshold for a married couple is set equal to the poverty line, a tax threshold for single persons of only half that amount will fall short of the poverty level of income for a single person.

A third objective is to make adjustments according to family size for ability to pay. Personal and dependent exemptions are the primary means of accomplishing this goal. The Treasury Department plan, as well as the Kemp-Kasten proposal, recognizes the need to adjust personal exemptions for inflation. The Bradley-Gephardt proposal makes no adjustment in the dependent's exemption and, in fact, through lack of indexing allows the real value of current dependent's exemption to decrease.

In its proposals the Treasury Department has attempted to balance the competing objectives of eliminating the marriage penalty, tracking poverty levels of income, not raising the tax on single persons too high relative to that on one-earner married couples, and adjusting appropriately for family size. The Treasury Department proposal, the Bradley-Gephardt proposal, and the Kemp-Kasten proposal will all repeal the two-earner deduction, which is needed less, once the rate structure is less steeply graduated.

C. Fair and Neutral Taxation

If the U.S. tax system is to be made fair and more neutral, the tax base must be defined comprehensively. Base broadening under the Treasury Department proposals comes from three major sources: taxing currently excluded forms of income, curtailment of existing tax subsidies to particular uses of income via itemized deductions, and limitations on existing abuses of the tax system.

1. **Excluded sources of income.** Fringe benefits provided by employers represent substantial amounts of real income that are excluded from the tax base. These are commonly divided into two groups, statutory and non-statutory, to reflect the fact that the former are explicitly excluded from taxation by law, whereas the latter have only been excluded by custom. This terminology is still useful, even though the Deficit Reduction Act of 1984 extended statutory exemption to certain of the non-statutory fringe benefits.

The most important statutory fringe benefit excluded from the tax base is premiums on accident and health insurance provided by employers. Other statutorily excluded fringe benefits include group-term life insurance, dependent care services, and certain living allowances. Under the Treasury Department proposals, most statutory fringe benefits will be taxed, with exceptions or limitations when amounts are small and valuation is difficult. Employer contributions to health plans will be taxed only to the extent that they exceed $70 per month for an individual employee and $175 per month for family coverage; these floors will be indexed to protect their real value from inflation. The Bradley-Gephardt proposals and, to some extent, the Kemp-Kasten proposals also include many major statutory fringe benefits in taxable income. Non-statutory fringe benefits (including those recently excluded by law) would not be taxed under any of the proposals.

All three proposals will tax unemployment compensation; the Treasury Department and Kemp-Kasten proposals will generally tax workers' compensation, because it also serves as a wage replacement program. All three proposals will tax income received in the form of scholarships and fellowships, but only to the extent that it exceeds tuition expenses. The increased tax thresholds provided by the higher personal exemptions and ZBA in the Treasury Department proposals will prevent the taxation of most low-income recipients of any of these benefits.

2. **Preferred uses of income.** Major itemized deductions allowed under current law are for state and local taxes, charitable contributions, and interest expense. Deductions also are allowed for medical expenses in excess of 5 percent of adjusted gross income (AGI), casualty losses in excess of 10 percent of AGI, and for miscellaneous other expenditures, including costs of earning income not deducted elsewhere. The Treasury Department proposal will phase out completely the deduction for all state and local taxes. Charitable contributions will be deductible only to the extent they exceeded 2 percent of adjusted gross income; the deduction of charitable contributions by non-itemizers will be eliminated. The deduction for a charitable donation of appreciated property will be limited to the indexed basis. The existing deduction for medical expenses in excess of 5 percent of AGI and casualty losses in excess of 10 percent of AGI will be left intact. The deduction for mortgage interest on the taxpayer's principal residence will be unchanged, but the deductibility of other personal interest expense will be reduced and limited for taxpayers with substantial interest expense in excess of realized capital income. Miscellaneous expenses of earning income will be combined with employee business expenses and made an "above-the-line" adjustment, rather than an itemized deduction; this combined deduction will be limited to the excess of such expenses over 1 percent of adjusted gross income. Placing this floor under itemized deductions for employee expenses will simplify compliance for many taxpayers and allow rates to be lowered further than if all expenses could be deducted.

The Bradley-Gephardt proposals will retain the deduction for state and local taxes on income and real property, but eliminate itemized deductions for all other state and local taxes. The proposals will retain the itemized deductions for interest on home mortgages, but will substantially limit deductions for other personal interest. The itemized deductions for charitable contributions and for casualty and theft losses will be retained, but that for medical expenses will be limited to expenditures in excess of 10 percent of adjusted gross income.

Under the Bradley-Gephardt approach itemized deductions could be used only in calculating tax under the 14 percent rate; they will not be deductible against the 12 percent and 16 percent surtaxes that raise marginal rates to 26 percent and 30 percent. By allowing itemized deductions only for purposes of computing income taxed at the 14 percent rate, the Bradley-Gephardt plan effectively converts

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itemized deductions into 14 percent tax credits. This approach limits the tax value of deductible expenses to the same dollar amount for all taxpayers. If the purpose of the deduction is to provide a subsidy through the tax system, this approach is satisfactory. However, to the extent that itemized deductions help define economic income properly subject to tax, the full deduction should be allowed in computing income for purposes of the surtaxes as well.

Under the Kemp-Kasten approach itemized deductions will be retained for interest on home mortgages and on educational loans, but not on other consumer debt, for state and local property and general sales taxes, for charitable contributions, and for medical expenses in excess of 10 percent of adjusted gross income and for casualty and theft losses. The deduction for state and local income taxes will be eliminated.

D. Tax Abuses

Some taxpayers improperly take business deductions for expenses that most Americans would view as personal expenses. In addition, various techniques are used by some taxpayers to shift income from themselves to their children, who are in lower tax brackets. For example, parents can transfer income-earning assets to their children or they can establish trusts that enable income to be subject to tax rates lower than those of the parents. Provisions in the Treasury Department proposal will prevent the claiming of business deductions for personal expenses and will limit the benefits of income shifting. Neither the Bradley-Gephardt proposal nor the Kemp-Kasten plan addresses these issues.

E. Simplification

The increases in the personal exemptions and zero-bracket amounts and the limitations on the availability of itemized deductions will simplify tax compliance for many Americans. With lower tax rates taxpayers will have less incentive to find deductible expenditures and because fewer deductions are available, they will have less need for recordkeeping.

1. **The return-free system.** Because of its increased capability of processing withholding and information returns, the Internal Revenue Service will soon have improved capability of calculating tax liabilities for many Americans. As a result, the Treasury Department is proposing that the United States begin to test a "return-free system," under which many individual taxpayers will be relieved of the obligation of filing an income tax return. Instead, for taxpayers who certify that they only had certain sources of income and deductions, the Internal Revenue Service will send the taxpayer a report of tax calculation based on information at its disposal. The taxpayer will then either accept the IRS report or indicate that additional information will require filing of a regular return. Initially, eligibility for the return-free system will be limited to taxpayers who had only wages subject to withholding and interest income subject

to information reporting. Thus, an estimated 20 percent of returns to be filed by non-itemizers in 1988 might rely completely on returns originally prepared by the Internal Revenue Service. None of the other proposals for tax reform and simplification include a return-free system.

2. **Other simplification.** The Bradley-Gephardt and Kemp-Kasten proposals share some of the simplification advantages of the Treasury proposals, but they leave intact many provisions that involve complexities for taxpayers. The Treasury Department proposals will repeal the credit for political contributions, the Presidential campaign checkoff, special 10-year averaging for lump-sum distributions, and the 3-year rule for recovery of retirement contributions. It will eliminate (or allow to expire) all existing tax credits, other than the foreign tax credit, the credit for research and experimentation, and the earned income tax credit. It will simplify the tax treatment of pensions, it will unify and simplify existing penalties, and it will unify the substantive rules for the taxation of gifts and estates. The Bradley-Gephardt and Kemp-Kasten proposals would also eliminate most tax credits and the special 10-year averaging for lump-sum distributions. These plans generally do not address the tax treatment of pensions or the substantive rules for the taxation of gifts and estates, or alter tax penalties. The Treasury Department proposal will retain income averaging, except for those who have been students during the base period. Both the Bradley-Gephardt and Kemp-Kasten plans will repeal income averaging in its entirety.

II. Basic Taxation of Capital and Business Income

Under current law capital and business income is subject to vastly different tax treatment, depending on its source. An important objective of the Treasury Department proposals is to make the tax treatment of business and capital income more uniform. This will allow business decisions to be based more on economic reality, and less on tax implications. Cutting corporate rates will further reduce the distortion of business decisions caused by the tax system.

A. Corporate Tax Rates

Under current law the marginal rate of tax paid on corporate income increases with the amount of income, reaching a maximum of 46 percent at an income of $100,000. The Treasury Department proposals will replace this graduated rate structure with a flat rate of 33 percent applied to all corporate income, including real capital gains of corporations. The Treasury Department proposals will retain the corporate minimum tax through 1992 and then phase it out over a three-year period, if most tax preferences are eliminated as proposed. The Bradley-Gephardt proposals will levy a 30 percent corporate rate and eliminate the corporate minimum tax. The Kemp-Kasten proposals will also subject most corporate income to a rate of 30 percent, but it will retain the corporate minimum tax, limit the tax rate on the first $50,000 of corporate income to 15 percent, and apply a 20 percent rate to capital gains of corporations.

B. Investment Tax Credit

The Treasury Department, as well as Bradley-Gephardt and Kemp-Kasten, proposes that the investment tax credit (ITC) be eliminated. The Treasury Department proposes repeal of the ITC because 1) the proposed system of capital recovery will compensate for inflation directly; 2) the current ITC discriminates against new businesses and companies with losses; 3) the ITC is a major source of tax shelter formation; and 4) administration of recapture rules with respect to the ITC is quite difficult and subject to abuse. At current low rates of inflation, moreover, the investment tax credit distorts resource allocation and it will continue to do so if retained in the proposed system. Rate reduction provides a uniform incentive for all corporations, and is therefore preferable to devices such as the investment tax credit, which is targeted to industries that are heavy producers or users of only the certain types of capital that benefit from the credit. Both the Bradley-Gephardt and Kemp-Kasten proposals will eliminate the credit for research and experimentation. The Treasury Department proposals will retain this credit, but restructure it to make it more effective.

C. Income Measurement: Inflation Adjustment

During periods of high inflation the current income tax causes capital income to be overstated and it causes interest deductions to be exaggerated. The result is misallocation of the nation's capital and undesirable incentives for borrowing and disincentives for saving. Current law reflects efforts to avoid these distortions and inequities by allowing recovery of capital more rapidly than it actually depreciates and by excluding part of nominal capital gains. These ad hoc adjustments are appropriate only for given rates of inflation. On the other hand, no adjustment is made for the effect of inflation in the calculation of costs of goods sold from inventories or for overstatement of interest income and expense resulting from inflation.

The Treasury Department proposes to ameliorate these problems by allowing explicit inflation adjustment for depreciable assets, inventories, interest income and expense, and the calculation of capital gains. With the measurement of income improved by these adjustments for inflation, the ad hoc adjustments for depreciable assets and capital gains will no longer be needed. Thus, depreciation deductions can be made to correspond more closely to economic depreciation and capital gains can be taxed as ordinary income. Expensing would, however, be allowed for the first $5,000 of depreciable business property. The deduction of capital losses will continue to be limited. The Treasury Department proposal will exclude from taxation a portion of interest income and disallow deduction of part of interest expense in excess of that on business indebtedness and mortgages on the taxpayer's principal residence, plus $5,000. The fraction of interest income and expense to be ignored in calculating taxable income will depend on the rate of inflation.

The Kemp-Kasten proposal also includes indexation of the basis of capital gains and taxation of all capital gains of individuals as ordinary income, but it does not include inflation adjustment of depreciable assets. (It will continue the present Accelerated Cost Recovery System and the presently suspended ability of firms to expense up to $10,000 of assets each year.) The combination of inflation adjustment for capital gains and continued ad hoc adjustment of depreciation allowances could create technical difficulties and unforseen misallocation of economic resources. Moreover, the failure to index the cost of goods taken from inventories will continue the present tax discrimination against inventory-intensive industries. The Kemp-Kasten proposal will allow unlimited capital losses. It attempts to deal with the artificial minimization of taxes that is possible when losses on some assets may be recognized even though gains on other assets need not be recognized by treating capital losses as a preference item to be subject to the alternative minimum tax.

The Bradley-Gephardt proposal eliminates the distinction between long-run and short-run capital gains by subjecting all nominal gains to taxation as ordinary income. This approach leaves the effective rate of taxation of real capital gains dependent upon the rate of inflation. As during the 1970s, effective rates could far exceed the statutory rate; they could go above 100 percent, and tax could be collected on real losses. Taxing nominal gains as ordinary income could create substantial disincentives for investment, invention and innovation, particularly in periods of high inflation. The Bradley-Gephardt proposal will apply 250 percent declining balance depreciation to assets classified under the Asset Depreciation Range System of depreciation, with no adjustment for inflation. As a result, it will be much too generous at low inflation rates, but not generous enough at high inflation rates. The Bradley-Gephardt approach will not index inventories or adjust the amount of interest to be included in income or allowed as an expense.

All three proposals retain the rollover of capital gains on a principal residence: the Treasury Department and Kemp-Kasten proposals retain the $125,000 one-time exclusion of gains on the principal residence; the Bradley-Gephardt proposal does so only for the purpose of computing income subject to tax at the 14 percent rate.

D. Retirement Savings

All three proposals leave intact the present tax treatment of individual retirement accounts (IRAs) and Keogh plans (retirement accounts for the self-employed). The Treasury Department proposal will make IRAs of spouses working in the home without pay subject to the same limits as those of employed taxpayers and raise the limit on tax-free contributions to IRAs.

All three proposals essentially leave intact the present tax treatment of qualified pension plans and profit-sharing plans. To achieve administrative simplicity, the Treasury Department proposals will eliminate the combined limits on amounts contributed to defined benefit and defined contribution plans which are not top-heavy, but will impose an excise tax on the receipt of extraordinarily large benefits after retirement. The Bradley-Gephardt proposal, by comparison, nearly halves the limits under present law. Under the Kemp-Kasten proposal, the current limits will be retained. The Treasury Department proposals will unify various other provisions, including penalties for premature withdrawals by employees.

E. Neutrality Toward the Form of Business Organization

Under present law corporations and partnerships are subject to substantially different tax treatment. Partnerships, regardless of their size or other features, are taxed as pass-through entities; that is, there is no tax at the partnership level, and all income or losses are simply passed on to individual partners for inclusion in their tax returns. As a result, partnerships are used as important vehicles for tax shelters, since they allow individuals to take deductions for partnership losses against income earned from other sources. In the case of large partnerships, pass-through treatment can create severe collection and other administrative costs. In the event of a partnership audit, collection notices must be sent to the hundreds or thousands of individual taxpayers who were owners of the partnership at the time the original, erroneous return was filed. Some of these taxpayers may have moved, some may be in substantially different circumstances, some may have died, and some may have sold their interests to others. Income earned by corporations, on the other hand, is subject to double taxation; corporate profits are taxed as earned and then dividends paid from after-tax income are taxed again when received by shareholders. One objective of the Treasury Department's study has been to make more consistent the treatment of partnerships and corporations which closely resemble one another.

The Treasury Department proposals will provide a more consistent treatment of similarly situated corporations and partnerships through 1) the reclassification of certain partnerships as corporations for tax purposes, and 2) the reduction of the double tax on dividends paid. The reclassification proposal involves treating as a corporation any limited partnership that includes 35 or more limited partners. In addition, corporations will be allowed a deduction for part of dividends paid. The dividends paid deduction will eliminate part of the double taxation of dividends, since the part of dividends allowed as a deduction to the corporation will be taxed only at the shareholder level.

Neither the Bradley-Gephardt nor the Kemp-Kasten proposals deal with the important issue of unification of the tax treatment of partnerships and corporations. The Treasury Department and Bradley-Gephardt proposals will repeal both the personal holding company tax and the rules for collapsible corporations. The Bradley-Gephardt proposal repeals the accumulated earnings tax; the Treasury Department proposes to retain it. All three proposals will repeal the small exclusion for dividends received by shareholders ($100 for single and separate returns; $200 for joint returns).

III. Industry-Specific Subsidies, Tax Shelters, and Other Tax Issues

A. General Issues of Income Measurement

Because certain provisions of current law do not take adequate account of the timing of income receipts and payments, taxation of income can be deferred until future years. This tax deferral lowers the effective tax rate on the tax-preferred activity, distorts the allocation of investment across industries, and causes similarly-situated taxpayers to be treated differently.

Current tax rules do not match taxable receipts and deductions for activities that require several years to produce. Matching can be achieved if the costs of producing assets are capitalized, that is, included in the basis of the asset and recovered (deducted) when the asset is sold or when the basis is depreciated. The rules requiring capitalization of expenses incurred in the construction of capital assets are incomplete and vary by type of activity. This treatment distorts the choice between purchased and self-constructed assets and encourages tax shelters in multiperiod production activities.

Under the Treasury Department proposals the capitalization rules will be reasonably comprehensive of all expenses and will be uniform across activities. The other proposals will extend 10-year amortization of construction period interest and taxes to other business assets, but are not as comprehensive as the Treasury proposal.

Under current law the gain on installment sales is not taxed until payments are received. Under the Treasury Department proposal, a taxpayer will not be entitled to use the installment sales method if the installment obligations are converted into cash by means of pledging or other arrangement, thereby eliminating the taxpayer's possible liquidity problem. The other two proposals do not change current law in this area.

Under current law, taxpayers can generally elect to use either the cash or accrual methods of accounting. Although the accrual method of accounting is considered to be a more accurate measure of annual economic income, the cash method is administratively simpler for certain taxpayers. The option to use different accounting methods allows taxpayers to reduce taxes artificially by mismatching recognition of taxable income and deductions. The Treasury Department proposal will require the use of the accrual method by all large firms, by all firms using the accrual method for financial reporting, and by firms holding inventories. The other two proposals do not address this issue. The other two proposals will require accrual accounting for farming and timber where the taxpayer has gross receipts greater than $1 million.

The preferential tax treatment of bad debt losses encourages lenders to make risky loans and favors debt over equity financing. The Treasury Department proposal will remove these distortions by repealing the deduction for additions to reserves for bad debt loan losses and limiting the bad debt loss deduction to the amount of the current loan losses. The Treasury Department proposal will apply to both financial and non-financial institutions. The other two proposals will change allowances for bad debt loan losses only for financial institutions.

With these modifications of tax law, taxable income will resemble much more closely economic income. Ultimately, the present corporate minimum tax will be unnecessary and evenutally it should be eliminated. It should be retained, however, over an interim period during which previously made investments continue to benefit from preferences allowed under current law. Whereas the Bradley-Gephardt proposal will also eliminate the corporate minimum tax, the Kemp-Kasten proposal will retain it.

B. Subsidies for Specific Industries

The Treasury Department proposals will repeal numerous preferential cost recovery provisions designed to favor one form of investment over another, or one industry over another. These special provisions operate as subsidies, altering economic decisions. Such subsidies are justified only if the subsidy corrects appropriately an otherwise incorrect market evaluation of costs and benefits. None of the subsidies to be repealed can be justified on these grounds. Moreover, since the subsidy they provide is in the form of exclusion of income from tax, or as tax deferral, these provisions unfairly benefit higher-income investors more than lower-income ones.

1. **Energy and Natural Resources.** Under the Treasury Department proposals expensing of intangible drilling costs in the oil and gas industry will be replaced by depreciation allowances, and percentage depletion will be replaced by cost depreciation. Indexing of the basis of non-depleted resources will be allowed. The Treasury Department proposal will also accelerate the phase-out of the windfall profit tax to 1988. The Bradley-Gephardt and Kemp-Kasten proposals will also eliminate percentage depletion, expensing of exploration and development costs, and the deduction for intangible drilling costs, replacing them with ordinary depreciation. The Bradley-Gephardt and Kemp-Kasten proposals, however, wil retain the windfall profit tax.

Under current law additions to reserves for strip mining reclamation can be deducted currently even though no expenditure has occurred. This tax treatment accelerates deductions for future expenses and lowers strip mining operators' effective tax rates through tax deferral. The Treasury Department proposal will require reclamation expenses to be deductible when the expenses have been paid or economic performance has occurred. The other two proposals do not change current law.

2. **Financial institutions.** Under current law various types of financial institutions (banks, thrift institutions, life insurance companies, and casualty insurance companies) are accorded a wide variety of preferential tax treatment. In effect, they are regulated through tax provisions that discourage competition. Besides discriminating in favor of investment in these institutions, relative to other investment alternatives, this patchwork treatment of preferences prevents the achievement of fair and neutral taxation, even within the financial sector. The Treasury Department proposals will make uniform the tax treatment of various types of financial institutions and generally subject income earned in the financial sector to the same tax law applied elsewhere in the economy. The Treasury Department proposals will repeal special exclusions, deductions and tax rates for the different financial institutions, require discounting of banks' bad debt loss reserves and casualty insurance company reserves, and restrict life insurance company reserves to the increase in policyholders' cash surrender value. The other two proposals will only change the special bad debt deductions of commercial banks and thrift institutions.

3. **Insurance investment income.** The exclusion of investment income ("inside" buildup) on life insurance policies and annuities is one of the major excluded sources of income. Interest income on savings held with other financial institutions is subject to tax whether or not the interest is currently distributed to the taxpayer. The tax-preferred treatment of the inside buildup encourages individuals to save through life insurance companies and perhaps to purchase life insurance that they would not buy except to gain access to the favorable tax treatment. All three proposals will tax the annual investment income earned on life insurance policies and annuities.

4. **State and local debt and investments.** Interest on debt issued by state and local governments (often called municipal bonds) has long been exempt from Federal income tax. In recent years the generally accepted exemption for general obligation bonds has been extended by state and local governments to "private purpose" activities -- activities such as home mortgages, educational institutions, hospitals, and industrial development projects -- that might more appropriately be financed entirely from local funds, or through private credit markets without Federal exemption for interest. In an attempt to limit these abuses, the Deficit Reduction Act of 1984 includes a limit of $150 per capita on issuance of private purpose obligations by any state and its subdivisions. Even worse, some state and local governments have used proceeds from their securities to engage in tax arbitrage, by investing them in private or Federal debt obligations that pay rates of interest in excess of the municipal bond rate because they are subject to Federal tax. Each state and locality is encouraged to engage in as much of these activities as possible, since the cost is borne primarily by taxpayers in other states and localities. The result is an unproductive increase in Federal tax rates and shift in burdens of taxation between states. Residents of

jurisdictions with cautious or conservative borrowing habits are especially penalized.

The Treasury Department proposals will repeal the tax exemption of interest on private purpose bonds issued by state and local governments and tighten the restrictions on tax arbitrage and advance refunding related to tax-exempt bonds. Both the Bradley-Gephardt proposal and the Kemp-Kasten proposal will repeal the exemption of interest on private purpose obligations.

5. **Other specific subsidies.** Among the subsidies the Treasury Department proposals and both congressional bills will repeal are: the business energy production and alcohol fuel credits; the complex Capital Construction Fund mechanism to subsidize investment in fishing vessels and inland waterway and ocean going ships; expensing of capital expenditures for farmland conditioning and soil and water conservation; and 7-year amortization of capital outlays for forestation and reforestation.

The Treasury Department and Bradley-Gephardt proposals, but not the Kemp-Kasten proposal, will repeal provisions allowing 5-year amortization of investment in the rehabilitation of low-income housing and certified pollution control facilities installed in pre-1976 plants.

The Treasury proposals, but neither the Bradley-Gephardt nor the Kemp-Kasten propsoals, will repeal the special favorable rule for deducting costs of future mine reclamation expenditures, the 5-year amortization of costs of registering trademarks and tradenames, and the 50-year amortization of investment in, and sunk costs of, railroad grading and tunnel bores.

C. Further Curtailment of Tax Shelters

Many taxpayers use tax shelters to reduce their current tax liability. Even though many tax shelters are perfectly legal, they distort the allocation of economic resources and undermine both the equity of the tax system and the perception of fairness. Many of the Treasury Department, Bradley-Gephardt, and Kemp-Kasten proposals discussed above will make investing in tax shelters much less attractive. Important examples include reform of depreciation rules and changes in the tax treatment of capital gains. All three proposals will limit the deduction for interest expense. To further curtail the attraction of tax shelters, the Treasury Department proposal will extend the at-risk rules for loss deductions to real estate. Both the Treasury Department proposals and the Bradley-Gephardt proposal will repeal the alternative minimum tax; the Kemp-Kasten proposal retains it.

D. International Issues

Income earned abroad by foreign subsidiaries of U.S. corporations is generally not subject to U.S. tax unless repatriated as dividends.

U.S. tax imposed on such dividends and on the earnings of foreign branches can be offset by a credit for taxes paid to foreign governments. The foreign tax credit is limited to the effective rate of U.S. tax paid on the foreign source income in question. Under current law companies are allowed to pool income and credits from all countries (though not from all sources) in calculating the limit on the foreign tax credit. In order to encourage U.S. exports, U.S. firms are allowed to establish Foreign Sales Corporations, the income from which benefits from tax deferral, even if distributed.

The Treasury Department and Kemp-Kasten proposals will continue the deferral of taxation of income from subsidiaries of domestic corporations. By comparison, the Bradley-Gephardt proposal will eliminate deferral. The Treasury Department proposal will require calculation of the limitation of the foreign tax credit on a country-by-country basis, in order to prevent an artificial incentive for American firms operating in high tax countries to invest in low-tax countries, rather than in the United States. Neither the Bradley-Gephardt nor Kemp-Kasten proposals address this issue. The Treasury Department proposal will continue the preferential treament of Foreign Sales Corporations. The Treasury Department proposal also deals with certain problems in the measurement and determination of source of income; the Bradley-Gephardt and Kemp-Kasten proposals do not do so. The Treasury Department proposal will modify the possessions tax credit. The Bradley-Gephardt proposal will repeal the possesions tax credit, whereas the Kemp-Kasten proposal will retain it in its current form. The Treasury Department and Kemp-Kasten proposals will retain the exclusion for income of Americans working abroad; the Bradley-Gephardt proposal will repeal this exclusion.

IV. Other Tax Issues

A. Taxation of Transfers

Because the bases of the estate and gift taxes are calculated differently, current law favors those who can afford to make lifetime gifts over those who need or desire to retain their property until death. The preference given to lifetime gifts has also caused complex and arbitrary rules for including in the donor's estate certain previously transferred property. The Treasury Department proposal will treat transfers more uniformly by imposing the gift tax on the same basis as the estate tax. This change will simplify transfer taxation by eliminating the need for the rules that include certain gifts in an estate. The Treasury Department proposals will also simplify the rules for generation-skipping transfers and the rules that allow the estate tax to be made in installments where the estate has insufficient liquid assets to pay the tax. The other two proposals generally do not change the substantive rules for the taxation of transfers.

B. Expiring Provisions

The Treasury Department proposes elimination (or the allowance of currently planned expiration) of all major tax credits other than the earned income tax credit, the foreign tax credit, the credit for the elderly, blind, and disabled, and the credit for research and experimentation. The Kemp-Kasten proposals will reduce the earned income credit and retain the foreign tax credit and will repeal the credit for the elderly and the disabled, for research and experimentation credit, and all major tax credits. The Bradley-Gephardt proposal will retain the foreign tax credit and the earned income credit, but will repeal the credit for the elderly and the disabled, the credit for research and experimentation and all major tax credits.

All three proposals will repeal or allow to expire the special treatment for dividend reinvestment in public utility stock. All three plans will repeal or allow to expire the exclusions for employer-provided legal services and transportation. The Treasury Department proposal and the Bradley-Gephardt proposals will also repeal or allow to expire the exclusion of employer-provided legal and educational assistance.

November 24, 1984

Appendix 8-A

COMPARISON OF TREASURY PROPOSAL WITH CONGRESSIONAL TAX REFORM BILLS

	TREASURY DEPARTMENT (TD)	BRADLEY-GEPHARDT (B-G)	KEMP-KASTEN (K-K)	ROTH-MOORE (R-M)	NICKLES - SILJANDER (N-S)	DECONCINI-SHELBY (D-S)
I. INDIVIDUAL INCOME TAXES						
A. Rate Reduction	3 rates: 15%, 25% 35% 1/	3 rates: 14%, 26%, 30% 2/	25% of taxable income. Exclusion for 20% of wages in FICA tax base 3/	4 rates: 12, 20, 30, & 34 on taxable income 4/	10% of taxable income 5/	19% of compensation 6/
B. Fairness for Families						
1. Zero bracket amount. 7/						
a. Single returns.	$ 2,800	$ 3,000	$ 2,700	$ 2,400	$ 0	$ 4,100
b. Married (joint return).	3,800	6,000	3,500	3,550	0	6,700
c. Married (separate return).	1,900	3,000	1,750	1,775	0	4,100
d. Head of household return.	3,500	3,000	2,700	2,400	0	6,000
2. Personal exemptions. 8/						
a. Taxpayer.	$ 2,000	$ 1,600 9/	$ 2,000	$ 1,050	$ 2,000	0
b. Dependent (each).	2,000	1,000	2,000 10/	1,050	2,000 11/	$ 810
c. Blind and elderly (each).	0	1,000	2,000	0	0	0
3. Tax-free amount excluding the earned income credit (1986 levels)						
a. Single returns	$ 4,800	$ 4,600	$ 5,130 12/	$ 3,610	$ 2,090	$ 4,470
b. Joint returns						
Family of 2	7,800	9,200	8,180 12/	5,920	4,180	7,310
Family of 4	11,800	11,200	12,540 12/	8,120	8,360	9,070
Family of 6	15,800	13,200	16,900 12/	10,320	12,540	10,830
c. Head of household returns						
Family of 2	7,500	5,800	7,310 12/	4,710	4,180	7,430
Family of 4	11,500	7,800	11,670 12/	6,910	8,360	9,190
Family of 6	14,500	9,800	16,030 12/	9,110	12,540	10,950
4. Provide a single credit for the elderly, blind, and disabled to replace the exemptions for the elderly and the blind.		Repeals credit for elderly and disabled	Repeals credit for elderly and disabled	Repeals credit for elderly and disabled	Repeals credit for elderly and disabled	Repeals credit for elderly and disabled

TREASURY DEPARTMENT (TD)	BRADLEY-GEPHARDT (B-G)	KEMP-KASTEN (K-K)	ROTH-MOORE (R-M)	NICKLES - SILJANDER (N-S)	DECONCINI-SHELBY (D-S)
5. Repeal deduction for two-earner married couples.	Yes	Yes	Yes	Yes	Yes
6. Indexation of zero bracket amount, personal and dependents exemptions and dollar amounts of earned income credit (EITC).	No	Yes. Also reduces EITC.	Yes. Also increases EITC.	Indexation. Repeals EITC.	Yes. Repeals EITC.
7. Replace child and dependent care credit with a deduction from gross income with cap on allowable expenses.	Yes 13/	Repeals credit	Repeals credit	Repeals credit	Repeals credit
C. Fair and Neutral Taxation					
1. Excluded Sources of Income					
1. Repeal exclusion of health insurance above a cap.	Limits exclusion 14/	No	Limits exclusion 14/	Repeals exclusion	No 15/
2. Repeal exclusion of group-term life insurance.	Yes 16/	No	No 16/	No	No 15/
3. Repeal exclusion of employer-provided death benefits.	No	No	Yes	Yes	No 15/
4. Repeal exclusion of dependent care services or reimbursement.	Yes	No	Yes	Yes	No 15/
5. Repeal special treatment of cafeteria plans.	Yes	No	Yes	Yes	No 15/
6. Repeal exemption of voluntary employee's beneficiary associations and trusts for supplemental unemployment compensation and black lung disability.	No	No	No	No	No
7. Repeal special provisions regarding incentive stock options.	No	No	No	No	No 15/
8. Repeal exclusion of military compensation with offsetting adjustments in military pay. mustering out pay.	No	No	Limited repeal of military tax-free allowances	Limited repeal of military tax-free allowances	No 15/
9. Repeal exclusion of rental allowances or rental value of minister's home.	No	No	Yes	Yes	No 15/

TREASURY DEPARTMENT (TD)	BRADLEY-GEPHARDT (B-G)	KEMP-KASTEN (K-K)	ROTH-MOORE (R-M)	NICKLES - SILJANDER (N-S)	DECONCINI-SHELBY (D-S)
b. Wage replacement payments					
1. Repeal tax-exempt threshold for unemployment insurance compensation.	Yes	Yes	Yes	Yes	No
2. Repeal tax exemption of workers' compensation payments, black lung, and certain veterans' disability payments, but make such income eligible for the credit for the blind, elderly, and disabled.	No Repeals credit.	Repeals exemption for certain disability payments. Repeals credit.	Repeals exemption for certain disability payments. Repeals credit.	Exempts disability payments. Repeals credit.	Repeals exemption and credit.
c. Other excluded sources of income					
1. Repeal exclusion of scholarships and fellowships in excess of tuition.	Yes	Yes	Yes	No	No
2. Repeal exclusion of awards and prizes.	No	No	No	No	Yes
2. Preferred uses of income.					
a. Repeal itemized deduction for state and local taxes:					
1. State and local real property taxees.	No 13/	No	Yes	No	Yes
2. State and local personal property taxes.	Yes	No	Yes	No	Yes
3. State and local income taxes.	No 13/	Yes	Yes	No	Yes
4. State and local general sales taxes.	Yes	No	Yes	No	Yes
b. Repeal the above-the-line deduction for charitable contributions.	No 13/	No	No	No	Yes 17/
c. Limit deductions for charitable contributions to those in excess of 2 percent of gross income.	No 13/	No	No	No	No 17/
d. Limit deduction of charitable contributions of appreciated property to the indexed basis.	No	No	No	No	No 17/
e. Repeal 50% and 30% limits on individual contributions.	No	No	No	No	No 17/

TREASURY DEPARTMENT (TD)	BRADLEY-GEPHARDT (B-G)	KEMP-KASTEN (K-K)	ROTH-MOORE (R-M)	NICKLES - SILJANDER (N-S)	DECONCINI-SHELBY (D-S)
f. Repeal 10% limit on corporate contributions (but retain 5% limit in certain cases).	Amends deduction 18/	No	No	No	No 17/
D. Tax Abuses					
1. Business Deductions for Personal Expenses					
a. Deny all entertainment expenses including club dues and tickets to public events except for business meals furnished in a clear business setting. Limit deduction for business meals on a per meal per person basis.	No	No	No	No	No 19/
b. Limit deductions for meals and lodging away from home in excess of 200 percent of the Federal per diem. When travel lasts longer than 30 days in one city, limit deductions to 150 percent of the Federal per diem (and disallow incidental expenses).	No	No	No	No	No 19/
c. Establish bright-line rules to separate indefinite and temporary assignments at 1 year.	No	No	No	No	No 19/
d. Extend foreign travel rules for allocation of expenses between personal and business expenses to all travel.	No	No	No	No	No 19/
e. Deny any deduction for travel as a form of education.	No	No	No	No	No 19/
f. Deny deductions for seminars held aboard cruise ships.	No	No	No	No	No 19/
g. Deny any deduction for travel by ocean liner, cruise ship, or other form of luxury water transportation above cost of otherwise available business transportation with medical exception.	No	No	No	No	No 19/
2. Income Shifting					
a. Revise grantor trust rules to eliminate shifting of income to lower-rate beneficiaries through trusts in which the creator retains an interest.	No	No	No	No	No 21/

TREASURY DEPARTMENT (TD)	BRADLEY-GEPHARDT (B-G)	KEMP-KASTEN (K-K)	ROTH-MOORE (R-M)	NICKLES - SILJANDER (N-S)	DECONCINI-SHELBY (D-S)
b. During lifetime of creator, tax trust at creator's marginal rate, and allow deductions only for non-discretionary distributions and set-asides. After creator's death, tax all undistributed trust or estate income at top marginal rate.	No	No	No	No	No 21/
c. Tax unearned income of children under 14 at the parent's tax rate (to the extent that such income exceeds the child's personal exemption).	No	No	No	No	No 21/
d. Revise income taxation of trusts.	No 20/	No 20/	No	No	No
E. Further Simplification					
1. Non-filing system, in which IRS would compute tax for many taxpayers.	No	No	No	No	No
2. Repeal individual minimum taxes.	Yes	No	Yes	Yes	Yes
3. Move miscellaneous deductions above the line, combine with employee business expenses and make subject to a floor.	No 13/	No	No	No	No
4. Repeal preferential treatment of capital gains.	Yes	Yes, for individuals.	Yes	No	Yes
5. Repeal political contribution credit.	Yes	Yes	Yes	Yes	Yes
6. Repeal presidential campaign checkoff.	No	No	No	No	Yes
7. Repeal deduction of adoption expenses for children with special needs, and replace with a direct expenditure program.	Repeals deduction only	No	Repeals deduction only	Repeals deduction only	Repeals deduction only
8. Disallow income averaging for taxpayers who were full-time students during the base period.	Repeals income averaging	Repeals income averaging	Repeals income averaging	No	Repeals income averaging
9. Repeal $100/$200 exclusion of dividend income.	Yes	Yes	Yes	Yes	Yes
F. Other Miscellaneous Reforms					
1. Increase limits on moving expenses.	No	No	No. Repeals deduction	No	No. Repeals deduction

TREASURY DEPARTMENT (TD)	BRADLEY-GEPHARDT (B-G)	KEMP-KASTEN (K-K)	ROTH-MOORE (R-M)	NICKLES - SILJANDER (N-S)	DECONCINI-SHELBY (D-S)
2. Special rule for allowing deduction of some commuting expenses of workers who have no regular place of work.	No	No	No	No	No
II. BASIC TAXATION OF CAPITAL AND BUSINESS INCOME TAX					
A. <u>Lower Corporate Tax Rate</u>					
1. Reduce maximum corporate rate to 33%.	30%	30% above $50,000	Retains current law	Retains current law	19% of business taxable income
2. Repeal graduated corporate rate structure.	Yes	No. 15% to $50,000	Retains current law	Retains current law	Yes
3. Repeal personal holding company tax.	Yes	Yes	No	No	Yes
B. <u>Taxing Real Economic Income</u>					
1. Index capital gains and tax as ordinary income.	No indexation: tax as ordinary income 23/	Indexation: Tax as ordinary income for individuals 24/	No indexation: Tax as ordinary income 25/	Retains current law. 26/	No indexation: Tax as ordinary income
2. Index depreciation for inflation and set depreciation allowances to approximate economic depreciation.	Modified ADR: no inflation adjustment	ACRS: no inflation adjustment	Current law for corps. Expensing for certain equipment for individuals.	Retains current law for corps. Repeals allowances for individuals.	Expensing
3. Repeal investment tax credit.	Yes	Yes	Retains for corps. only	Yes, except for corps.	Yes
4. Repeal collapsible corporation rules.	Yes	No	No	No	No
5. Allow expensing of the first $5,000 of depreciable business property but repeal legislative increases in that dollar limit.	No	No	No 27/	No	No
6. Allow indexed FIFO and repeal conformity requirement.	No	No	No	No	No
7. Index interest receipts and payments in excess of mortgage interest plus $5,000.	No	No	No	No	No

	TREASURY DEPARTMENT (TD)	BRADLEY-GEPHARDT (B-G)	KEMP-KASTEN (K-K)	ROTH-MOORE (R-M)	NICKLES - SILJANDER (N-S)	DECONCINI-SHELBY (D-S)
C.	Retirement Savings.					
1.	Raise IRA limits to $2,500.	No	No	No 28/	No	No
2.	Make IRAs available to both employees and spouses working in the home.	No	No	No 28/	No	No
3.	Subject all tax-favored retirement plans (TFRP's) to uniform distribution rules.	No	No	No	No	No 29/
a.	Subject all pre-retirement distributions from TFRP's to a 20 percent premature distributions tax, generally, and 10 percent for tuition and first home purchase.	No	No	No	No	No 29/
b.	Subject all TFRP's to uniform minimum distribution rules.	No	No	No	No	No 29/
c.	Repeal 10-year averaging for lum-sum distribution.	Yes	Yes	Yes	No	No 29/
d.	Eliminate special recovery rules for qualified plan distributions.	No	No	No	No	No 29/
e.	Repeal special treatment for distributions of employer securities.	No	No	No	No	No 29/
4.	Simplify the deduction, contribution, and benefit limits for TFRP's.					
a.	Repeal aggregate-based deduction limits for profit-sharing and stock bonus plans.	No	No	No	No	No 29/
b.	Subject excess contributions to a 6 percent excise tax to recapture excessive tax benefits.	No	No	No	No	No 29/
c.	Repeal combined plan limit for non-top-heavy plans.	No 30/	No	No	No	No 29/
d.	Subject all retirement distributions in excess of $112,500 per year to a 10 percent excise tax.	No	No	No	No	No 29/
5.	Miscellaneous changes.					
a.	Extend deduction limits for TFRP's to ESOP's, and repeal the ESOP credit.	Repeals ESOP credit only.	Repeals ESOP credit only.	No	No	No 31/

TREASURY DEPARTMENT (TD)	BRADLEY-GEPHARDT (B-G)	KEMP-KASTEN (K-K)	ROTH-MOORE (R-M)	NICKLES - SILJANDER (N-S)	DECONCINI-SHELBY (D-S)
b. Repeal "cash and deferred arrangements"	No	No	No	No	No 29/
c. Postpone deduction for interest on debt incurred to finance employee contributions to TFRP's until taxable distributions are made.	No	No	No	No	No 29/
D. Neutrality Toward the Form of Business Organization					
1. Reduce double taxation of distributed corporate equity income by allowing a 50 percent dividend deduction.	No	No	No	No	No 22/
2. Require that all partnerships with more than 35 partners be taxed as corporations.	No	No	No	No	No
III. INDUSTRY-SPECIFIC SUBSIDIES, TAX SHELTERS, AND OTHER ISSUES					
A. General Issues of Income Measurement					
1. Match expenses and receipts from multiperiod production.	No 32/	No 32/	No	No	No
2. Restrict use of cash accounting method.	Yes: limited to farming (including timber)	Yes: limited to farming (including timber)	No	No	No
3. Limit bad debt deductions to actual loan losses.	No	No	No	No	No
4. Disallow installment sales treatment when receivables are pledged.	No	No	No	No	No
5. Repeal corporate minimum tax.	Yes	No	No	No	Yes
B. Subsidies for Specific Industries					
1. Special rules for energy and natural resource industries.					
a. Repeal windfall profit tax.	No	No	No	No	No
b. Repeal percentage depletion; replace with cost depletion adjusted for inflation.	Yes: replace with depre-ciation	Yes: replace with depre-ciation	No	Repeals, except for corps.	No 33/

TREASURY DEPARTMENT (TD)	BRADLEY-GEPHARDT (B-G)	KEMP-KASTEN (K-K)	ROTH-MOORE (R-M)	NICKLES - SILJANDER (N-S)	DECONCINI-SHELBY (D-S)
c. Repeal expensing of intangible drilling costs.	Yes	Yes	No	Repeals, except for corps.	No 33/
d. Repeal expensing of qualified tertiary injectant expenses.	Yes	No	No	Repeals, except for corps.	No 33/
e. Repeal expensing of hard mineral exploration and development costs.	Yes	Yes	No	Repeals, except for corps.	No 33/
f. Repeal special treatment of coal, oil and timber royalty income.	Yes	Yes, except for corps.	No	No	Yes
g. Repeal special rules for mining reclamation reserves.	No	No	No	Repeals, except for corps.	No 33/
h. Repeal nonconventional fuel production tax credit, alcohol fuel credit, and excise tax exemption.	Repeals credits	Repeals credits	Repeals credits, except for corps.	Repeals credits, except for corps.	Repeals credits
2. Special Rules of Financial Institutions					
a. Commercial banks and thrift institutions.					
1. Repeal special bad debt deductions for banks and thrift institutions.	No 34/	No 34/	No	No	No
2. Disallow 100% of interest incurred to carry tax-exempt bonds by depository institutions.	No	No	No	No	No
3. Repeal tax exemption of credit unions.	Yes	No	No	No	Yes
4. Repeal special carryover rules and special merger rules of thrift institutions.	No	No	No	No	No
b. Life insurance companies					
1. Limit life insurance reserve deductions to the increase in policyholders' cash surrender value.	No	No	No	No	No
2. Repeal special deduction of percentage of taxable income for life insurance companies.	No	No	No	No	No

TREASURY DEPARTMENT (TD)	BRADLEY-GEPHARDT (B-G)	KEMP-KASTEN (K-K)	ROTH-MOORE (R-M)	NICKLES - SILJANDER (N-S)	DECONCINI-SHELBY (D-S)
3. Repeal tax exemption for certain insurance companies.	No	No	No	No	No
c. Property and casualty (P&C) insurance companies					
1. Limit P&C reserves to the discounted present value of future liabilities.	No	No	No	No	No
2. Repeal mutual P&C insurance companies' deduction for additions to protection against loss accounts.	No	No	No	No	No
3. Limit deductibility of P&C policyholder dividends.	No	No	No	No	No
4. Repeal special tax exemption, rate reductions, and deductions of small mutual P&C insurance companies.	No	No	No	No	No
3. Insurance Investment Income					
a. Repeal exclusion of annual income on life insurance policies.	Yes	Yes	No	No	Yes 35/
b. Treat policyholder loans as coming first from any tax-exempt inside buildup.	No	No	No	No	No
c. Repeal exclusion of current annuity income.	Yes	Yes	No	No	Yes
4. State and Local Government Debt and Investment					
a. Repeal the tax exemption of private purpose tax-exempt bonds.	Yes	Yes	No	No	No
b. Tighten restrictions on tax arbitrage and advance refunding for tax-exempt bonds.	No	No	No	No	No
5. Repeal special expensing and amortization rules.					
a. Repeal expensing of soil and water conservation expenditures, expenditures by farmers for fertilizer and for clearing fields.	Yes	Yes	No	Repeals, except for corps.	No
b. Repeal 5-year amortization of expenditures for rehabilitation of low income rental housing.	Yes	No	No	Repeals, except for corps.	No 33/

TREASURY DEPARTMENT (TD)	BRADLEY-GEPHARDT (B-G)	KEMP-KASTEN (K-K)	ROTH-MOORE (R-M)	NICKLES - SILJANDER (N-S)	DECONCINI-SHELBY (D-S)
c. Repeal 5-year amortization of certified pollution control facilities.	Yes	No	No	Repeals, except for corps.	No 33/
d. Repeal 50-year amortization of railroad grading and tunnel bores.	No	No	No	Repeals except for corps.	No 33/
e. Repeal 5-year amortization of trademark expenses.	No	No	No	Repeals, except for corps.	No 33/
f. Repeal 84-month amortization of reforestation expenditures and 10 percent tax credit for such expenditures.	Yes	Yes	No	Repeals, except for corps.	No 33/
7. Other specific subsidies.					
a. Repeal rehabilitation tax credits.	Yes	Yes	Yes, except for corps.	Yes, except for corps.	Yes
b. Tighten rules for depreciating leasehold improvements.	No	Repeals	No	Repeals, except for corps.	No
c. Repeal special rules for returns of magazines and paperback books and for qualified discount coupons.	Yes	No	No	Repeals, except for corps.	No
d. Repeal exclusion relating to Merchant Marine Capital Construction Fund.	Yes	Yes	No	No	No
e. Rationalize credit for research and experimentation.	Repeals credit	Repeals credit	No	Repeals, except for corps.	Repeals credit
C. Further Curtailment of Tax Shelters					
1. Disallow most current deductions for schedule A interest in excess of sum of home mortgage interest, investment income, and income from limited partnerships and S corporations plus $5,000.	Allows deduction for home mortgage interest. Limits deduction for consumer interest. 36/	Allows deduction for home mortgage interest. Limits deduction for consumer interest. 37/	Allows deduction for home mortgage interest. Disallows deduction for consumer interest.	Retains current law.	Repeals interest deduction including home mortgage interest.
2. Extend limits on interest deduction where taxpayer is not at risk to real estate and equipment leasing.	No	No	No	No	No

TREASURY DEPARTMENT (TD)	BRADLEY-GEPHARDT (B-G)	KEMP-KASTEN (K-K)	ROTH-MOORE (R-M)	NICKLES - SILJANDER (N-S)	DECONCINI-SHELBY (D-S)
D. International Issues 38/					
1. Change foreign tax credit limitation to a separate per-country limitation.	No	No	No	No	No
2. Modify rules defining source of income derived from sales of inventory-type property and intangible property.	No	No	No	No	No
3. Repeal the secondary dividend rule and replace with a branch profits tax.	No	No	No	No	No
4. Repeal special preference for 80/20 corporations.	No	No	No	No	No
5. Clarify treatment of foreign exchange gains and losses.	No	No	No	No	No
6. Repeal possessions tax credit and replace with a phased out wage credit.	Repeals credit	No	No	No	Repeals credit
E. Other Tax Issues					
1. Transfer Taxation					
a. Unify estate and gift tax structure by grossing up the tax on gifts, and simplify rules for determining when a transfer is complete for gift tax purposes.	No	No	No	No	No
b. Simplify taxation of generation-skipping transfers, and modify credit for tax on prior transfers to a lower generation.	No	No	No	No	No
c. Impose a rule to prevent abuse of minority discounts.	No	No	No	No	No
d. Replace the rules governing payment of estate tax in installments with simplified rules based on estate liquidity, but make interest incurred by an estate non-deductive for estate tax purposes.	No	No	No	No	No

TREASURY DEPARTMENT (TD)	BRADLEY-GEPHARDT (B-G)	KEMP-KASTEN (K-K)	ROTH-MOORE (R-M)	NICKLES - SILJANDER (N-S)	DECONCINI-SHELBY (D-S)
e. Reduce estate tax deduction for claims against an estate by the amount of income tax savings from payment of the expense.	No	No	No	No	No
f. Simplify state death tax credit and gift tax rate and credit by making it a flat percent of Federal estate tax collected.	No	No	No	No	No
g. Repeal special tax rules for redemption of stock to pay death taxes.	No	No	No	No	No
h. Tighten rules regarding powers of appointment	No	No	No	No	No
2. Penalties 39/					
a. Simplify information return penalties.	No	No	No	No	No
b. Repeal maximum limits on penalties.	No	No	No	No	No
c. Replace failure to pay penalty with a cost-of-collection charge.	No	No	No	No	No
3. Expiring provisions					
a. Residential and certain business energy tax credits.	Repeals	Repeals	Yes, except for corps.	Repeals	Repeals
b. Targeted jobs credit.	No stated proposal	Repeals	No stated proposal	Repeals	Repeals
c. Expensing of expenditure to remove architectural barriers to the elderly and handicapped.	No stated proposal	No stated proposal	No stated proposal	No stated proposal	Allows expensing 33/
d. Credit for testing orphan drugs.	Repeals	Repeals	Repeals, except for corps.	Repeals, except for corps.	Repeals
e. Special treatment for dividend reinvestment in public utility stock.	Repeals	Repeals	Repeals	No stated proposal	Repeals
f. Exclusion of employer-provided legal services.	Repeals	Repeals	Repeals	Repeals	No stated proposal 15/
g. Exclusion of employer-provided education assistance.	Repeals	No stated proposal	Repeals	Repeals	No stated proposal 15/
h. Exclusion of employer provided vanpooling.	Repeals	Repeals	Repeals	Repeals	No stated proposal 15/

FOOTNOTES

1/ For single returns the 15 rate would apply to taxable income above $2,800, the 25 percent rate to taxable income above $19,300, and the 35 percent rate to taxable income above $38,100. For joint returns the 15 percent rate would apply to taxable income above $3,800, the 25 percent rate to taxable income above $31,800, and the 35 percent rate to taxable income above $63,800. For head of household returns the 15 percent rate applies to taxable income above $3,500, the 25 percent rate to taxable income above $25,000 and the 35 percent rate to taxable income above $48,000.

2/ 14% of taxable income; surtax of 12% on adjusted gross income (AGI) in excess of $40,000 or $25,000 for joint and single returns, respectively; surtax of 16% on AGI's in excess of $65,000 and $37,500 for joint and single returns, respectively. Heads of households would be treated like single individuals. The maximum rate would be 30%. Itemized deductions, personal exemptions, and the deductions for charitable contributions and child care expenses can only be used to calculate the tax subject to the 14 percent rate.

3/ If earned income is less than $15,000 for a married couple or $10,000 for a single person, 20% of total income may be excluded up to $10,000 or $15,000. Exclusion phases out at the rate of 12.5 cents per dollar of income in excess of the FICA wage base.

4/ These rates apply when the proposal is fully phased -in (1990 and thereafter).

5/ In N-S, taxable income of individuals excludes alimony, social security benefits, disability income, state and local bond income, railroad retirement benefits, and certain Federal retirement benefits.

6/ In D-S compensation is defined as cash wages. Non-cash fringe benefits are excluded from compensation.

7/ Estimated current law values for 1986 are $2,510, $3,710, $1,850, and $2,510 for single returns, joint returns, separate returns, a/nd head of household returns, respectively. The ZBAs are at 1986 levels for TD, 1984 levels for KK, 1985 levels for R-M, 1984 levels for N-S, and 1983 levels for D-S.

8/ Estimated current law value for 1986 is $1,090. The exemptions are at 1986 levels for TD, 1984 levels for KK, 1985 levels for R-M, 1983 levels for D-S.

9/ B-G provides head of households an exemption of $1,800.

10/ K-K would disallow dependency exemptions for students over age 18.

11/ In N-S, dependency exemptions are limited to children, stepchildren under 18, full-time student dependents, and dependents with less than $2,000 of income.

12/ The amount shown represents the total of the zero bracket amount plus the personal exemptions. Taxpayers could also exclude 20 percent of their earned income, up to the FICA wage base. Taxpayers with less than $10,000 or $15,000 of earned income for single and joint returns, respectively, could exclude 20 percent of their total income up to $10,000 or $15,000.

13/ In B-G, deductions can only be used to calculate the tax subject to the 14 percent rate.

14/ B-G and R-M limit the exclusion of employer contributions to accident and health insurance to amounts attributable to providing wage replacement payments.

15/ Under D-S individuals would exclude fringe benefits, but businesses would not deduct compensation in the form of fringes.

16/ B-G and R-M would repeal exclusion but only to the extent that employer paid premiums exceed employee paid premiums.

17/ D-S would repeal charitable deduction for both businesses and individuals.

18/ B-G would limit the deduction to 50 percent of contributions.

19/ D-S would allow a deducion for business travel and entertainment expenses, if reasonable.

20/ B-G would tax estate and trusts at a 30% rate. K-K would tax estates and trusts at a 25% rate.

21/ D-S would reduce the incentive for income shifting by taxing all income at the 19 percent rate.

22/ D-S would provide dividend relief by taxing corporate income only once at the corporate level.

23/ For purposes of computing the base tax, B-G would retain the one-time exclusion of $125,000 of gain on the sale of a principal residence by taxpayers who are 55 years old or older. This exclusion would not apply for purposes of computing the surtaxes.

24/ K-K would reduce the capital gains tax rate to 20% for corporations. Capital losses would be deductible against ordinary income, but would be subject to the individual minimum tax. The one-time exclusion for $125,000 of gain on the sale of a principal residence by taxpayers who are 55 or older would be retained.

25/ R-M would repeal the one-time exclusion of gain from sale or exchange of principal residence.

26/ N-S would repeal the one time exclusion of $125,000 of gain on the sale of a principal residence for taxpayers 55 years old and older.

27/ R-M would allow individuals to expense certain equipment.

28/ R-M provides a new SUSA savings account with deductible annual limits of $10,000 and $20,000 for single and joint returns, respectively. Funds could be used for non-retirement purposes. Income earned on the account would be tax-exempt until withdrawn.

29/ D-S would disallow the deduction for contributions to pension plans and would treat pension contributions as compensation of the employee.

30/ B-G would reduce limits on qualified pension plans from $30,000 on defined contribution plans and $90,000 on defined benefit plans to $15,000 and $45,000, respectively.

31/ D-S does not have a specific proposal on TFRP's, but would repeal all tax credits.

32/ B-G and K-K would repeal expensing of interest and taxes paid during the construction of a building and would require that these costs be amortized over 10 years.

33/ D-S would permit expensing of capital costs.

34/ B-G and K-K would repeal the deduction for bad debt reserves for financial institutions in excess of their actual experience.

35/ Under the business tax, interest paid to customers of financial institutions would not be deductible.

36/ For purposes of computing the base tax, B-G would allow itemized deductions for home mortgage interest and nonbusiness interest to the extent of investment income. For purposes of computing the surtaxes, investment interest is deductible to the extent of investment income.

37/ K-K would allow deductions for interest on loans to pay educational expenses, but not for other consumer debt.

38/ B-G would repeal deferral of foreign source income, DISC, and the exclusion of income of Americans working abroad. K-K would repeal DISC. R-M would repeal the exclusion of income of Americans working abroad. D-S would not tax the foreign source income of U.S. citizens and corporations, but would tax the U.S. source income of foreigners.

39/ N-S contains a special tax amnesty provision which waives the criminal and civil penalties for tax underpayment for taxpayers who agree to certain conditions.

Appendix 8-B

SUMMARY OF TAX REFORM BILLS INTRODUCED DURING THE 98TH CONGRESS

H.R. 170, the Tax Simplification Act, was introduced by Mr. Hansen. The bill would tax the income of individuals, estates, and trusts at the rate of 15 percent. The deduction for personal exemptions would be increased to $3,000. Most deductions and exclusions would be repealed, including those for medical expenses, capital gains, and IRAs. Itemized deductions would continue to be allowed for expenses attributable to the conduct of a trade or business and for the production of income, for charitable contributions to a church or a convention or association of churches, and for alimony payments. Tax credits would continue to be allowed. The bill would not amend the corporate income tax.

H.R. 542, the Flat Rate Tax Act of 1983, was introduced by Mr. Philip M. Crane. The bill would tax the income of individuals, estates, and trusts in excess of the deduction for personal exemptions at the rate of 10 percent. The allowance for personal exemptions would be increased to $2,000 and would be indexed for inflation occuring after 1982. All exclusions, deductions, and credits would be repealed. The bill would not amend the corporate income tax.

H.R. 1664, the Flat Rate Tax Act of 1983, was introduced by Mr. Paul. The bill would tax the income of individuals, estates, and trusts at the rate of 10 percent. The personal exemptions would be increased to $2,500. The bill would not amend the corporate income tax.

H.R. 1770, the Flat Tax Act of 1983, was introduced by Mr. Dreier. The bill would tax the gross income of individuals, estates, and trusts in excess of the deduction for personal exemptions at the rate of 14 percent. The allowance for personal exemptions would be increased to $2,000. All exclusions, deductions, and credits would be repealed. The bill would not amend the corporate income tax.

H.R. 2137, the Flat Rate Tax Act of 1982, was introduced by Mr. Paul. The bill would tax the gross income of individuals, estates, and trusts in excess of $10,000 at the rate of 10 percent. All exclusions, deductions, and credits for individual taxpayers would be repealed. The bill would not amend the corporate income tax.

H.R. 2520, the Income Tax Simplification Act of 1983, was introduced by Mr. Panetta. The bill would tax the income of individuals, corporations, estates, and trusts at the rate of 18 percent. For individuals, the bill would replace the standard deduction and the deductions for personal, blind and elderly exemptions with a tax credit. The credit for personal exemptions would be $1,000 for a single return and $2,000 for a joint return.

The credit for each dependent, the blind, and the elderly would be $200 each. Most credits (except the foreign tax credit), exclusions, and deductions would be repealed, except for those that are related to the conduct of a trade or business or the production of income. Individuals would continue to be allowed to deduct alimony payments. The bill would repeal special rules that apply to natural resources industries, including the deduction for depletion and for intangible drilling and development costs, and special rules relating to insurance companies and banking institutions. The bill would also repeal deductions for certain entertainment expenses, and employer contributions to pension, stock bonus, profit-sharing or annuity plans. The bill would repeal the special tax treatment afforded Domestic International Sales Corporations and the exclusion of income of Americans working abroad. The special tax treatment of capital gains would be repealed, including the provisions that allow the rollover of gain on the sale of a home. Income averaging would be repealed.

H.R. 3271, the Fair Tax Act of 1983, was introduced by Mr. Gephardt. This bill is the same as S. 1421, introduced by Senator Bradley. The provisions of these bills are summarized in Appendix 8-A.

H.R. 3516, the Flat Rate Tax Act of 1983, was introduced by Mr. Don Young. The bill would tax gross income over $10,000 at the rate of 15 percent. All exclusions, credits, and deductions would be repealed, except for the deductions for charitable contributions, home mortgage interest, and expenses incurred in carrying on a trade or business. The bill would not amend the corporate income tax. The bill would provide certain taxpayer protection standards that relate to the administration of the tax.

H.R. 4776, the Flat Rate Tax Act of 1984, was introduced by Mr. Quillen. The bill would tax the income of individuals, estates, and trusts at the rate of 10 percent. Exclusions would be repealed, except for social security benefits, veterans benefits, and interest on tax-exempt bonds. The allowance for personal exemptions would be increased to $2,000. Other deductions would be repealed, except for charitable contributions, home mortgage interest and interest used to finance investment, state and local income and property taxes, and trade and business expenses. Tax credits would be repealed. The bill would not amend the corporate income tax.

H.R. 4871, introduced by Mr. Dannemeyer, directs the Treasury Department to propose legislation and provides guidelines that would be used to develop the legislation. All income of businesses and individuals would be taxed only once at a 15 percent rate. The poorest households would not pay income tax. Individual taxpayers would be allowed a deduction for personal and dependency exemptions, charitable contributions, and home mortgage interest. Capital gains would be exempt from tax. For the business tax, the distinction between corporations, partnerships, farms, and professionals would be removed. Deductions would be allowed for capital expenses, for the cost of goods and services, and charitable contributions.

H.R. 5432, the Ten Percent Flat Tax Rate Act, was introduced by Mr. Siljander. This bill is the same as S. 5432, introduced by Senator Nickles. The provisions of these bills are summarized in Appendix 8-A.

H.R. 5484, the Ten Percent Tax Rate Act, was introduced by Mr. Paul. The bill would tax the income of individuals at the rate of 10 percent. The personal exemptions would be increased to $2,000. Certain exclusions would continue to be allowed, including alimony payments, scholarship and fellowship grants, supplemental security income, disability payments, government employee retirement benefits, interest on certain tax-exempt bonds, and fringe benefits. Deductions would continue to be allowed for trade and business expenses, and for expenses related to the production of income. Most other deductions would be repealed, including the deductions for medical expenses, alimony payments, taxes, and for two-earner married couples. All tax credits for individuals would be repealed. The estate and gift tax provisions would be repealed. The bill would not amend the corporate income tax.

H.R. 5711, introduced by Mr. Shelby, is the same as S. 557, introduced by Senator DeConcini. The provisions of these bills are summarized in Appendix 8-A.

H.R. 5841, the Progressive Consumption Tax Act of 1984, was introduced by Mr. Heftel. The bill would tax consumption of individuals at graduated rates that range from 10 percent to 50 percent. The consumption of corporations would be taxed at the rate of 30 percent. To compute taxable consumption, the taxpayer would add net income, any increase in debt, and any decrease in saving. From that total, the taxpayer would subtract any decrease in debt and any increase in savings. To compute net income the taxpayer would be allowed deductions for trade and business expenses, capital losses, certain expenses related to the production of income, moving expenses and alimony. Individuals could claim a standard deduction, equal to $3,400 for joint returns and $2,300 for single returns. A credit of $200 would be provided for each personal exemption. Most credits, exclusions and deductions allowed under current law would be repealed. The deduction for interest would be limited to home mortgage interest, interest on debt used to purchase investment assets, and interest incurred in the active conduct of a trade or business. The deduction for charitable contributions would be limited to 5 percent of adjusted gross consumption. The deduction for medical expenses would continue to be allowed. Capital losses would be fully deductible. Casualty and theft losses in excess of $500 would be deductible. The deduction for property taxes would be repealed. The gift tax would be repealed, but gifts would be includible in the recipient's gross income.

H.R. 6165, the Fair and Simple Tax Act of 1984, was introduced by Mr. Kemp. The this bill is the same as S. 2948, introduced by Senator Kasten. The provisions of these bills are summarized in Appendix 8-A. H.R. 6165 and S. 2948 replace H.R. 5533 and S. 2600, respectively.

H.R. 6364, the Broad-Based, Enhanced Savings Tax Act of 1984, was introduced by Mr. Moore. This bill is the same as S. 3042, introduced by Senator Roth. The provisions of these bills are summarized in Appendix 8-A.

H.R. 6384, the SELF-Tax Plan Act of 1984, was introduced by Mr. Schulze. This bill is the same as S. 3050, introduced by Senator Quayle. S. 3050 replaces S. 1040. Taxable income in excess of $6,000 for single returns and head of household returns, and $10,000 for joint returns would be subject to tax at graduated rates ranging from 15 percent to 30 percent. The personal exemption would not be increased. All tax credits for individuals would be repealed. Many exclusions for individuals would be repealed, including interest on certain state and local government bonds. The exclusion for scholarships and fellowships would be limited to tuition expenses. Many deductions for individuals would be repealed, including the deductions for casualty and theft losses, two-earner married couples, intangible drilling and development costs, and percentage depletion. Home mortgage interest would be deductible, but other consumer interest would not be deductible. Unemployment compensation and governmental welfare or assistance benefits would be taxable. Capital gains would be taxed like ordinary income. The bills would not amend the corporate income tax, but directs the Treasury Department to study certain corporate and individual income tax changes.

6420, the Cash Flow Income Tax Act of 1985, was introduced by Mr. Heftel. The bill would tax the income of individuals at graduated rates ranging from 10 percent to 30 percent. Income of corporations would be taxed at the rate of 30 percent. Income of estates and trusts in excess of $3,000 would be taxed at the rate of 30 percent. Individuals would be allowed a standard deduction of $8,000 for joint returns, $6,000 for head of household returns, and $4,000 for single returns. A nonrefundable credit equal to $200 for each dependent would be permitted. Most other credits, exclusions, and deductions provided under current law would be repealed. To compute adjusted gross income, a taxpayer would add net income, any increase in debt, and any decrease in savings. From this total, the taxpayer would subtract any decrease in debt and any increase in savings. The taxpayer would be permitted to elect an exclusion of up to $20,000 in debt. To compute net income, the taxpayer would be permitted deductions for trade and business expenses, foreign taxes, capital losses, certain expenses related to the production of income and alimony payments. Interest expenses for the purchase of investment assests and home mortgage interest would continue to be deductible, but consumer interest would not be deductible. The deduction for charitable contributions would be limited to 5 percent of adjusted gross income. The deduction for property taxes would be repealed. Deductions would be permitted for medical expenses in excess of 10 percent of adjusted gross income and for casualty and theft losses in excess of $500. Capital losses would be fully deductible. Gifts and bequests in excess of $5,000 per year would be includable in the recipient's gross income.

S. 1767, the Personal Income Tax Reform Act of 1983, was introduced by Senator Mitchell. The income of individuals, estates, and trusts would be subject to a base tax equal to 12 percent and a surtax that ranges from 8 percent to 24 percent. Personal exemptions would be increased to $1,750 for a taxpayer who is the head of household, and $1,500 for any other taxpayer. The amount of dependency exemptions would be $1,000 each. The standard deduction would be increased to $4,600 for joint returns. For all other returns, the amount would be $2,300. Most of the exclusions, deductions, and credits contained in current law would be repealed. One-third of the employer's contribution to the employee's medical care plan would be included in the employee's income. Scholarship and fellowship grants in excess of tuition and related expenses would be included in income. The deductions for two-earner married couples and for adoption expenses would be repealed. For individual taxpayers, the capital gains exclusion and the distinction between short and long term capital gains are repealed. The deduction for interest would be allowed for home mortgage interest, interest on trade or business debt, and other interest subject to limitations. The credit for dependent care expenses would be replaced with an itemized deduction. The exclusion for the gain on the sale of a principal residence for a taxpayer who is 55 years old or older would be replaced with an itemized deduction. Individual retirement accounts, and qualified pension, profit-sharing, and stock bonus plans would be taxed at the rate of 12 percent. Income averaging would be repealed. The bill would not amend the taxation of corporations.

S. 2158, the Simpliform Tax Act, was introduced by Senator Hatfield. The bill would tax the income of individuals at graduated rates ranging from 6 percent to 30 percent. Joint returns would be eliminated. The standard deduction would be repealed and the personal and dependency exemptions would be replaced by credits equal to $250 each. Most credits, deductions, and exclusions provided under current law would be repealed. Deductions would continue to be allowed for expenses related to the production of income, and for alimony payments. Certain deductions allowed under current law would be replaced by tax credits. A credit would be provided for 20 percent of qualified medical expenses in excess of 10 percent of adjusted gross income (AGI). A credit would be provided for home mortgage interest equal to 15 percent of the interest paid in excess of one percent of AGI, up to a maximum credit of $1,000. A credit would also be provided for 20 percent of charitable contributions in excess of one percent of AGI, and for 15 percent of state and local taxes in excess of one percent of AGI, up to a maximum credit of $1,000. The bill would repeal the partial exclusion of capital gains and would index the basis of assets for determining capital gains and losses. The bill would not amend the corporate income tax, but directs the Treasury Department to conduct a study of amendments to the corporate income tax that would lower the rate of tax, eliminate tax preferences, and structure the corporate tax in a way that is similar to the individual income tax provided in the bill.

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Chapter 9

CONSUMED INCOME TAX

A tax on consumed income, one of the four options considered by the Treasury Department in its study of fundamental tax reform, is a frequently mentioned alternative to the income tax. The base of a comprehensive personal tax on consumption, or consumed income, differs from that of a comprehensive income tax only in that a deduction is allowed for net saving. This effectively excludes capital income from the tax base because deferring the tax on saving until withdrawal is, on average and in present value terms, equivalent to exempting the return to saving from taxation.

Apart from the deduction for net saving, the bases of the two types of taxes are identical. They are both direct personal taxes which can be structured to reflect the individual circumstances of taxpayers. Thus, like the income tax, a consumed income tax can contain personal exemptions, a zero-bracket amount, itemized deductions, and flat or graduated rates. Personalization of this type is not possible under a transaction-based sales tax on consumption, such as a value-added tax or a national retail sales tax (discussed in chapter 10).

A comprehensive consumed income tax and a comprehensive income tax also share the advantages obtained from moving from the current, narrow base to a broad, uniform tax base. (These advantages are discussed in chapter 5.) Many of the issues covered in the discussion of the base of a modified income tax would also arise under a tax on consumed income. For example, except for contributions to retirement plans, most fringe benefits provided by employers represent a form of consumption; therefore, they should be subject to a tax on consumed income as well as on all income. Similarly, expenditures such as for moving expenses and medical care might not be viewed as taxable consumption, just as they may be viewed as reducing ability to pay income taxes. Other expenditures that qualify as itemized deductions under the current income tax, such as state and local taxes and charitable contributions, could either be granted or denied preferential treatment under the consumed income tax. Because these issues are, for the most part, no different under a consumed income tax and an income tax, they are not discussed further in this chapter.

This chapter describes the main features of a consumed income tax, and then discusses its advantages and disadvantages. It is important to specify clearly whether a consumed income tax is being compared to the current income tax or to a broad-base income tax. Since a consumed income tax and a comprehensive income tax share many of the same advantages over current law, the more important comparision for judging the desirability of a consumed income tax is with a broad-base income tax.

I. Consumed Income Tax Base, Rates, and Administration

A tax on consumed income would not be administered by asking a taxpayer to add together all consumption expenditures during the year; that would clearly be an impossible task. Rather, the taxpayer would report total income and be allowed a deduction for net saving. Conversely, dissaving would be subject to tax. All saving and dissaving would have to occur through "qualified accounts" held with financial institutions so that annual saving and dissaving could be reliably reported and measured.

A. The Tax Base.

The principle of taxing consumption determines the treatment of loans under a consumed income tax. Since repayment of debt is equivalent to saving, a deduction would be granted for such repayment and for payments of interest; similarly, the proceeds of borrowing would be included in taxable consumption. If net loan proceeds were not included in the tax base, taxpayers could "game" the tax system simply by borrowing funds, depositing them in a qualified account, and taking a deduction for the increase in their "saving". Purchasing assets with borrowed funds does not add to net saving, and therefore would not qualify for a deduction under a consumed income tax. Although the present value of the taxes might not be affected, since the taxpayer could not deduct the repayments and interest on the loan, omitting borrowing from the base would enable the taxpayer to postpone the liability. This would disrupt the timing of government receipts and would seem unfair. More extreme tax avoidance would occur if borrowing were not in the base but deductions were allowed for loan repayments, or even just for interest payments. Under these circumstances taxpayers could actually reduce their future as well as present tax liability by borrowing.

An exception to the rule on borrowing could be made to exclude the proceeds of home mortgages from the base of a consumed income tax, provided that no deductions were allowed for subsequent repayment of principal and interest. This treatment would avoid a huge consumption tax liability at the time of home purchase and would effectively spread out tax payments over the life of the loan (since deductions for loan repayment and interest are denied), without the complexity of actual averaging. Similarly, tax on withdrawels from a qualified account used for a down payment on a home could be spread out, too. Special treatment for owner-occupied housing might be acceptable because, under certain circumstances, it would not alter the present value of taxes, and because the possibilities for "gaming" would be limited.

The tax treatment of business assets would also be based on the principle of taxing consumption. Accordingly, the purchase of business assets would be deducted immediately; that is, investment is expensed under a consumed income tax. The returns to the asset and the amount received upon sale would be included in the tax base, unless reinvested. Similarly, the purchase of corporate stock or other financial assets is deductible; dividends and interest received, as well as the receipts from selling the stock or bond, are included in the tax base unless they are saved.

Under a consumed income tax, there is even less theoretical justification for a corporate income tax than under a comprehensive income tax. The rationale for eliminating the corporate income tax is easily seen by considering the uses to which net corporate income can be put. Earnings that are retained should not be taxed because they are a form of saving, and the consumed income tax explicitly excludes saving from the tax base. Corporations would not pay tax on income distributed to shareholders, because dividends would be taxable to shareholders, unless they saved them. At most, a corporate income tax might be retained for three reasons: (1) to prevent foreign investors in the United States from automatically benefitting from the elimination of the corporate income tax, (2) to assess an additional tax on extraordinary returns to investment in the corporate sector, or (3) to tax indirectly corporate expenditures which represent consumption on the part of employees by denying corporations deductions for such expenditures.

There is general agreement that gifts and inheritances should be included in the taxable consumption of the recipient, unless saved. Some advocates of a tax on consumed income believe that gifts and bequests also represent consumption of the donor, and thus should be included in the tax base of the donor, as well as in the base of the recipient. This would make the base of the consumed income tax lifetime income. However, other advocates of a consumed income tax point out that this would amount to double taxation of the gift or bequest, and believe quite strongly that gifts and bequests should be taxed only to the recipient and not to the donor. The distributional implications of this issue are enormous. If bequests and gifts were excluded from the consumed income tax base of the donor, higher rates would be required to approximate the existing distribution of tax burdens by income class. Moreover, the "wealthy miser" would almost completely escape tax under such a tax on consumed income, and large fortunes could be passed on between generations tax-free.

Thus, under a comprehensive consumed income tax, the tax base would include all forms of current monetary and in-kind income, the current consumption value of all fringe benefits supplied by employers, the proceeds of sales of capital assets and the returns to direct investment that are not reinvested, withdrawals in excess of deposits in saving accounts, the proceeds of all borrowing in excess of loan repayments, and gifts and inheritances received. Accrued interest, earnings from ownership of corporate shares, increases in the value of pension and life insurance reserves, and other increases in the value of asset holdings would not be subject to tax until paid out, borrowed, or otherwise withdrawn for consumption.

This tax on consumed income then amounts to a tax on the sum of gifts, inheritances, and labor income received. For the economy as a whole and for most taxpayers, who receive only an insignificant amount of gifts and inheritances, a consumed income tax would, in fact, be virtually equivalent to a tax only on wages. Capital income would in effect be exempt. Although individuals would have to pay tax on capital income when it was used for consumption, the deduction of saving (out of wages) and the tax exemption of interest income results in a present value of the tax liability which, under certain circumstances, is the same as if the individual had been taxed only on total wages when paid.

B. Tax Rates

Because the household sector is a net lender in the economy, the base of a consumed income tax would be smaller than the base of an income tax with identical treatment of items other than capital income. Thus, to raise an equal amount of revenue as an income tax, a consumed income tax would have to have higher rates. The tax exemption of capital income must be weighed against higher marginal tax rates on labor income. The percentage difference in marginal tax rates between a consumed income tax and a broad-based income tax would depend on the difference in the tax base. The tax rates under a consumed income tax might still be lower than the rates on the narrow base of the current income tax.

C. Administration

In order to administer a consumed income tax and to minimize noncompliance, almost all financial transactions would have to be conducted through one or more IRA-type qualified accounts held through banks, brokerages, or other financial institutions to insure reliable information reporting. A useful way to think of qualified accounts under a tax on consumed income is to imagine extension of the present rules for individual retirement accounts (IRAs) and Keogh plans to cover all forms and amounts of saving and dissaving (including loans). Any amounts put into such accounts (including loan repayments of principal and interest) would be deductible. Investment income earned on the accounts would be currently tax exempt unless withdrawn, but any withdrawal from the accounts (including the proceeds of loans) would be taxable.

Requiring virtually all financial transactions to be recorded through a qualified account is necessary to prevent abuses of the tax system. In some cases, the present value of the tax liability of transactions conducted outside of qualified accounts might be the same as transactions through qualified accounts, but the taxpayer would be able to time the tax payments to his or her advantage. Excluding the proceeds of borrowing from the tax base (which is equivalent to borrowing outside of qualified accounts) provides an example of this. In other instances, avoiding qualified accounts could actually reduce the present value of the tax liability. This could occur if the taxpayer expects unusually high returns on an investment. By not making an investment through a qualified account, and not getting a deduction for it, the taxpayer "prepays" the tax. But the value of the tax on the actual consumption from the high returns would have been greater than the prepayment amount. Allowing taxpayers to choose whether to use qualified accounts would provide only ex ante equity in taxation, whereas requiring qualified account treatment for all transactions provides ex post equity.

The unit of taxation under a consumed income tax would probably be the family, rather than the present tax unit. The problems under an income tax caused by transfers of income to family members with low marginal rates would be magnified under a consumed income tax. Consumption cannot be as clearly attributed to individual family members as income can. Distinctions between a "gift" and "shared consumption" would be meaningless within most families. Furthermore, the family is the more appropriate unit for taxing consumption, since in general all family members (at least within the same household) share in a common standard of living.

II. Advantages of a Consumed Income Tax

One of the major advantages that a comprehensive consumed income tax would have over the present income tax would be a uniform tax base, which would eliminate many of the economic distortions and inequities of the present system. Of course, a comprehensive income tax would share this advantage over current law. Relative to a broad-base income tax, a comprehensive consumed income tax would still have several advantages in terms of administration, economic effects, and equity.

A. Administrative Advantages

The main administrative advantages of a tax on consumed income are that it avoids most problems of measuring income from business and capital, it does not require complicated indexing adjustments to make it inflation-proof, and it provides a simple solution to the current problems of tax shelters and tax arbitrage.

1. Income measurement issues. The measurement of income from business and capital is inherently difficult. Many of the most complicated provisions of the current income tax can be traced to problems of income measurement. A major advantage of a tax on consumed income would be that it avoids most of these problems.

Business income measurement. A number of the complexities in measuring business income stem from issues of timing. For example, under current law taxpayers are allowed to choose whether to employ cash or accrual accounting. Under either accounting convention, there are important questions of interpretation. When, for example, should a cash-basis taxpayer record expenses incurred during one year for the purpose of earning income in a later year? When should an accrual basis taxpayer reflect income from projects that extend beyond one year? Taxpayers employing different accounting methods -- including affiliated or commonly owned taxpayers -- can engage in transactions that produce recognition of expenses (by the accrual basis taxpayer) but postponement of recognition of receipt (by the cash basis taxpayer), thereby reducing their aggregate tax liability. Under most proposals, a consumed income tax would be based on cash flow; the taxpayer has or has not paid or received cash or its equivalent. None of the problems described above would exist under a consumed income tax of this type.

Problems of depreciation accounting, depletion allowances, amortization, and accounting for inventories for tax purposes also would not arise under a consumed income tax. The cost of depreciable assets would simply be currently deducted (expensed) in the year of acquisition under the cash flow tax. Similarly, expenditures on goods placed in inventory would be automatically expensed. Various other types of cash expenditures are expensed, rather than capitalized and amortized over their useful life. In the case of natural resources, all costs of acquisition, exploration, and development would be expensed, rather than recognized over the lifetime of the resulting asset through cost depletion; the possibility of percentage depletion should never arise. By comparison, under the income tax it is necessary to determine the useful life of assets and the pattern of depreciation to employ for tax purposes. Special and arbitrary rules are required under current law for property such as motion pictures, sound recordings, and trademarks.

For certain purposes the characterization of an income flow can affect tax treatment under the income tax; for example, the distinction between dividends and interest is often important. Under an ideal tax on consumed income all such distinctions would be irrelevant. Perhaps more important, the distinction between income and return of capital would also be meaningless under a tax on consumed income since cash received would be taxable unless reinvested. Similarly, payment of cash would always produce deductions, whether the payments were for expenses or for repayment of capital.

Capital gains would not be subject to tax under an ideal tax on consumed income. Rather, the taxpayer would be allowed a deduction for the full value of expenditures on capital assets. The entire proceeds of asset sales would be included in taxable consumption, unless reinvested. This treatment would have several administrative advantages. First, there would be no need to know the original basis (usually the cost) of capital assets, since basis would be irrelevant in calculating the consumed income tax; this would greatly simplify both taxpayer compliance and tax administration. Second, since capital gains would receive no special treatment, there would be no incentives to characterize income as capital gain. This would eliminate the complex distinctions between capital gains and ordinary income in current law, as well as the associated tax shelters.

Averaging. Current law includes some fairly complicated provisions for income averaging. Such provisions are necessary under a progressive income tax so that an individual with fluctuating income does not bear a heavier tax burden than an individual with the same average income received at a steady rate. Since annual consumption does not fluctuate as much as annual income, there would be less need for complex averaging provisions under a consumed income tax.

Pensions. *A primary administrative advantage of a tax on consumed income in the area of measurement of individual income lies in the simplification of the tax treatment of pensions.* At present, contributions to certain qualified pension accounts are accorded consumption tax treatment; that is, contributions are fully deductible but receipt of both principal and interest is subject to tax. Contributions are, however, subject to limitations, and pre-retirement withdrawals are penalized. However, many pension plans and other vehicles for retirement saving are not covered by these rules. Under a tax on consumed income all saving for retirement -- indeed, all saving -- is accorded uniform treatment: deduction upon contribution and taxation of both the original contribution and subsequent earnings at the time of withdrawal.

2. **Inflation-proof tax base.** *During inflationary periods, the* current income tax generally mismeasures income from capital and from business; real income is understated in some instances and overstated in others. This occurs for a number of reasons: depreciation is based on historical costs; tax is collected on nominal capital gains, rather than real (inflation-adjusted) gains; the deduction for the cost of goods sold from inventory is often based on the value of the oldest goods in stock at the beginning of the year; and interest income and expense are calculated without recognizing that nominal interest rates include an inflation premium that should neither be taxed nor deducted. During the 1970s the mismeasurement of business and capital income resulted in substantial overtaxation of these forms of income, which in addition to being inequitable, had a serious depressing effect on capital investment. Adjusting depreciation allowances, the cost of goods sold from inventories, capital gains, and interest income and expense for inflation is inevitably complicated. Because the tax on consumed income is based on cash flow, it requires no inflation adjustment to make it inflation-proof. Cash flow is inherently measured in dollars of the current period, so there is no occasion to combine current income and expenses with historical ones.

3. **Tax shelters and tax arbitrage.** Tax shelters and tax arbitrage are a major source of inequity and distortion under the current income tax system. Any attempts at reforming the tax system must address their underlying causes; these include -- usually in combination -- acceleration of deductions for expenses, preferential treatment of capital gains or the return to saving (often through vehicles typical of a consumed income tax, such as pensions, IRAs, and life insurance policies with large saving components), and borrowing in order to realize deductions for interest expense. The relative advantage of the consumed income tax with respect to tax shelters is the simplicity of the solution. By addressing the underlying causes of tax avoidance, a well-structured income tax would certainly reduce the use of tax shelters. But it would require extensive and complex provisions, including "at risk rules" intended to prevent taxpayers from taking

deductions in excess of their actual investment in the asset, limitations on the deduction of inflation-adjusted interest expenses, real economic depreciation with more complete cost capitalization rules, and full taxation of real capital gains.

In contrast to the complex rules necessary to prevent tax shelters under an income tax, existing tax shelters would simply disappear with the tax exemption of capital income. The relative advantage of current tax shelters would be eliminated if all purchases of capital goods were expensed, if capital gains and the returns to saving were taxed only when consumed, and if borrowing were subject to tax unless offset by additional investment.

Some caution must be exercised, however, in extolling the relative advantage of a consumed income tax with regard to tax shelters. Unless the family was the tax unit, and to some extent even if it were, attribution of consumption to related individuals subject to low marginal tax rates would be a new tax reduction technique under a graduated consumed income tax. This is just one example of how any tax preference or possible tax loophole would likely be exploited under a consumed income tax. The difficult measurement issues which gave rise to loopholes in the present income tax are fairly well known after 70 years of experience. Similar measurement difficulties in an actual consumed income tax would probably give rise to many new and different "tax shelters".

B. Economic Advantages

Advocates of a consumed income tax argue that it would have two important advantages over an income tax. First, it would not distort the consumer choice between present and future consumption. Second, it would probably increase saving, which in turn would increase investment, productivity and growth. Implementation of a consumed income tax would also affect individual behavior regarding gifts and bequests.

1. **Economic neutrality.** An individual can consume income now or save it in order to consume it later. The cost or "price" of future consumption is inversely related to the net rate of return to saving obtained by the individual; a higher rate of return implies a lower price, since more future consumption can be purchased for any amount saved. A consumed income tax does not change the price of future consumption since it does not change the rate of return to saving. In contrast, by taxing the return to saving, the income tax raises the price of future consumption, thus distorting the choice between consuming now or saving for future consumption. In this sense, unlike the income tax, the consumed income tax does not discriminate against saving.

However, eliminating the income tax discrimination against saving by enacting a consumed income tax would have some adverse effects as well. Although only the income tax discriminates against saving, both the income and consumed income taxes distort the individual decision to work more or take more leisure (broadly defined to include non-market production in the home). However, tax rates must be higher under a consumed income tax, as the base is smaller. As a result, the consumed income tax distorts the work-leisure choice more than the broad-based income tax does. Thus, in terms of overall economic neutrality, the relative merits of the two taxes are unclear on theoretical grounds. (The theoretical argument is unlikely to be resolved in the near future; for example, there is little empirical evidence and no consensus about the value of an esoteric but critical parameter in the analysis -- the labor supply response to changes in the return to saving.) Under many assumptions about individual behavior, the consumed income tax results in a smaller total distortion of the two choices and thus is preferable in terms of economic neutrality. However, under other assumptions, the income tax can be shown to result in a smaller overall distortion.

2. **Effect on saving.** The effect on saving of implementing a consumed income tax is also controversial. As described above, saving would be encouraged under the consumed income tax because the income tax discrimination against saving would be eliminated. However, because the net return to saving would be higher, any particular goal for future consumption could be attained with less current saving; this would reduce the need to save. The net effect of taxation on saving is a topic of much debate. Most economists believe that, relative to an income tax, a consumed income tax would result in more saving, and thus more investment, faster growth and eventually higher wages; some contend the effects would be very significant. However, many economists argue that little change in saving would result.

Also, if the marginal tax rate at the time of dissaving were lower than the tax rate at the time the deductions were taken, the effective tax rate on the return to saving would be negative -- not only would the government collect no tax on the saving, it would actually pay people to save. Although this would further encourage saving, it would reduce total tax collections and require higher marginal tax rates on the remaining tax base.

3. **Effects on gifts and bequests.** The tax treatment of gifts and bequests under the consumed income tax would affect individual decisions to give and to leave inheritances. Gifts and bequests would probably be stimulated if they were taxed only to the recipient. However, the opposite effect would occur if they were taxed to both the donor and recipient. Saving would also be stimulated in the former case but discouraged in the latter.

C. Equity Advantages

Many advocates of taxes on consumed income believe that consumption provides a better measure of ability to pay than does income. One argument for a tax on consumed income is that annual income, which is subject to considerable fluctuation, is a less satisfactory indicator of ability to pay than is permanent income, and that consumption is a better proxy for permanent income than is annual income.

At another level of sophistication, some advocates of a particular form of consumed income tax argue that ability to pay should be measured in terms of lifetime income, rather than annual income. Lifetime income can, in turn, be measured in present value terms in either of two ways: as the sum of gifts and bequests received plus labor income, or as the sum of consumption plus amounts given or bequeathed to others. Under this rationale, the tax base of the tax on consumed income is appropriate because it is exactly a measure of lifetime income, but only if gifts and bequests are included in the tax base of the donor as well as the recipient.

The consumed income tax can be viewed as more equitable than an income tax from the perspective of the lifetime. Under certain circumstances, including a constant tax rate over the lifetime of the taxpayer, the value of taxes paid under a consumed income tax does not depend on when a person consumes or receives earnings. By comparison, an income tax levies higher taxes on individuals who earn income at a relatively early age or spend it at a relatively older age.

Finally, some advocates of a tax on consumed income believe it is more equitable because individuals should be taxed on "what they take out of the pot" (consumption) rather than "what they put into it" (income). Since this position basically involves philosophical judgments, it is inherently inconclusive.

III. Disadvantages of a Consumed Income Tax

Although the advantages of a tax on consumed income are numerous, the Treasury Department believes they are outweighed by a number of serious administrative, economic, and equity disadvantages. These include increased complexity for individual taxpayers, higher marginal tax rates, serious compliance problems, perceived unfairness, and a lengthy transition period with complicated treatment of existing wealth. Again, the relative advantages and disadvantages of a comprehensive consumed income tax must be compared to those of a broad-base income tax, not just to the current income tax system.

A. Administrative Disadvantages

A consumed income tax would be simpler for business and for taxpayers with much capital income. However, it would probably be more complicated for the average individual taxpayer. The elements of a consumed income tax required to separate saving from consumption would be unfamiliar and complex. In addition, increased compliance difficulties, troublesome international issues, and potential constitutional challenges are unique to a consumed income tax.

1. **Complexity for average taxpayers.** Under a consumed income tax, problems of measuring the tax base for individuals would be different,

rather than eliminated. For the family of a typical wage earner, the problems of measuring capital income that a consumption tax avoids are of little concern. Such a family's tax picture would be complicated by the addition to the tax base of borrowing and savings account withdrawals. Also, taxpayers would confront a more elaborate tax administration system, with "qualified accounts" for all financial transactions, and the possibility of withholding on borrowing, on withdrawals of savings, as well as negative withholding on deposits in qualified accounts.

Borrowing. Most families would have to keep track of their net borrowing under a consumed income tax. In addition to reporting their wage income, they would have to report any new borrowing and any repayments of prior borrowing. Taxpayers would find it hard to understand why all borrowing -- including consumer loans, credit card debt, and business loans -- would be part of the tax base. Unlike the present income tax, with its deduction of gross additions to IRAs, a consumed income tax would allow a deduction only for net saving, that is, increases in saving in excess of increases in debt. Conversely, any increases in debt in excess of the increase in saving would be included in the tax base.

Qualified financial accounts. The requirement that almost all financial transactions be conducted through qualified accounts would reduce a taxpayer's financial flexibility and ability to maintain the privacy of his or her financial affairs. Taxpayers would have to learn to think of amounts accumulated in a qualified account as pre-tax funds. The amount of consumption a given amount of saving could buy would be less than the amount accumulated, since taxes would have to be paid on any net withdrawal from an account. The same is true of existing state sales taxes, but not of the current income tax.

Treatment of personal-use assets. The tax treatment of housing, autos, other consumer durables, and "collectibles" like art and antiques is an important and difficult issue under a consumed income tax. These items have both consumption and investment characteristics since they provide consumption services over a number of years. Treating them like ordinary consumer goods by including the full purchase price in the tax base overstates the taxpayer's consumption that year. However, there are no annual monetary payments, like lease payments paid by a renter, associated with these goods to indicate the amount of annual consumption services.

Treating personal assets like ordinary investments, on the other hand, understates the taxpayer's consumption. Owner-occupied housing and pieces of art provide good examples of this. Suppose an individual buys a house or painting for $100,000 and sells it for the same price three years later. If the purchase is treated as an investment, an individual would be able to deduct the purchase price of $100,000 and then include the resale price of $100,000 in taxable income. In this example the taxpayer has no net tax liability (indeed he postpones tax for three years). Yet the house or art has provided consumption benefits while used by the taxpayer. If the purchase price were deductible, the ownership and use of a car that was bought for $10,000 and sold three years later for $4,000 would actually reduce tax liability, thus subsidizing the consumption services provided by the personal asset.

One compromise way to treat personal use assets would require consumers to include the full purchase price of certain major consumer assets in the tax base but allow them to spread out the tax payments over a number of years. But averaging is notoriously complicated anytime there is a change in the taxpaying unit, such as through marriage, death, or divorce. Alternatively, purchases of a limited group of consumer durables, perhaps only housing, could be made out of non-qualified accounts; the proceeds of loans from such accounts would not be included in the tax base, and deposits and repayment of loan principal and interest would not be deductible. Under certain circumstances, this treatment would be equivalent to the qualified account approach in terms of present value of tax liability. However, the simultaneous use of qualified accounts for certain transactions and non-qualified accounts for others increases complexity and the potential for tax avoidance. In addition, this treatment raises questions about the proper treatment of extraordinary gains realized upon disposition of the asset.

Extended withholding. Under the present system of withholding, most taxpayers experience little net tax liability at the end of the year. Relatively few taxpayers are required to file statements of estimated tax and make quarterly payments of tax. Even with itemized deductions, most taxpayers can adjust withholding to achieve a satisfactory degree of similarity between total amounts withheld and ultimate tax liability. Those who file estimated returns generally have substantial non-labor income that is not subject to withholding and are more able to cope with the complexities of filing an estimated return.

The situation is potentially quite different under a tax on consumed income. Withholding applied only to income would frequently produce a poor approximation of ultimate tax liability if the tax base were consumption, rather than income. With withholding on consumed income, most taxpayers would have to become more actively and frequently involved in determining their withholding, guessing and revising their expected consumption several times a year. In the absence of a system of withholding on loans and withdrawals, any major purchase, such as that of a vacation or an automobile, could result in a substantial underpayment of tax. Consumer loans or withdrawals taken out near the end of a year might be particularly troublesome, since they could not easily be reflected in withholding, unless anticipated earlier. For example, loans taken out to finance Christmas presents might unexpectedly increase tax liability for many taxpayers. Year-end contributions to savings accounts may also not be reflected in withholding during the year. But these are likely to be welcome, because they result in reduced tax liability or even a refund, rather than increased tax.

Both taxpayer convenience and protection of revenues might dictate that a system of universal withholding be applied to all loans, withdrawals, deposits, and repayments. This prospect raises several problems. Under a graduated tax schedule, the lender would not know the correct rate at which to withhold, so that withholding would have to be at a flat rate. With a simplified rate structure, this might not appear to be problematic, since most taxpayers would be subject to tax at the same marginal rate. However, it would overwithhold low consumption taxpayers and underwithhold large consumers. In addition, withholding on loans and repayments would logically be coupled with negative withholding on saving: for a $5,000 deposit, the bank would credit $6,000 (at a 20 percent withholding rate). At a minimum, this would be complex and confusing to taxpayers.

2. **Compliance**. With consumption defined as income minus net saving, a tax on consumed income would entail many of the compliance problems of an income tax -- plus additional difficulties of monitoring saving and dissaving. While taxpayers would have an incentive to report all the deductions for saving and investment to which they are entitled, they would have an incentive for not reporting withdrawals or borrowing. Consequently, qualified accounts could only be established in institutions that could provide reliable and accurate reporting.

Tax evasion would be more rewarding and consequently more tempting with a tax on consumed income. In this case, evasion would involve not reporting or erroneously deducting the full principal plus earnings on capital transactions, rather than just the earnings. The IRS estimates that 40 percent of capital gain transactions are not reported. This is serious enough under current law, where only the gains are taxed, and at preferential rates. It would be much more serious under a tax on consumed income, where the entire proceeds of a sale, not just the gain, would be taxable (unless reinvested) and at ordinary rates. Compliance with a consumed income tax would therefore require a more extensive system of information reporting and monitoring than does an income tax.

To prevent legal "gaming of the system" and illegal tax evasion, a number of comprehensive, and possibly complex enforcement procedures would be necessary. These would go beyond third-party information reporting that would be useful under an income tax. They might include a comprehensive inventory of all existing wealth upon enactment of the tax, registration of private borrowing, and a far-reaching system of exchange controls to facilitate policing of foreign transactions.

3. **Constitutionality**. The Sixteenth Amendment of the U.S. Constitution empowers the Federal Government "... to lay and collect taxes on incomes, from whatever source derived ...." Experience suggests that the Sixteenth Amendment would not prevent taxation from being limited to income that is consumed. After all, many forms of saving now effectively result in tax exemption. Nor does there appear to be any problem in taxing dissaving of amounts that have previously

benefitted from tax exemption or deferral, such as qualified pension accounts, individual retirement accounts, or Keogh plans; this is also a feature of current law. But the tax on consumed income goes beyond the deduction for saving, deferral of tax on interest, and inclusion of dissaving in the tax base. It includes borrowing in the tax base, even for taxpayers who have no income. Although a consumed income tax is not likely to be found unconstitutional, there is little doubt that the constitutionality of a tax on consumed income would be challenged on the ground that the Sixteenth Amendment does not allow imposition of a direct tax on amounts borrowed. Such a challenge might impair administration of the tax pending resolution of the dispute in the courts.

4. International issues. A shift by the U.S. to a consumed income tax would at best be disruptive of international relations, would increase the opportunities to use foreign transactions to avoid or evade U.S. taxes, and would provide tax incentives for immigration and emigration.

The U.S. tax in the world economy. Under current law, U.S. citizens, residents, and corporations are taxed on their worldwide income, with credit for foreign income taxes paid. Nonresident aliens and foreign corporations are generally taxed on their U.S. source income. It would be impossible to require all international savings transactions to flow through U.S. qualified accounts. Therefore, a shift to a consumed income tax would apply only to U.S. residents; for them the tax base would be worldwide consumption. A deduction for foreign income taxes paid could be allowed; however, it would be difficult to devise a workable foreign tax credit. For nonresidents (citizens and noncitizens alike), the tax base would continue to be income -- income from U.S. sources (which would be a change for nonresident citizens). The corporate income tax could be eliminated for both domestic and foreign corporations, though retaining it during a transition period would help phase out the foreign tax credit. In order to tax the corporate income of nonresident investors, "withholding-at-source" taxes on their dividends and interest could be raised; taxing their share of earnings retained by U.S. corporations would be more problematical.

Eliminating the corporate income tax and replacing the foreign tax credit with a deduction would increase the attraction of U.S. investment, relative to investments elsewhere, for domestic and some foreign businesses. Other nations might object to the resulting capital outflow. In addition, after the many years that the U.S. has had a foreign tax credit and advocated it as a mechanism for relieving double taxation and achieving "capital export neutrality," other nations might protest the replacement of the credit with a deduction as a breach of a longstanding commitment. In many cases, such a change would require overriding an existing U.S. tax treaty with the other country.

Compliance. Detecting foreign borrowing and receipts from foreign corporations raises compliance problems for a consumed income tax that are more serious than under an income tax. U.S. residents could borrow abroad and then "save" the unreported foreign borrowing in a domestic qualified account, thereby lowering current year taxes by taking a deduction for the "saving". This would not necessarily reduce the present value of their tax liability, since they would not be able to deduct future repayments on the loan. (If such repayments were deductible at lower rates, taxes would be reduced.) It may, however, be viewed as inequitable to allow those taxpayers with access to foreign lenders to juggle the timing, if not the present value, of their tax liability. Futhermore, the proper timing of foreign loans and U.S. deposits would enable the taxpayer to reduce somewhat the present value of the tax liability, as long as there were no withholding on the loan. Allowing deductions for investments in foreign business that the U.S. could not monitor would enable taxpayers to consume the return and repayment of those investments tax free. Solutions could be devised to stop this type of abuse. They would require, however, a great deal of added complexity, either by tracing funds flowing into and out of the U.S., or disallowing deductions for investments in countries with which the U.S. does not have effective exchange of information arrangements.

Emigration and immigration. A pioneering shift by the U.S. to a consumed income tax would also encourage individuals to emigrate to avoid U.S taxes in times of high consumption, such as retirement. Exit taxes and an expansive definition of residence could moderate this tendency, although again at the cost of increased complexity. *Immigrants* would also be required to include in their receipts assets brought into the country to prevent them from sheltering U.S. consumption. These twin issues of immigration and emigration have not weighed heavily in U.S. debates on the consumed income tax, but several European nations have considered them major obstacles.

B. Economic Disadvantages

All tax systems distort some form of economic behavior -- consumption choices, the work-leisure tradeoff, the consumption-saving tradeoff, financing decisions, production decisions, and the decision to comply with or evade taxes. The types of decisions affected depend on the transactions included in the tax base. Both a comprehensive consumed income tax and a broad-base income tax would reduce many of the economic distortions in current law by lowering marginal tax rates and treating all sources and uses of income more consistently.

One of the advantages of a consumed income tax, under certain circumstances, is neutrality with respect to the consumption-saving tradeoff. However, in order to achieve this neutrality while financing a given level of Federal Government services, the exclusion of net savings from the tax base requires higher marginal tax rates on the remaining taxable items. Higher marginal tax rates increase the efficiency losses from the remaining distortions in the tax system.

1. Higher marginal tax rates on wages. As noted above, marginal tax rates on wage income would be higher under a consumed income tax since capital income would effectively be excluded from the tax base. As a result, the consumed income tax would discourage work effort more than would a broad-base income tax applied to both capital and labor income. The work disincentive would fall hardest on second workers. The higher marginal tax rate might encourage more non-market activity or underground economy activity that is not subject to tax, further narrowing the base for a consumed income tax.

2. **Tax preferences under a consumed income tax.** Much of the discussion of consumed income taxes has implicitly been overly optimistic about the possibilities of the repeal of all tax preferences and the complete neutrality toward saving that consumption tax treatment would imply.

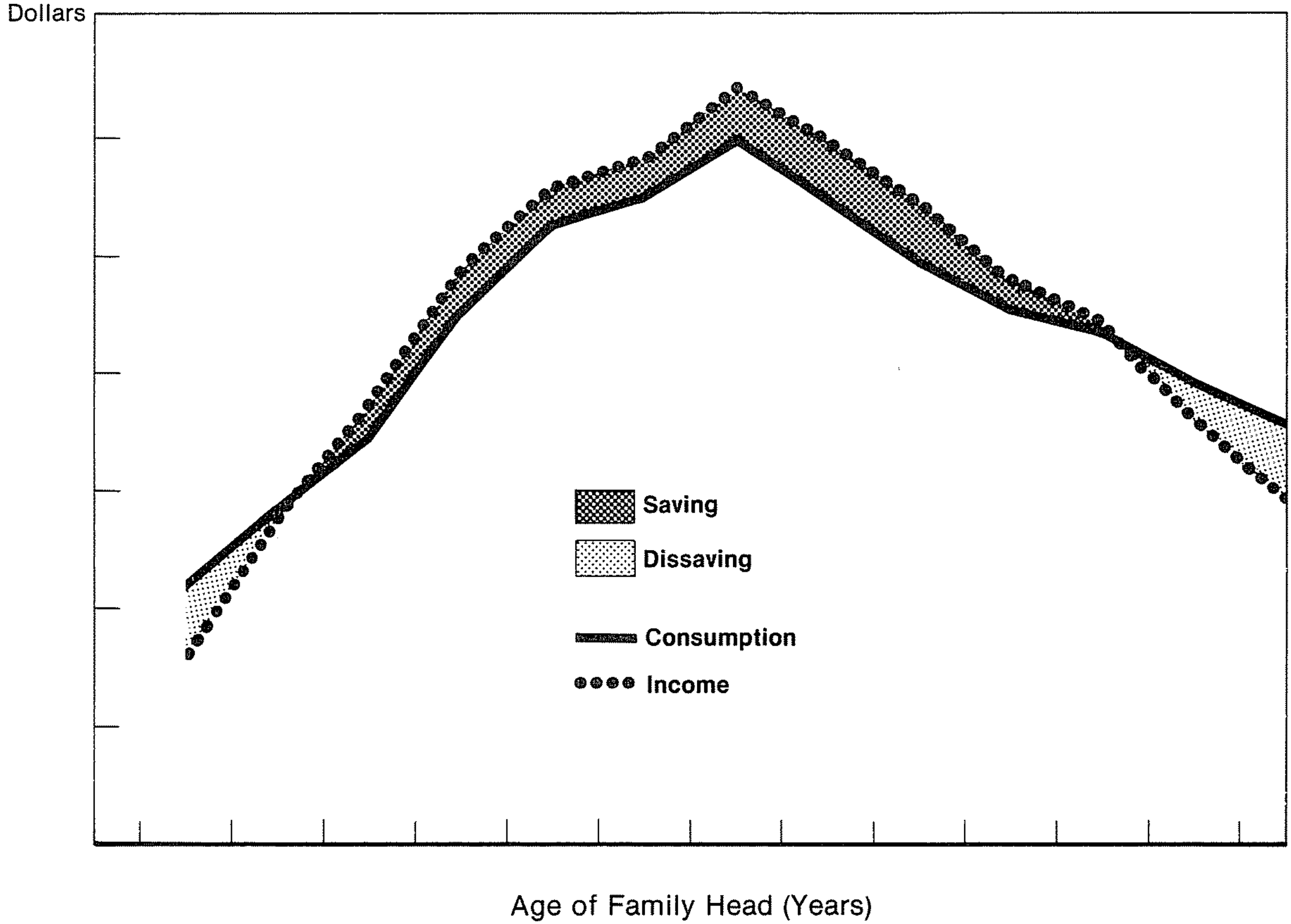
Under a consumed income tax, the effective tax rate applied to income from capital would be zero only if no form of capital income benefitted from preferential tax treatment. But historical experience in the United States suggests that zero would only be an upper bound on the taxation of capital income under a consumption tax.

Under an ideal consumed income tax all interest income would be exempt until consumed. In such a system state and local securities would lose their tax advantage over other investments. If political forces succeeded in maintaining the existing differential between the treatment of interest from state and local bonds and other forms of investment income, it would be necessary to pay a Federal subsidy on interest from such bonds. Similarly, if it were desired to continue preferential tax treatment for housing, energy or other natural resources, research and development, or any of the many other forms of investment that now benefit from preferential treatment, it would be necessary to extend to those activities a negative effective tax rate. To provide any preferential treatment of particular investments through the tax Code, legal tax shelters would have to be permitted, with the resulting economic distortions and perception of unfairness. Negative effective tax rates would perpetuate the type of distorting effect that the present tax system has on the allocation of resources. As under current law, the investment projects that were the most productive for the economy would not necessarily provide the most attractive after-tax yield. This differential would lead resources to flow to less productive uses, preventing the economy from reaching its maximum level of output and growth.

Even if preferential tax treatment is not accorded to particular investments, a consumed income tax with graduated rates and a tax threshold may reduce the effective tax rate on some saving below zero. This is inherent in the typical pattern of lifetime saving and consumption. (See Figure 9-1.) Most saving occurs during middle age (during working and child-raising years) at the same time when family consumption is highest and thus marginal tax rates are highest. Dissaving and borrowing occur during periods when consumption is lower and thus when marginal tax rates are lower. Therefore, the present value of the tax deduction of savings (and repayment of debt) would possibly be greater than the present value of the tax liability on

Figure 9-1

LIFETIME PATTERN OF INCOME AND CONSUMPTION
(Average Income and Consumption, Distributed by Age of Family Head)



borrowing and dissaving for some taxpayers. The tax system would actually subsidize saving, paying people to save at the cost of higher taxes and tax rates on labor income. This problem might be reduced in a system with relatively wide tax brackets.

3. **Corporate taxes under a consumed income tax.** One of the advantages of a consumed income tax is that repeal of the corporate income tax would obviate the need for a complicated scheme of integrating the corporate and individual income tax systems. Because investment income would not be subject to tax until consumed, there is no theoretical justification for a corporate income tax under a consumed income tax. As discussed above, there are other reasons, however, why the corporate income tax might be retained with a consumed income tax. If the corporate income tax were retained, the mechanism by which capital income is exempted from tax would pose significant problems.

Under a consumed income tax, all purchases of capital investments are deducted immediately (expensed). The large upfront deductions of investment would offset income earned, and in many cases would be larger than needed to simply offset all tax liability. Any business that grows fast enough or is less profitable than average would owe no Federal income tax liability. Only firms that grow relatively slowly or have above average profitability would pay corporate tax. This result would cause the fairness of the tax to be questioned.

The tax system is not likely to allow for full benefit of tax deductions via refunds of excess deductions, due to serious perception problems. In order for firms to utilize excess deductions, there would need to be generous carryover rules with payment of interest by the Federal Government on such "losses". Otherwise -- and perhaps even then -- companies would find it attractive to merge with, or acquire other firms to create a new form of tax shelter. This tax incentive can be expected to distort managerial decisions on firm size, ownership, and product mix, as well as increase industrial concentration and reduce competition.

4. **Government as business partner.** The deduction for saving and investment has the effect of making the government a "silent partner" in the investment. With a 20 percent tax rate, a person or corporation would only have to save $4,000 to invest $5,000; the government provides the other $1,000 through lower taxes. Only if the investment is successful will the government get its money back when the investor decides to use the profits to finance consumption. If the investment fails, the government would lose its investment. Having the government as a partner may influence investors' choices of risk. They may be less cautious in risking losses since some of the money at stake is not their own, but they may also be less adventuresome in seeking high returns since they have to share the proceeds with the government.

C. Equity Disadvantages

Any tax system which is based on voluntary compliance must be perceived as fair and equitable. Although theoretical arguments can be made about the fairness of a consumed income tax over the lifetime of taxpayers (always subject to various assumptions), the public perception of fairness is likely to be judged annually at the time of payment of tax, rather than over the individual's entire lifetime.

1. **Perception of lifetime fairness.** Many taxpayers borrow when they are young and establishing families and most draw down accumulated savings (dissave) during retirement. During middle age, people save to retire previous indebtedness and accumulate wealth with which to finance retirement. Under the current tax on annual income, most families pay relatively little tax when they are young and have low incomes and again when they are old and retired and drawing down accumulated wealth; by comparison, they pay relatively more tax during middle age. Under the consumed income tax there would be a shift in tax liability toward periods of borrowing and dissaving and away from periods of saving and repayment of debt. Thus, although similar in present value terms, taxes would be higher during early adulthood and retirement than under the income tax; similarly, during middle age taxes would be lower than under the annual income tax. Though an economic argument can be made that this pattern of tax payments is more neutral and more equitable than that under the income tax, it seems unlikely that this would be the public perception.

2. **Perception of fairness between rich and poor.** There is a general presumption that all taxes on consumption must be regressive, because consumption falls as a percentage of income as income rises. While this presumption is generally accurate for consumption taxes based on transactions, such as a value-added tax or retail sales tax, it need not be accurate for a personal tax on consumed income. A tax on consumed income can be made progressive by allowing personal exemptions, a zero-bracket amount, and graduated rates.

The ultimate judgement on the fairness of the income tax relative to a tax on consumed income comes down to a subjective choice between income and consumption as the more appropriate standard for measuring both economic equals and economic inequality for tax purposes. If the accumulation of wealth has value beyond the consumption that it can buy -- if it confers power, prestige, or peace of mind -- then annual consumption does not measure equals. In that case, a consumed income tax would unavoidably be unfair even if it assessed the same tax on all individuals with the same lifetime income.

A distinction is sometimes made between wealth that individuals accumulate during their lifetimes as a result of their own energies, and wealth that is inherited from previous generations. The treatment of gifts and bequests under a consumed income tax then becomes an important factor in judging the overall fairness of the system.

Indeed some supporters of a consumed income tax consider such a tax equitable only if gifts and bequests are taxed to both the donor and the beneficiary.

D. Transition Problems

One of the most serious obstacles to adoption of a consumed income tax is the treatment of existing wealth. Movement to a tax on consumed income raises special transition issues beyond those that result from any broad-based tax reform. The unique issues involve how consumption out of wealth accumulated under the current income tax ("old wealth") should be treated, and how repayment of debt incurred under the current system ("old debt") should be treated.

There are three possible approaches to these issues, each of which has significant drawbacks.

Taxing old wealth. First, all old wealth could be subject to tax when consumed. With no special transition rules, old wealth would be treated the same as newly accumulated wealth. Taxing old wealth (and deducting repayment of old loans) would broaden the tax base immediately, and thus permit low tax rates, but it would be an inequitable approach to transition and fraught with compliance problems.

All wealth existing on the effective date of the new tax would have to be registered and considered to be in qualified accounts. Taxpayers would have a clear incentive to understate assets. This could be done most easily by converting them to cash or balances held abroad. Such assets could then be fed back into the system as saving or used for tax-free consumption. Though this problem would be temporary, until all hidden assets had been revealed, the revenue loss and inequities it would produce would be enormous. To prevent hoarding of cash, it might be necessary to introduce a new system of money on the effective date of the consumed income tax. To prevent hoarding in foreign accounts, even more far-ranging steps, possibly including foreign exchange controls, would be necessary.

Individuals consuming out of old wealth would generally be taxed twice: Once when they had saved under the income tax out of after-tax dollars, and then again when they consume under the new tax on consumed income. This would be particularly difficult for the elderly because many would have saved without counting on a second tax on their consumed income. Conversely, issuers of old debt would receive a windfall gain. They would deduct interest and repayments of principal, even though the loan was never included in their tax base. Special relief could be provided to older taxpayers, but only by complicating the system considerably. The practical difficulties of wealth inventory at the beginning of the new tax system and the extreme inequities of taxing old wealth and subsidizing old debt make this approach infeasible.

Exempting old wealth. Second, all old wealth could be exempt from the new tax. If all wealth owned on the day the consumed income tax became effective were considered to be in nonqualifed accounts, then these savings would not be subject to tax when used for consumption, and double taxation would not be a problem. This approach, however, would allow wealthy holders of old wealth to eliminate all tax liability for years into the future (perhaps generations) simply by shifting assets from nonqualified accounts to deductible qualified accounts, thereby reducing their tax liability. Separate accounting for old and new wealth would greatly complicate compliance and administration. The reduction in the tax base would necessitate such high marginal tax rates on the remaining tax base that any efficiency gains from a consumed income tax would be postponed for decades.

Partial exclusion of old wealth. A middle ground solution would be essential, in which taxpayers were allowed some minimal amount of tax-free consumption from accumulated wealth. One possible approach to reduce windfall gains and losses would be to allow a limited amount of old wealth accumulated out of after-tax income to buy tax-free consumption, but to allow a deduction only for new saving (not for repayment of debt). Windfall gains and double taxation of existing wealth would be reduced, but not eliminated. Distinguishing between old and new saving would be difficult and would require complex rules, such as those required to determine what portion of the trillions of dollars worth of existing land, housing, stocks, and other forms of wealth was purchased out of after-tax income. Moreover, limitations on tax-exempt consumption would be difficult to monitor and to administer when the taxpaying unit changes. At the very least, such a partial exclusion of consumption would complicate tax compliance and administration for nearly a generation.

IV. Conclusions

The tax on consumed income has considerable attraction. Particularly important is the fact that under the consumed income tax the most vexing problems in the measurement of income from business and capital that plague the current income tax simply do not exist. By comparison, the oft-repeated economic advantages of neutrality toward saving and of equity from a lifetime perspective appear to be secondary.

The disadvantages of a consumed income tax appear to outweigh these advantages. First, the advantages are purchased at the cost of excluding all capital income from tax, a policy that is questionable on equity grounds. Moreover, exempting capital income from tax as a matter of course implies that certain activities can be accorded preferential treatment only by taxing them at negative effective tax rates. The implications of negative tax rates for the misallocation of the nation's capital stock are striking, indeed.

Second, the first nation to implement a tax on consumed income will find itself totally out of step with the international conventions for the taxation of multinational business.

Third, while a consumed income tax would be simpler for business, it would probably not be simpler for most individuals. Withholding would probably be less accurate and more taxpayers would be required to file estimated taxes.

Fourth, the transition to a tax on consumed income raises especially troublesome problems. It would not be satisfactory either to tax all consumption out of previously accumulated wealth or to exempt all such consumption. But any system of partial exemption would cause considerable complexity for a generation of taxpayers. A different type of transition problem involves the possibility of pre-effective date hoarding to avoid paying tax on consumption.

Fifth, advocates of a tax on consumed income do not agree on the proper tax treatment of gifts or bequests. Some would support a consumed income tax only if gifts and bequests were treated as taxable consumption of the donor; others would strenuously oppose taxing these transfers to the transferror. The implications for the pattern of tax burdens on wealthy individuals are quite profound.

All things considered, the Treasury Department has decided against proposing a tax on consumed income and in favor of a modified flat tax on income.

Chapter 10

VALUE-ADDED TAX AND RETAIL SALES TAX

I. Introduction

In addition to the income tax reforms described above, the Treasury Department also considered a different option, the imposition of a national sales tax. This chapter describes the types of sales taxes considered and their advantages and disadvantages, with emphasis on their economic effects. Volume III of the Tax Reform Report discusses these issues in much greater detail, focusing on the value-added tax. This is the form of sales tax that would be most appropriate for use at the Federal level, if a decision was ever made in favor of a national sales tax.

II. Alternative Forms of Sales Taxation

Sales taxes may be single stage in nature, applying to only one stage in the production or distribution process, such as a retail or manufacturers tax, or to all stages, such as a value-added tax. Only two types of general sales tax deserve serious consideration for adoption by the Federal Government, a retail sales tax and a value-added tax extending through the retail level. Sales taxes that do not include the retail level, such as a manufacturers or wholesale tax or a value-added tax that stopped at the wholesale level, are inferior alternatives and should not be considered for the United States.

A. Retail Sales Tax

Forty-five of the states, the District of Columbia, and many local governments have a retail sales tax, a single-stage tax that applies to all sales to final consumers, not just those made by retailers. A retail sales tax is levied on all final or retail sales of goods and services except those that are exempt from tax. More than one half of the states, for example, exempt food consumed at home for distributional reasons. Most services are not taxed, except in a few states, partly to achieve social objectives and partly for administrative reasons. Many, but not all, sales to business firms are exempt. This exemption is achieved by allowing firms to make tax-free purchases of various categories of goods, such as those purchased for resale, or by exempting certain items commonly bought only by businesses, such as equipment and machinery. The exemption of business purchases is necessary to prevent a product, or inputs into its production, from being taxed more than once as it moves through the production-distribution process. Exports (other than those made directly by foreign tourists in the United States) are not taxed under a retail sales tax, but imported goods are taxed when sold at retail in a state with a sales tax.

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The operation of a 5 percent retail sales tax is illustrated in the simple two-stage example in Table 1. It is assumed that a winery grows its own grapes, makes no purchases of produced goods from other firms, and makes no retail sales, but sells $200 worth of wine to a grocery store. The grocer sells the wines purchased from the winery to households for $300. With a retail sales tax, no tax would apply on the sales by the winery to the grocer because these are not retail sales; since the wine purchased is for resale, the grocer is registered to make tax-free purchases. But the grocer would collect $15 on his retail sales of $300. (See line d.)

Compared to a tax with numerous exceptions and exclusions, a broad-based retail sales tax would be less likely to interfere with decisions by individuals and business firms on what to consume and what to produce and would be easier to administer. Ideally, a comprehensive retail sales tax would apply to all consumption expenditures. For 1988, the projected level of total personal consumption expenditures is about $3,100 billion and each percentage point of a tax levied on this total would therefore yield about $31 billion. In fact, any realistic sales tax base would probably be well below this, because of the difficulty or inadvisability of taxing certain types of consumer expenditures. As explained below, a more realistic, but comprehensive base would base be about $2,400 billion.

B. Value-Added Tax

Though the value-added tax is unfamiliar to most Americans, it is imposed throughout much of the rest of the world. A value-added tax that extends through the retail level is levied on each firm in the production and distribution chain, from the extraction of raw materials through the manufacturing and distribution processes, to the last sale to final customers. Thus, under a comprehensive value-added tax, all businesses, not just those that sell at retail, would pay tax on their sales. An important characteristic of a value-added tax is that tax is applied only to the value added by the firm, that is, to the excess of its sales over its purchases of goods from other business firms. A value-added tax is usually collected by the tax credit method; each firm applies the tax rate to its taxable sales, but is allowed a credit for value-added tax paid on its purchases of goods and services for business use, including the tax paid on purchases of capital equipment under a consumption-type value-added tax. As a result, the only tax for which no credit would be allowed would be that collected on sales made to households, rather than to businesses. Since the sum of the values added at all stages in the production and distribution of a good are equal to the retail selling price of the good, the revenue base of a retail sales tax and a value-added tax with the same coverage are theoretically identical, and a given tax rate will yield the same amount of tax revenue under either approach. Thus, despite its multistage character, a value-added tax is very much like a retail sales tax in that it is a tax on expenditures by consumers.

Table 10-1

ILLUSTRATION OF A RETAIL SALES TAX
AND A VALUE-ADDED TAX

(Tax Rate is 5 Percent)

Assumed Facts	Winery	Grocery Store	Total
a. Sales	200	300	**
b. Purchases	0	200	**
c. Value added (a-b)	200	100	**
Calculation of Retail Sales Tax			
d. Tax (5% of a, for grocer only)	*	15	15
Calculation of Value-Added Tax			
e. Tax on sales (5% of a)	10	15	**
f. Credit for tax on purchases (5% of b)	0	10	**
g. Net tax (e-f)	10	5	15

* Retail sales tax is collected only on retail sales by grocer; it is not levied on sales by the winery.

** Not relevant for illustration.

The value-added tax can also be illustrated using the simple example in Table 1. Both the winery and the grocery store would collect the 5 percent tax on their sales ($10 and $15, respectively, on sales of $200 and $300), and both would be allowed a credit for tax paid on business purchases. In this example, the winery has no purchases from other firms and thus no credit for tax paid, but the grocer is allowed a credit for the $10 in tax collected by the winery on sales to the grocer. Since the tax is on final consumers, no credit is allowed for the $15 of tax collected on the grocer's sales to households. As with a retail sales tax, value-added tax would not be charged on export sales, but it would apply to imports.

This illustration reveals a key characteristic of the value-added tax: it is simply an alternative means of collecting a tax that has ultimate effects quite similar to those of a retail sales tax. This point is further illustrated in the example of Table 1 by noting that the total amount of tax collected from the winery and the grocer under the value-added tax, $15 (see the "total" column in line g), is the same as that collected from the grocer alone under a retail sales tax (see line d). Consideration of more detailed examples involving imports, exports, capital goods, intermediate goods, and more complex processes of production and distribution does not seriously alter this fundamental conceptual equivalence between an ideal retail sales tax and a value-added tax of the type most likely to be imposed in the United States.

This similarity between the two taxes greatly simplifies the task of Americans trying to understand and assess the advantages and disadvantages of the unfamiliar value-added tax. For most purposes, one can simply consider the pros and cons of a "sales tax," without asking whether the tax is to be implemented as a retail tax or as a value-added tax. Only if it is decided that a Federal sales tax may be desirable must attention turn to more detailed consideration of the differences in the way the two taxes are administered and to the economic effects created by those administrative differences. These differences are considered briefly below and in greater detail in Volume III.

C. Advantages of Uniform Rates

To avoid unintended distortions in consumer behavior, a sales tax should constitute a uniform percentage of all consumption expenditures. This objective can be best achieved with a broad-based retail sales or value-added tax imposed at a single rate. Still, the experience of the states with the retail sales tax and of European countries with the value-added tax shows that it may be necessary to exclude some goods or services from the tax base for distributional reasons or to help achieve social objectives. For example, exclusion of food or medical care may be deemed necessary to avoid imposing an undue burden on those below the poverty level, and education and religious activities may be excluded from taxation as a way of encouraging these activities. Any exclusions from the tax base, however, should be kept to a minimum and should be solidly justified on the basis of distributional, social, or administrative necessity. Apart from the exclusions that are necessary to achieve these goals, there should be only one rate of tax, and it should be applied to a comprehensive tax base.

There are both administrative and economic reasons for this judgment. First, differences in rates impose on business firms and their employees the necessity to know which rate to apply to any given item and the obligation to make the proper distinction as sales are made. If orange juice, for example, is tax free, but juice substitutes are taxed at the standard rate, and orange soda is taxed at a higher luxury rate, then each grocery store clerk must know which rate to apply to these different products. Distinctions of this type also greatly complicate tax administration, since it is necessary for auditors to verify the rates reported on various sales.

The use of multiple or differential rates also interferes with tax neutrality by distorting consumer choices away from highly taxed items and toward lightly taxed ones. The end result is reduced consumer satisfaction and a less efficient use of the economy's resources. This is why it would be preferable not to exclude food from the tax base, if there is an acceptable and effective alternative for reducing the sales tax burden on the poor. For the same reasons, services, as well as goods, should be subject to tax. The failure to tax expenditures on services favors those persons with relatively strong preferences for services and distorts consumption away from commodities and toward services. Moreover, if services are not taxed, the tax rates on taxable sales or on income must be higher than otherwise in order to raise a given amount of revenue, thereby creating further distortions and disincentives.

Nor should higher rates be applied to "luxuries" or to goods deemed not to be necessities in an effort to increase the progressivity of the tax system. Doing so distorts consumption decisions and creates difficulties in complying with the tax and in administering it. Moreover, it is unnecessary. Given the existence of a progressive individual income tax, it is far easier to increase progressivity, if that is the goal, by adjusting the structure of income tax rates.

D. Sales Taxes Unworthy of Consideration

The retail sales tax and a value-added tax extending through the retail level are the only types of sales tax that should be considered for adoption by the United States. Thus, even if a Federal sales tax is thought useful, the United States should categorically reject: a single-stage tax levied before the retail level, such as a manufacturers or wholesale tax; a value-added tax that does not include the retail stage; and a multiple-stage "turnover" or cascade tax that allows businesses no credit for tax paid on purchases for business use.

Developing countries view nonretail taxes as attractive since the number of taxpayers needs to be kept to a manageable size for administrative and enforcement purposes. Moreover, recordkeeping is often not adequate to apply a sales tax to the numerous small firms at the retail level in developing countries. Instead, these countries may simply collect tax at the manufacturing (or import) stage or on wholesale sales to retailers. In the United States, in contrast, there is no administrative or compliance argument against including the retail level in a sales tax; state experience with the retail sales tax amply and persuasively demonstrates this.

There are many economic and administrative disadvantages to excluding the retail stage from a sales tax. These can be discussed for a single-stage tax that excludes the retail level, though the same arguments would apply to a value-added tax that is "truncated" to exclude retailing. Such a tax would be equivalent to a single-stage tax imposed at the wholesale level.

Suppose that a major oil company is economically integrated from the oil field to the service station, owning oil fields, refineries, a wholesale distribution system, and even retail outlets. It would clearly be unfair and distortionary to exclude all of the company's retail sales from taxation, just because the company sells its own products directly to consumers. Rather, to be fair and neutral it would be necessary to impute a value to the products at the wholesale level in order to achieve parity with those retailers not associated with a comparable integrated company. But to assign a value, for tax purposes, to "sales" between affiliated enterprises would be administratively burdensome, possibly open to abuse, and it would be especially difficult in those industries in which products are not standardized and in which there are few sales occurring at market prices between unrelated parties.

Even in the absence of any manipulation of imputed prices and the administrative effort that would be required to prevent it, omitting the retail level from the tax base would create economic distortions that would waste resources and favor or penalize both consumers and firms in a capricious and haphazard manner that was totally unrelated to any policy objective. A retail sales tax or value-added tax that extended through the retail level and applied to most goods and services would be neutral between types of consumption. By comparison, a tax that excluded the retail level would favor products of industries with a high percentage of value added at the retail level. That is, it would favor products with high retail margins. Services would probably be excluded from a nonretail tax because they are inherently a retail activity. A nonretail tax would create an incentive to restructure business operations to minimize tax liability, basically by transferring functions and costs forward beyond the point of impact of the tax. In the case of a manufacturers tax, for example, activities that might ordinarily be undertaken by a manufacturer and reflected in the manufacturer's price, such as advertising and transportation, would be spun off to separate subsidiaries beyond the manufacturing sector or purchased from unrelated firms in order to keep them out of the tax base. The manufacturing level tax employed by Canada is notorious for these types of difficulties and a value-added tax is currently under consideration as a replacement.

A multiple-stage turnover tax is even worse than a single-stage tax levied before the retail level. Under such a tax, goods are subject to tax each time they are sold. Thus the amount of tax ultimately imposed on a given product depends on how many times it has turned over (been sold) during the production-distribution process. This distorts economic decisions and produces undesirable incentives for tax-motivated vertical integration, something a value-added tax avoids by allowing a credit for tax paid on all purchases for business use. In addition, a turnover tax discriminates against products in which value added occurs early in the production-distribution process, much as a manufacturers or wholesale tax does. Finally, it is impossible to remove a turnover tax from exports precisely, since the amount of tax that has been paid on a given product depends on the degree of vertical integration and whether value is added early or late in the production and distribution chain. For the same reason, it is impossible to levy a tax on imports to compensate exactly for taxes paid on comparable goods produced domestically. Merely applying the tax to the tariff-inclusive value of imports is not sufficient because the imported value will not necessarily be the same as the value at which the manufacturers or wholesale tax would apply to a domestic good. It is for reasons such as these that turnover taxes have long been considered unacceptable and that the European countries abandoned the turnover tax in favor of the value-added tax when the Common Market was established.

III. Pros and Cons of a National Sales Tax

A Federal retail sales or value-added tax that included the retail level would have both advantages and disadvantages. Since little needs to be said in describing the advantages, they are simply listed here. The disadvantages are described in greater detail, since they are more specific to this particular form of taxation.

A. Advantages of a Sales Tax

A national sales tax would have several major advantages that are discussed in detail in Volume III. If it were used to replace part of the income tax, a Federal sales tax would allow even lower income tax rates. By taking pressure off the definition and measurement of taxable income, a sales tax would help reduce income tax avoidance and evasion as well as lessen the incentive to shelter income from the income tax. Based on consumption, rather than income, a national sales tax would not discriminate against saving the way the income tax does. Accordingly, it may increase the level of private saving and generate a corresponding increase in capital formation and economic growth. A broad-based sales tax would almost certainly distort economic choices less than the income tax does. In contrast to the income tax, it would not discourage capital-intensive methods of production or risk taking and it would be neutral with regard to consumption behavior, neither encouraging nor discouraging consumption of particular goods or services.

One claim commonly made for a value-added tax, that it would improve the competitive position of U.S. products in world markets, is generally incorrect. Under international rules, exports may be sold free of any sales tax and imports pay the same sales tax as domestically-produced goods. Thus, a value-added tax could be rebated on goods that are exported; similarly, value-added tax could be collected on imported goods, either at the time of importation or at the first domestic sale. The refund of taxes on exports and collection of tax on imports, known as border tax adjustments, are sometimes likened to an export subsidy and import tariff, which, at fixed exchange rates, would stimulate exports and discourage imports.

But these border tax adjustments simply allow U.S. exports to occur free of value-added tax; they do not reduce the price at which U.S. exports were sold before the tax was imposed. Imposing the tax on imports merely places imports on an equal tax footing with domestic goods. Thus, by itself, a value-added tax is no more likely than a retail sales tax to have favorable effects on international trade. A retail sales tax would not apply to exports either, and it would apply to retail sales of imported goods. Only if a sales tax replaced part of a tax that could not be rebated on exports or collected on imports, such as the corporation income tax, would there be reason to expect that U.S. products would be more competitive. This would only happen, however, if the substitution of a sales tax for the corporate income tax did not cause the domestic price level to increase and if exchange rates are fixed.

B. Disadvantages of a Sales Tax

1. ***Growth of government.*** The United States stands almost alone among the developed countries of the free world in not levying a national sales tax. Virtually all of the members of the European Economic Community (EEC) employ a national value-added tax. (Greece, which recently joined the Community, is scheduled to adopt a value-added tax on January 1, 1986). Of the twenty-three members of the Organization for Economic Cooperation and Development (OECD), only two countries -- Japan and Turkey -- use neither a value-added tax nor a general sales tax.

The lack of a national sales tax in the United States is reflected closely in the percentage of Gross Domestic Product (GDP) devoted to public use in the United States and in other countries. In 1982 total tax revenues at all levels of government averaged 30.5 percent of GDP in the United States. The comparable figure for the EEC countries was 40.1 percent and for the countries of the OECD, exclusive of the United States, it was 37.1 percent. In the United States, sales taxes (state and local) took approximately 6 percentage points less of GDP than in the EEC and in the OECD (exclusive of the United States). It is not only sales taxes that are lower in the United States; corporate income and social security taxes also are substantially lower in the

United States than in many other developed countries. Still, these figures suggest that even if a sales tax were initially imposed as a partial replacement for the income tax in a revenue-neutral change, public spending in the United States would eventually be greater with a national sales tax than without one.

2. Regressivity. A general sales tax is often criticized as unfair to lower income individuals and families. There are two aspects to this equity argument: the absolute burden of the tax on the lowest income groups, and the regressivity of the tax or the relatively higher burden of the tax at the lower income levels than at the higher. As explained below, there are four alternatives for lessening the burden of the tax on the poor. For those individuals and families that are above the poverty level of income and thus subject to the income tax, the regressivity of a sales tax can be offset through the adjustment of income tax rates or through non-refundable credits against the income tax.

3. Effect on prices. Assuming an accommodating monetary policy, a sales tax would almost certainly increase the price level by roughly the percentage it represents of consumption spending. That is, a 4 percent sales tax that applied to 75 percent of consumption expenditures would increase the general price level by about 3 percent. Although this would be a one-time occurrence, not an annual increase, it might cause "ripples" of wage increases, because of cost-of-living adjustments, and these could be reflected in further price increases. To the extent the sales tax replaced part of the income tax, there would be little offsetting reduction in prices or wages.

4. Administrative costs. Administration of a Federal value-added tax would require substantial additional resources. The Internal Revenue Service estimates that once the administrative program was fully phased in, the annual administrative costs would run about $700 million (at 1984 prices), or about 0.4 percent of revenues from a 10 percent broad-based value-added tax. To administer a value-added tax, the IRS would require approximately 20,000 additional personnel.

5. Federal pre-emption. States, and more recently local governments, consider the sales tax base their exclusive fiscal domain. Federal imposition of a sales tax might reduce somewhat the ability of state and local governments to tax that base and would therefore be seen by those governments as an unwelcome intrusion. This concern could be reduced if Federal adoption of a retail sales tax led to increased cooperation between the various levels of governments in tax administration and collection. This cooperation would be much easier to achieve if the Federal Government adopted a retail sales tax than if it adopted a value-added tax. If the state and Federal tax bases were identical, state taxes could be collected by the Federal Government as it collected its own tax. Of course, a Federal sales tax could not simply be collected by the states, because of the current differences in state tax bases.

IV. Relevance of the European Experience

Though the reasons that motivated the European countries to switch to the value-added tax during the late 1960s and the 1970s are largely irrelevant for the present debate in the United States, European experience does contain important lessons for the United States. Before adopting the value-added tax, most of the members of the EEC had multiple-stage turnover taxes of the type described and analyzed above. As a result, the switch to the value-added tax represented a rationalization and clear improvement of the European tax systems, rather than the creation of a new source of revenue. The United States, by comparison, does not have an inefficient sales tax that needs to be overhauled.

The European switch to the value-added tax involved a relatively minor change in tax administration. Therefore, few additional administrative resources were required. By comparison, since the United States has no Federal sales tax, a substantial increase in IRS administrative resources would be required to implement a value-added tax.

Because the European value-added taxes replaced existing sales taxes, there was little effect on consumer prices or on the distribution of tax burdens across income classes. By comparison, an American value-added tax would raise prices in the year it was introduced and would add a regressive element to the Federal tax system, unless steps were taken to reduce the regressivity.

European experience also indicates that a consumption-type value-added tax, collected by the tax credit method, would be the most appropriate type for the United States and that serious administrative, compliance, and efficiency problems are involved in the use of the tax to achieve non-revenue objectives. That is, multiple rates of tax and efforts to favor certain types of consumption by exclusions or lower rates involve significant costs and complexities, as well as revenue losses.

V. Tax Base and Revenue Potential

Total personal consumption expenditures are estimated to be about $3,100 billion in 1988; each percentage point of a value-added tax levied on this total would yield $31 billion. In fact, the tax base is likely to fall well below total consumption, for a number of reasons. Since certain items would be excluded either for distributional or administrative reasons, a more realistic, but broad, base would be about $2,400 billion in 1988 levels of expenditure. If food consumed at home also is excluded, the tax base would fall to $2,000 billion. The most important items of personal consumption that are excluded from the tax base in arriving at these figures are described briefly below and discussed more fully in Volume III.

Owner-occupied housing is difficult to tax under any sales tax. Ideally, housing services would be taxed over the life of a house, but this is clearly impossible because of the difficulty of valuing the housing consumed by owner occupants, the value of the so-called "imputed rent" or what the house would rent for on the open market. Since the "rent" on owner-occupied housing cannot be taxed, it would be unfair and distortionary to tax the rents on tenant-occupied residential housing. One alternative would be to tax newly-constructed housing while excluding the rental value of residential housing from the tax base (both tenant- and owner-occupied). This alternaive would reduce the base by about $290 billion in 1988. If this approach imposes an unacceptable tax burden on housing, another alternative, following the practice with state retail sales taxes, would be to tax the cost of materials entering into new housing construction, repair, and alterations.

A number of other personal consumption items would also probably not be included even in the most comprehensive value-added tax base for a variety of reasons. Medical care, educational expenses, and religious and welfare expenses would probably not be taxed for social and distributional reasons. Because of the problems of defining value added, it would be difficult to tax certain banking services and insurance, and tax could not be collected on the consumption expenditures of Americans travelling abroad, but foreigners travelling in the United States would pay tax on some items. There also would be pressure to exclude urban transit service, which is heavily subsidized. Combined with the proposed treatment of housing, exclusion of all of these items from the tax base would result in a comprehensive value-added tax base of about $2,400 billion, or 77 percent of total personal consumption expenditures of $3,100 billion.

VI. Reducing Regressivity

The most frequent objection to any form of general sales tax is its regressivity, and especially the burden it places on families with incomes below the poverty level. Regressivity within the portion of the population subject to the income tax -- roughly those above the poverty level in the present proposals for income tax reform -- can be offset by changes in income tax rates or by tax credits; but no adjustment of tax rates or non-refundable credits can eliminate the sales tax burden on those below the income tax threshold.

There are four possible approaches to removing the burden of a sales tax on low-income households below the income tax threshold. First, food for home consumption can be excluded from the tax base. This approach is followed in 27 of the state sales taxes. (One state uses a lower rate for food.) There are, however, problems with this approach. Even though expenditures on food consumed at home are regressive (a larger percentage of income being spent on food at low income levels than at middle and upper income levels), about 80 percent of the revenue loss from excluding food from the tax base would be from expenditures by those wih incomes above the poverty level. Given the administrative and economic advantages of applying uniform rates to a comprehensive base, exclusion of food is not a desirable way to reduce regressivity.

A second approach would be to establish a system of refundable credits under the income tax to offset the burden of the sales tax on the consumption expenditures necessary for a minimum standard of living. Though this approach could, in principle, effectively eliminate the burden of a sales tax on an essential level of consumption, it also suffers from a number of drawbacks. First, if the credit is available to all taxpayers, rather than just low income individuals and families, it is expensive. If the credit were available to everyone, it would absorb about one-third of the revenue from the sales tax. While it would reduce the burden of the sales tax for families below the poverty line, 90 percent of the credit would go to those above the poverty level. This demonstrates that the credit should be phased-out for incomes above the poverty level; a credit that is phased-out between the poverty level of income and 150 percent of that level would absorb about a tenth of the revenue from a sales tax. A phased-out credit, however, would be more complex and, in effect, would generate higher marginal income tax rates over the phase-out range. A credit of either type may also be viewed as establishing, in embryonic form, the administrative machinery for a new social program such as a family assistance plan. It can be argued that the desirability of such a program should be debated explicitly in the context of welfare reform, rather than being introduced as a by-product of adopting a sales tax. Several of the states, however, have used this approach for lessening the burden of the sales tax without kindling a debate over welfare reform.

The third approach is indexed transfer payments. If all families below the poverty income line received government transfers, and no one else did, it would be relatively easy to overcome the low-income burden of a sales tax; transfers could simply be increased to offset the sales tax paid by low income families. But not all low income individuals and families receive transfers, and many above the poverty level do receive them. Even so, adjustment of transfers offers a third potential means of reducing sales tax burdens on the poor.

A personal exemption type of value-added tax would be a fourth method of eliminating the sales tax burden on low-income families. Under this approach, which would differ substantially from a conventional value-added tax, workers would be considered to be "sellers" of labor services and would be subject to a value-added tax, but they could not take credits for value-added tax on their purchases of consumption goods. Employers would be allowed a credit for the taxes "charged" by employees on their wages. Treating employees as sellers of labor, rather than employees, changes the value-added tax in one crucial way: it would allow the introduction of personal exemptions in the calculation of the value-added tax liability of workers. That is, workers could be allowed an exemption from value-added tax for a specified amount of the income earned from "selling" their labor to the employer. This approach could alleviate the burden of the tax on low-income individuals receiving labor income, but it would not help those not receiving labor income, such as retirees without pensions or the unemployed. The approach also raises some questions about whether the tax would be shifted to consumers to the same extent that a traditional value-added tax would be shifted.

VII. Value-Added Tax versus Retail Sales Tax

The value-added tax and the retail sales tax are collected in different ways; thus they have somewhat different administrative implications and economic effects, despite their basic similarity. On balance the administrative advantages of the value-added tax appear to outweigh the primary administrative advantage of the retail sales tax in the American context, its much greater familiarity.

Purchases for business use should not be taxed under a sales tax; otherwise production techniques will be distorted, the value of a product will be taxed more than once, and exports will be penalized. Under a value-added tax any tax collected on capital goods, intermediate products, or other inputs to the production-distribution process is allowed as a credit against the tax imposed on the sales made by the purchasing firm. This means that goods and services purchased for business use are automatically freed from tax; by and large, only goods and services sold to households are ultimately taxed under the value-added tax. Tax auditors need only to check the purchasing firm to ensure that purchases for which a credit is claimed were used for business purposes. By comparison, it is more difficult under a retail sales tax to completely exempt all business purchases. Firms must provide exemption certificates to their suppliers to buy tax free, and auditors must check both the supplier and purchaser in cases of doubt. At the state level, this system of exemption certificates applies only to goods purchased for resale or goods that become component parts or physical ingredients of produced goods; other purchases, such as machinery and equipment, are only exempt if specifically provided in the state statute. The end result is that not all business purchases are free of retail sales tax; about 20 percent of sales tax revenue is from taxing business purchases.

Another important advantage of the value-added form of sales tax is the fact that tax is collected as products move from stage to stage in the production-distribution process. Thus by the time a product reaches the retail stage, much of its total value has already been taxed. (In the example of Table 1, two-thirds of the tax was collected from the winery, and only one-third from the grocer.) This means that tax evasion at the retail level is less of a problem under a value-added tax than under a retail sales tax; under the latter tax, evasion at the retail level means that no tax is collected. (Of course, all previously collected revenue from the value-added tax could be lost if the retailer understates sales but claims a credit for all value-added tax paid on purchases.) The possibility of collecting tax before the retail level can be particularly important in the case of sales by street vendors and purveyors of certain services in the legal underground economy. A Federal sales tax of as little as 4 percent, together with state and local taxes, could produce a combined rate of tax of 10 percent or more in many states, and the combined rate could easily exceed 15 percent if the value-added tax approached European rates. Rates this high could increase the incentives for evasion.

Related to this advantage is the audit trail provided by the chain of taxes and credits with the value-added tax. In the example of Table 1, the grocer can only claim credit for tax paid on purchases from the winery if the grocer can produce an invoice documenting that he was charged tax by the winery. Auditors can then trace the invoice back to see that the winery remitted to the government the tax claimed as a credit by the grocer. There is no such paper trail under a retail sales tax.

VIII. Implementation

A value-added tax could not be imposed quickly by employing the existing personnel and practices of the Internal Revenue Service. Rather, it would be necessary to employ and train additional IRS agents, acquire additional computer capability, establish new administrative procedures, and engage in a major effort in taxpayer education. These requirements are described more fully in Volume III. The Internal Revenue Service estimates that it would need 18 months after enactment before it could begin to administer a value-added tax. Thus, if legislation imposing a value-added tax were enacted in late 1985, the tax could be made effective July 1, 1987.

The one-time start-up costs for recruiting and training IRS agents, acquiring enhanced computer capabilities, and educating the public about the value-added tax are substantial. These start-up costs indicate clearly that the value-added tax should not be considered as a temporary source of revenue. Moreover, given the magnitude of both the start-up costs and the on-going annual costs of administration and compliance, it would be unwise to introduce a value-added tax at less than at a rate of 5 or 6 percent. (Some experts believe that imposition at a rate below 10 percent would not be sensible.)

IX. Conclusions

Because of its inherent regressivity, a Federal value-added tax or other form of general sales tax should not be adopted as a total replacement for the income tax. Implementing a Federal sales tax would be costly and it would take time. Therefore, it does not seem desirable to introduce a Federal sales tax solely as a replacement for part of the present income tax, even though doing so would take pressure off the latter. Reform of the income tax, along the lines proposed in Chapters 5 through 7 is a more appropriate avenue of fundamental tax reform in a revenue neutral context.

For economic and administrative reasons any Federal sales tax that is adopted should extend through the retail level and should be applied as widely as possible at a uniform rate of tax. The value added technique appears to be somewhat preferable to the retail sales technique as a means of implementing a sales tax.

A Federal sales tax would have considerable advantages and serious disadvantages. These must be weighed carefully in deciding whether a sales tax should be imposed. The advantages include neutrality toward saving, capital formation, production techniques, and consumption decisions. The disadvantages are regressivity, a one-time increase in prices, Federal intrusion into the sales tax area, the administration and compliance costs of a new Federal sales tax, and the likelihood of greater public expenditures. Any proposal for introducing a sales tax should include steps to relieve the tax burden on low-income individuals and families.

APPENDIX A

EFFECTIVE DATES AND TRANSITION RULES

Implementing the Treasury Department's reform proposal will involve a fundamental tradeoff. On the one hand, immediate implementation of the proposals would be desirable in order to capture as soon as possible the gains in equity, economic neutrality and simplicity described at length in this report; immediate implementation would also be the simplest policy, as it would avoid inevitably complex transition rules. On the other hand, immediate implementation of the proposals would be unfair and disruptive; taxpayers who made commitments based on the current tax structure would suffer unanticipated gains and losses when the tax law was changed suddenly. Such reform-induced windfall gains and losses amount to essentially arbitrary redistributions of income and are therefore an undesirable, if inevitable, consequence of reform. The magnitude of the gains and losses induced by implementation of the Treasury Department's proposal could be reduced by delaying or phasing-in implementation or by using "grandfathering" provisions which guarantee current tax treatment to taxpayers who made commitments based on current law.

The Treasury Department's proposal provides for a fair and orderly transition by striking a balance between the conflicting objectives of maximizing the equity, economic neutrality and simplicity gains of rapid implementation and minimizing the arbitrary redistributions of income induced by unexpected tax reform. All four of the implemetation options described above -- immediate coupled with grandfathering provisions, delayed, phased-in, and immediate -- are utilized toward this end. The proposed effective dates and transition rules for each element of the Treasury Department's proposal are summarized in Table A-1; the listing of proposed changes corresponds to those in Appendixes 5-A, 6-A, and 7-A. The proposed effective dates and transition rules assume that legislation is introduced in early 1985, and that the reform package is enacted on July 1, 1985 with a general effective date of January 1, 1986.

The proposed transition rules can be divided into four general categories. Detailed descriptions of the transition rules are provided in Volume II. The four general categories are summarized as follows.

(1) <u>Immediate implementation with grandfathering</u>. Where feasible, grandfathering provisions are effective in avoiding reform-induced windfall gains and losses. They have the effect of applying the new tax laws to new commitments but avoiding a change in the tax treatment of commitments made on the basis of current law. Elements of the proposal which provide for permanent grandfathering of existing

commitments include the new real economic depreciation rules, the elimination of the investment tax credit, the extension of the at risk rules, the elimination of a variety of special expensing and amortization rules and other subsidies, the taxation of certain life insurance and annuity income, the new treatment of insurance company loss reserves, changes in the treatment of irrevocable non-grantor trusts, and the unification of the estate and gift tax laws. Note that whenever grandfathering occurs, it will generally benefit taxpayers to qualify for such treatment. In order to prevent a flood of tax-motivated commitments made prior to the general enactment date, grandfathering frequently will be granted only to commitments made prior to the date legislation is introduced; note that such treatment is more generous than granting grandfathering only to commitments made prior to the announcement date of a proposal, as has sometimes occurred in the past.

Grandfathering can also be provided on a temporary basis, where the goal is to reduce the windfalls caused by reform, but to subject all commitments to the same tax treatment by some fixed point in time. This is the approach taken for reform in the area of fringe benefits, where the new rules will apply as contracts expire or, at the latest, by January 1, 1989; also, application of the new rules will be delayed for one year in the cases of the two largest fringe benefits, employer-provided health care and life insurance, in order to allow time for employers and insurance companies to adjust to the new tax law. Similarly, partnerships existing prior to the date legislation is introduced will not be subject to the new corporate-type taxation until January 1, 1990.

Treatment similar in spirit to temporary grandfathering is proposed in several areas where the proposal will eliminate unfair preferential tax treatment, but immediate implementation would result in a large one-time increase in income as previously tax-advantaged income is brought into the tax base. In these cases, the adverse effects of the one-time increase in income will be tempered by allowing the increase in income to be spread evenly over a fixed number of years for tax reporting purposes. This treatment is proposed for the elimination of special bad debt deductions and the deduction for additions to "protection against loss" accounts by property and casualty insurance companies, the restriction of the use of cash accounting, and the new rules for insurance policyholder loans.

(2) <u>Delayed implementation</u>. Delayed implementation of some of the Treasury Department's proposals is recommended for four reasons.

First, delay reduces the magnitude of reform-induced redistributions by postponing the change in tax liability and by allowing time for existing commitments to expire. For these reasons, interest indexing will be postponed until January 1, 1988, and capital gains indexing (on non-depreciable assets) will be postponed until January 1, 1989.

Second, delay allows time for rebudgeting in cases where the elimination of preferential tax treatment should be offset by appropriate increases in Federal, state or local expenditures. For this reason, the changes in the taxation of military compensation and of unemployment and workers' compensation will be delayed until January 1, 1987.

Third, delay allows time for adjustment to new rules. Many of the changes in the taxation of estates will be delayed for one year in order to allow estate planners time to adjust to the new rules. Similarly, the replacement of the possessions tax credit with a wage credit will be delayed for one year to allow businesses time to adjust to the new tax structure.

Fourth, repeal of the individual and corporate minimum taxes -- subject to full implementation of the reform proposal -- will be delayed until January 1, 1990 in order to subject to taxation existing preferences which are grandfathered.

(3) Phased-in implementation. Phasing-in implementation is recommended for several elements of the Treasury Department reform package. Since phasing-in involves a modified form of delayed enactment, it not only has the advantage of reducing the magnitude of reform-induced redistributions, but also the further advantage of capturing some of the equity and economic neutrality gains from reform immediately. Phasing-in is recommended for the dividend relief proposal, the elimination of the itemized deduction for state and local taxes, the new limit on charitable contributions, the elimination of graduated corporate tax rates, the extension of the limit on interest deductions, and the denial of business deductions for entertainment expenses and meal costs in excess of a limit.

(4) Immediate implementation. In many cases, the Treasury Department's reform proposals can be implemented immediately with little effect on existing commitments. The changes in the zero bracket amount, personal exemptions, and a variety of credits and deductions fall into this category; the changes in individual and corporate rates will be delayed for six months solely to achieve the goal of revenue neutrality in the initial year after enactment. Similarly, the extension of Individual Retirement Accounts and the new rules on pension distributions will be implemented immediately.

Another class of proposals where reform should be implemented immediately are those involving provisions that are particularly objectionable in terms of violating equity principles. These include some changes in trust rules, limits on deductions for business expenses away from home, and highly preferential special rules for life and property and casualty insurance companies. Similarly, in view of the strong equity and neutrality arguments for elimination of the special preferences for the energy and natural resource industries, the Treasury Department proposes that these preferences be repealed immediately; to reduce the impact of immediate implementation on the energy industry, the repeal of the windfall profits tax will be accelerated by three years, with the scheduled three-year phase-out beginning on January 1, 1988 instead of January 1, 1991.

Table A-1

EFFECTIVE DATES AND TRANSITION RULES

Proposed Changes	Effective Dates and Transition Rules	
I. INCOME TAX REFORM AND SIMPLIFICATION FOR INDIVIDUALS		
A. Rate Reduction		
1. Reduce rates and collapse present 15 tax rates for single taxpayers and 14 tax rates for married taxpayers and heads of households into 3 rates.	7-1-86	delay designed to achieve revenue neutrality in initial year
B. Fairness for Families		
1. Increase the Zero Bracket Amount from $2,510 to $2,800 for single filers, from $2,510 to $3,500 for heads of households, and from $3,710 to $3,800 for joint filers.	1-1-86	
2. Increase personal exemptions from $1,090 to $2,000.	1-1-86	
3. Fold additional exemptions for the blind and elderly into an expanded credit for the elderly and disabled, and make all taxable disability income eligible for the credit.	1-1-86	
4. Repeal deduction for two-earner married couples.	1-1-86	
5. Index Earned Income Tax Credit.	1-1-86	
6. Replace child and dependent care credit with a deduction from gross income with same cap ($2,400 if one child, $4,800 if two or more).	1-1-86	
C. Fair and Neutral Taxation		
1. Excluded Sources of Income		
a. Fringe Benefits		
1. Repeal exclusion of health insurance above a cap ($175 per month for family coverage, $70 per month for individual coverage).	1-1-87 1-1-89	for contracts after date legislation is introduced; or expiration date (if earlier) for contracts existing prior to date legislation is introduced; delay allows time for adjustment to new rules
2. Repeal exclusion of group-term life insurance.	1-1-87 1-1-89	for contracts after date legislation is introduced; or expiration date (if earlier) for contracts existing prior to date legislation is introduced; delay allows time for adjustment to new rules

Proposed Changes	Effective Dates and Transition Rules
3. Repeal exclusion of employer-provided death benefits.	1-1-86 for contracts after date legislation is introduced; 1-1-89 or expiration date (if earlier) for contracts existing prior to date legislation is introduced
4. Repeal exclusion of dependent care services or reimbursement.	1-1-86 for contracts after date legislation is introduced; 1-1-89 or expiration date (if earlier) for contracts existing prior to date legislation is introduced
5. Repeal special treatment of cafeteria plans.	1-1-86 for contracts after date legislation is introduced; 1-1-89 or expiration date (if earlier) for contracts existing prior to date legislation is introduced
6. Repeal exemption of voluntary employee's beneficiary associations and trusts for supplemental unemployment compensation and black lung disability.	1-1-86 for income earned after 1-1-86
7. Repeal special treatment of incentive stock options.	1-1-86 for all options granted after date legislation is introduced; permanent grandfathering for options granted prior to date legislation is introduced
8. Tighten exclusion of employee awards.	1-1-86
9. Repeal exclusion of certain military compensation, with offsetting adjustments in military pay schedules.	1-1-87 delay allows time for offsetting change in expenditures
10. Repeal exclusion of rental allowances or rental value of a minister's home.	1-1-87 delay allows time for adjustment to new rules
b. Wage Replacement Payments	
1. Repeal tax-exempt threshold for unemployment insurance compensation.	1-1-87 delay allows time for offsetting change in state expenditures
2. Repeal tax exemption of workers' compensation, blacklung, and certain veterans' disability payments, but make all such income eligible for the credit for the elderly, blind, and disabled.	1-1-87 for all payments except workers' compensation for injuries prior to 1-1-87; delay allows time for offsetting changes in state and federal expenditures; permanent grandfathering for workers' compensation for injuries prior to 1-1-87
c. Other Excluded Sources of Income	
1. Repeal exclusion of scholarships and fellowships in excess of tuition.	1-1-86 for awards after 1-1-86; grandfathering up to four years for awards prior to 1-1-86
2. Repeal exclusion of awards and prizes.	1-1-86
2. Preferred Uses of Income	
a. Repeal the itemized deduction for state and local taxes.	1-1-86 Phase-in -- 50% deduction for 1 year, complete repeal by 1-1-87
b. Repeal the above-the-line deduction for charitable contributions.	1-1-86 (scheduled expiration date is 1-1-87)
c. Limit itemized deductions for charitable contributions to those in excess of 2 percent of gross income.	1-1-86 Phase-In -- 1% limit for 1 year; full enactment by 1-1-87

Proposed Changes	Effective Dates and Transition Rules	
d. Limit deduction for charitable contributions of appreciated property to indexed basis.	1-1-86	
e. Repeal 50% and 30% limits on individual contributions.	1-1-86	
f. Repeal 10% limit on corporate contributions (but retain 5% limit in certain cases).	1-1-86	
D. Tax Abuses		
1. Business Deductions for Personal Expenses		
a. Deny all entertainment expenses including club dues and tickets to public events, except for business meals furnished in a clear business setting. Limit deduction for business meals on a per meal per person basis.	1-1-86	Phase-In -- allow 50% deduction (in excess of meal limit) for 1 year; full enactment by 1-1-87
b. Limit deductions for meals and lodging away from home in excess of 200 percent of the Federal per diem. When travel lasts longer than 30 days in one city, limit deductions to 150 percent of the Federal per diem.	1-1-86	
c. Establish bright-line rules to separate indefinite and temporary assignments at one year.	1-1-86	
d. Deny any deduction for travel as a form of education.	1-1-86	
e. Deny deductions for seminars held aboard cruise ships.	1-1-86	
f. Deny any deduction for travel by ocean liner, cruise ship, or other form of luxury water transportation above the cost of otherwise available business transportation with medical exception.	1-1-86	
2. Income Shifting		
a. Revise grantor trust rules to eliminate shifting of income to lower rate beneficiaries through trusts in which the creator retains an interest.	1-1-86	
b. During creator's lifetime, tax trusts at the creator's tax rate and allow deductions only for non-discretionary distributions and set-asides. After creator's death, tax all undistributed trust or estate income at the top marginal rate.	1-1-86	for irrevocable grantor trusts and all irrevocable trusts created after date legislation is introduced; irrevocable non-grantor trusts created prior to date legislation is introduced would be subject to rules applicable after creator's death
c. Tax unearned income of children under 14 at the parents' rate (to the extent such income exceeds the child's personal exemption).	1-1-86	
d. Revise income taxation of trusts.	1-1-86	for estates of decedents dying after 1-1-86

Proposed Changes	Effective Dates and Transition Rules	
E. Further Simplification		
1. Non-filing system, in which IRS would compute taxes for many tax payers.	1-1-86	legislation effective; implementation date open
2. Repeal individual minimum taxes (only if basic reforms are fully implemented).	1-1-90	delay allows time to tax current preferences which are grandfathered
3. Move miscellaneous deductions above the line, combine with employee business expenses, and make subject to a floor.	1-1-86	
4. Repeal preferential treatment of capital gains.		(transition rule specified under II)
5. Repeal political contribution credit.	1-1-86	
6. Repeal presidential campaign checkoff.	1-1-86	
7. Repeal deduction of adoption expenses for children with special needs, and replace with a direct expenditure program.	1-1-87	delay allows time for offsetting change in expenditures
8. Disallow income averaging for taxpayers who were full-time students during the base period.	1-1-86	
9. Repeal $100/$200 exclusion for dividend income.	1-1-86	
F. Other Miscellaneous Reforms		
1. Increase limits on moving expenses.	1-1-86	
2. Special rule for allowing deduction of some commuting expenses by workers (*e.g.*, construction workers) who have no regular place of work.	1-1-86	
II. BASIC TAXATION OF CAPITAL AND BUSINESS INCOME		
A. Lower Corporate Tax Rates		
1. Reduce maximum corporate rate to 33%.	7-1-86	
2. Repeal graduated corporate rate structure.	7-1-86	for corporations formed after date legislation is introduced; for corporations formed prior to date legislation is introduced, phase-in one-half of rate increase to maximum corporate rate in 7-1-86, with all corporations facing same tax rate by 1-1-87
3. Repeal personal holding company tax.	1-1-87	delay until phased-in of repeal of graduated corporate rate structure is complete

Proposed Changes		Effective Dates and Transition Rules
B. Taxing Real Economic Income		
1. Index basis (cost) of assets and tax real gains as ordinary income.	1-1-86 1-1-89	for all assets purchased after 1-1-86; for non-depreciable assets purchased prior to 1-1-86; certain assets not subject to indexing (including depreciable assets purchased prior to 1-1-86 and non-depreciable assets purchased prior to 1-1-86 and sold between 1-1-86 and 1-1-89) will receive a capital gains exclusion rate set so that the maximum effective rate on total gains equals 20 percent (also, recapture rules will eventually be repealed)
2. Index depreciation for inflation and set depreciation allowances to approximate economic depreciation.	1-1-86	for assets purchased after 1-1-86; permanent grandfathering for assets purchased prior to 1-1-86
3. Repeal investment tax credit.	1-1-86	for investments made after 1-1-86; investments made prior to 1-1-86 receive full credit
4. Repeal collapsible corporation rules.	1-1-89	delay until taxation of indexed capital gains at ordinary income rates begins
5. Allow expensing of the first $5,000 of depreciable business property, but repeal currently scheduled increases in that dollar limit.	1-1-86	
6. Allow indexed FIFO and repeal LIFO conformity requirement.	1-1-86	
7. Index interest receipts and payments in excess of mortgage interest plus $5,000.	1-1-88	delay mitigates effects on lenders and borrowers in existing loans
C. Retirement Savings		
1. Raise IRA limits to $2,500.	1-1-86	
2. Make IRA's available to both employees and spouses working in the home.	1-1-86	
3. Subject all tax-favored retirement plans to uniform distribution rules.		
a. Subject all pre-retirement distributions from tax-favored retirement plans to a 20 percent premature distributions tax generally, (but 10 percent if used for tuition or first-home purchase).	1-1-86	

Proposed Changes	Effective Dates and Transition Rules	
b. Subject all tax-favored retirement plans to uniform minimum distribution rules.	1-1-86	
c. Repeal 10-year averaging for lump-sum distributions.	1-1-86	
d. Eliminate special recovery rules for qualified plan distributions.	1-1-86	
e. Repeal special treatment for distributions of employer securities.	1-1-86	
4. Simplify the deduction, contribution, and benefit limits for tax-favored retirement plans.		
a. Repeal aggregate-based deduction limit for profit-sharing and stock bonus plans.	1-1-86	
b. Subject excess contributions to a 6 percent excise tax to recapture excessive tax benefits.	1-1-86	
c. Repeal combined plan limit for non-top-heavy plans.	1-1-86	
d. Subject all distributions in excess of $112,500 per year to a 10 percent excise tax.	1-1-86	
5. Miscellaneous changes.		
a. Extend deduction limits for tax-favored retirement plans to employee stock ownership plans, and repeal the employee stock ownership plan credit.	1-1-86	
b. Repeal "cash or deferred arrangements."	1-1-86	
c. Subject reversions of funds from tax-favored retirement plans to employers to a 10 percent excise tax.	1-1-86	
D. <u>Neutrality Toward the Form of Business Organization</u>		
1. Reduce double taxation of distributed corporate earnings by allowing 50% dividend paid deduction. (Allow 50% dividends-received deduction for intercorporate dividends).	1-1-87	Phase-In -- 25% deduction for 1 year, with increases of 5% per year to 50% deduction by 1-1-92 (with matching reductions for corporate dividends-received deduction); permanent grandfathering for preferred stock issued prior to 1-1-87
2. Repeal $100/$200 exclusion of dividend income.	1-1-86	
3. Require that all limited partnerships with more than 35 limited partners be taxed as corporations.	1-1-86	for partnerships formed after date legislation is introduced;
	1-1-90	for partnerships existing prior to date legislation is introduced

Proposed Changes	Effective Dates and Transition Rules	
III. INDUSTRY-SPECIFIC SUBSIDIES, TAX SHELTERS AND OTHER TAX ISSUES		
A. General Issues of Income Measurement		
1. Match expenses and receipts from multiperiod production.	1-1-86	for costs incurred on long-term contracts after 1-1-86 and self-constructed assets built after 1-1-86, with 10 year phase-in for existing timber and with income increase for inventory change spread evenly over 6 years
2. Restrict use of cash accounting method.	1-1-86	with income increase due to change spread evenly over 6 years
3. Limit bad debt deductions to actual loan losses.	1-1-86	with income increase due to change spread evenly over 10 years
4. Disallow installment sales treatment when receivables are pledged.	1-1-86	for new pledges; pledges existing prior to 1-1-86 would be subject to new rules 1-1-91
5. Repeal corporate minimum tax (only if basic reforms are fully implemented).	1-1-90	delay allows time to tax current preferences which are grandfathered
B. Subsidies for Specific Industries.		
1. Energy and Natural Resource Subsidies		
a. Repeal windfall profits tax.	1-1-88	move forward 3 years phase-out currently scheduled to begin on 1-1-91; complete repeal by 1-1-91 (instead of currently scheduled 1-1-94)
b. Repeal percentage depletion; use cost depletion, adjusted for inflation.	1-1-86	
c. Repeal expensing of intangible drilling costs.	1-1-86	
d. Repeal expensing of qualified tertiary injectant expenses.	1-1-86	
e. Repeal expensing of hard mineral exploration and development costs.	1-1-86	
f. Repeal special treatment of royalty income.	1-1-86	
g. Repeal special rules for mining reclamation reserves.	1-1-86	
h. Repeal non-conventional fuel production tax credit, alchohol fuels credit and excise tax exemption.	1-1-86	except for legislated exceptions regarding fuel from plants completed by 1-1-86
2. Special Rules of Financial Institutions		
a. Commercial banks and thrift institutions		
1. Repeal special bad debt deductions for banks and thrift institutions.	1-1-86	with income increase due to change spread evenly over 10 years
2. Disallow 100% of interest incurred to carry tax-exempt bonds by depository institutions.	1-1-86	for bonds acquired after 1-1-86; permanent grandfathering for bonds acquired prior to 1-1-86

Proposed Changes	Effective Dates and Transition Rules	
3. Repeal tax exemption of credit unions.	1-1-86	
4. Repeal special carryover rules, and repeal special merger rules for thrift institutions.	1-1-86	
b. Life Insurance Companies		
1. Limit life insurance reserve deductions to the increase in policyholders' cash surrender value.	1-1-86	for policies issued after 1-1-86; permanent grandfathering for policies issued prior to 1-1-86
2. Repeal special deduction of percentage of taxable income of life insurance companies.	1-1-86	
3. Repeal tax exemption for certain insurance companies.	1-1-86	
c. Property and Casualty (P&C) Insurance Companies		
1. Limit P&C reserves to the discounted present value of future liabilities.	1-1-86	for reserves acquired after 1-1-86; no recapture on reserves acquired prior to 1-1-86
2. Repeal mutual P&C insurance companies' deduction for additions to protection against loss account.	1-1-86	for policies issued after 1-1-86; income increase due to new rules (including existing "permanently deferred" amounts in income) would be spread evenly over 6 years.
3. Limit deductibility of P&C policyholder dividends.	1-1-86	
4. Repeal special tax exemption, rate reductions, and deductions of small mutual P&C insurance companies.	1-1-86	
3. Insurance Investment Income		
a. Repeal exclusion of investment income on life insurance policies.	1-1-86	for income earned after 1-1-86;
b. Treat policyholder loans as coming first from any tax-exempt inside buildup.	1-1-86	for loans made after 1-1-86; loans existing prior to 1-1-86 would be subject to new rules 1-1-91
c. Repeal exclusion of current annuity income.	1-1-86	for income earned after 1-1-86;
4. State and Local Government Debt and Investments		
a. Repeal the tax exemption of nongovernmental purpose tax-exempt bonds.	1-1-86	for bonds issued after 1-1-86, but allow refinancing of existing obligations with no extension of maturity
b. Tighten restrictions on tax arbitrage and advance refunding for tax-exempt bonds.	1-1-86	for bonds issued after 1-1-86, including refundings
5. Special Expensing and Amortization Rules		
a. Repeal expensing of soil and water conservation expenditures, expenditures by farmers for fertilizer and for clearing fields.	1-1-86	for contracts after date legislation is introduced; permanent grandfathering for contracts prior to date legislation is introduced

Proposed Changes	Effective Dates and Transition Rules
b. Repeal 5-year amortization of expenditures for rehabilitation of low income rental housing.	1-1-86 for contracts after date legislation is introduced; permanent grandfathering for contracts prior to date legislation is introduced
c. Repeal 5-year amortization of certified pollution control facilities.	1-1-86 for contracts after date legislation is introduced; permanent grandfathering for contracts prior to date legislation is introduced
d. Repeal 50-year amortization of railroad grading and tunnel bores.	1-1-86 for contracts after date legislation is introduced; permanent grandfathering for contracts prior to date legislation is introduced
e. Repeal 5-year amortization of trademark expenses.	1-1-86 for contracts after date legislation is introduced; permanent grandfathering for contracts prior to date legislation is introduced
f. Repeal 84-month amortization of reforestation expenditures and 10% tax credit for such expenditures.	1-1-86 for contracts after date legislation is introduced; permanent grandfathering for contracts prior to date legislation is introduced
6. Other Specific Subsidies	
a. Repeal rehabilitation tax credits.	1-1-86 for leases signed after date legislation is introduced; permanent grandfathering for leases signed prior to date legislation is introduced
b. Repeal special rules for returns of magazines and paperback books and for qualified discount coupons.	effective year of enactment, with balances of suspense accounts existing prior to enactment deductible in the year of enactment
c. Repeal exclusion relating to Merchant Marine Capital Constuction Fund.	1-1-86 for income earned after 1-1-86 with no tax-free contributions after date legislation is introduced; special rules for withdrawals between 1-1-86 and 1-1-96 with funds remaining on 1-1-96 treated as withdrawn at that time
d. Rationalize credit for research and experimentation.	1-1-86 for all research and experimentation after date legislation is introduced
C. Further Curtailment of Tax Shelters	
1. Disallow most current interest deductions (with carryforward) in excess of the sum of mortgage interest on the taxpayer's principal residence, investment income, income from limited partnerships and S corporations, and $5,000.	1-1-86 Phase-In -- use new netting rules with existing $10,000 limit for 2 years; drop limit to $5,000 beginning 1-1-88
2. Extend at risk limitations to real estate and equipment leasing.	1-1-86 for sales and leases after date legislation is introduced; permanent grandfathering for sales and leases prior to date legislation is introduced

Proposed Changes	Effective Dates and Transition Rules	
D. International Issues		
1. Change foreign tax credit limitation to a separate per country limitation.	1-1-86	excess foreign tax credits accumulated prior to 1-1-86 carried forward up to 5 years; losses occurring prior to 1-1-86 recaptured until exhausted
2. Modify rules defining source of income derived from sales of inventory-type property and intangible property.	1-1-86	for all sales after date legislation is introduced; permanent grandfathering for sales contracted prior to date legislation is introduced
3. Repeal the secondary dividend rule and replace with a branch profits tax.	1-1-86	
4. Repeal special preference for 80/20 corporations.	1-1-86	for all interest paid on obligations incurred after date legislation is introduced; permanent grandfathering for interest paid on obligations incurred prior to date legislation is introduced
5. Repeal possessions tax credit and replace with a phased out wage credit.	1-1-87	delay allows time for adjustment to new wage credit
6. Clarify treatment of certain transactions in foreign currency.	1-1-86	for all transactions after enactment; option to elect grandfathering on hedging contracts open as of 1-1-86
E. Other Tax Issues		
1. Transfer Taxation		
a. Unify estate and gift tax structure by grossing up the tax on gifts, and simplify rules for determining when a transfer is complete for gift tax purposes.	1-1-86	with special treatment for gifts transferred prior to 1-1-86
b. Simplify taxation of generation-skipping transfers, and modify credit for tax on prior transfers to a lower generation.		new generation skipping transfer rules apply to transfers made after enactment with exception of transfers made under wills or revocable trusts of decedents dying before one year after enactment date; new tax credit rules apply to estates of decedents dying one year after enactment date; delay allows time for adjustment to new rules
c. Impose a rule to prevent abuse of minority discounts.		new rules apply to transfers occurring and decedents dying after enactment date; special rules would apply to fractional transfers made prior to enactment date

Proposed Changes	Effective Dates and Transition Rules	
d. Replace the rules governing payment of estate tax in installments with simplified rules based on estate liquidity, but make interest incurred by an estate non-deductible for estate tax purposes.	1-1-86	
e. Reduce estate tax deduction for claims against an estate by the amount of income tax savings from payment of the expense.	1-1-86	for decedents dying after 1-1-86; for decedents dying prior to 1-1-86, new rules would apply to income recognized and deductions paid after 1-1-87
f. Simplify state death tax credit by making it a flat percentage of federal estate tax collected.		new rules apply to decedents dying one year after enactment date
g. Repeal special tax rules for redemption of stock to pay death taxes.	1-1-86	for decedents dying after 1-1-86, except for one year delay to 1-1-87 for redemptions pursuant to agreements binding on 1-1-86
h. Tighten rules regarding powers of appointment.	1-1-86	
2. Penalties		
a. Simplify information return penalties.	1-1-86	
b. Repeal maximum limits on penalties.	1-1-86	
c. Replace failure-to-pay penalty with a cost of collection charge.	1-1-86	
3. Expiring Provisions		
a. Residential and certain business energy tax credits.	1-1-86	with unused credits carried forward
b. Targeted jobs tax credit.	1-1-88	
c. Expensing of expenditures to remove architectural barriers to the elderly and handicapped.	1-1-86	
d. Credit for testing orphan drugs.	1-1-88	
e. Special treatment for dividend reinvestment in public utility stock.	1-1-86	
f. Exclusion of employer-provided legal services.	1-1-86	
g. Exclusion of employer-provided educational assistance.	1-1-86	
h. Exclusion of employer-provided van-pooling.	1-1-86	

Fundamental Tax Reform
Change in Receipts by Source

($millions)

	1986	1987	1988	1989	1990
	Fiscal Years				
INCOME TAX REFORM AND SIMPLIFICATION FOR INDIVIDUALS 1/					
A. Rate Reduction					
Rate schedules (see Note B at end of table).................	-33,824	-92,696	-106,710	-118,197	-132,093
B. Fairness for Families					
Increase the Zero Bracket Amount...........................	2/	2/	2/	2/	2/
Increase personal exemptions...............................	2/	2/	2/	2/	2/
Fold exemptions for the blind and elderly into an expanded credit for the elderly and disabled, make all taxable disability income eligible..............................	-56	-372	-354	-335	-319
Repeal second earner deduction.............................	2/	2/	2/	2/	2/
Index earned income tax credit.............................	-7	-215	-380	-498	-578
Replace child and dependent care credit with a deduction from gross income..............................	-25	-254	-280	-303	-328
Fairness to Families, subtotal.............................	-88	-841	-1,014	-1,136	-1,224
C. Fair and Neutral Taxation					
Excluded Sources of Income:					
Limit exclusion of health insurance........................	--	4,648	8,012	9,835	11,870
Repeal exclusion of group term life insurance..............	--	1,592	2,551	2,819	3,044
Repeal exclusion of employer provided death benefits........	7	49	49	49	49
Repeal exclusion of dependent care services.................	4	6	7	8	10
Repeal special treatment of cafeteria plans.................	196	709	1,645	2,713	3,218
Repeal exemption of VEBAs, supplementary unemployment trusts, and black lung disability trusts......	157	419	457	483	540
Repeal exclusion of employee awards........................	*	*	*	*	*
Repeal exclusion of certain military pay...................	3/	3/	3/	3/	3/
Repeal exclusion of parsonage allowances...................	--	50	152	160	164
Repeal tax exempt threshold for unemployment compensation...	--	531	1,466	1,404	1,313
Repeal exclusion of workers' compensation (net of credit)...	--	218	1,515	1,895	2,093
Repeal exclusion of veterans' service disability compensation (net of credit)...............................	--	919	1,475	1,538	1,603
Limit exclusion of scholarships and fellowships............	30	202	207	213	219
Repeal exclusion of prizes and awards......................	*	*	*	*	*
Excluded Sources of Income, subtotal.......................	394	9,343	17,536	21,118	24,122
Preferred Uses of Income:					
Repeal deduction for state and local taxes.................	2,378	18,631	33,862	35,685	38,683
Repeal above-the-line charitable contributions deduction....	419	2,687	--	--	--
Limit charitable contribution deductions (2% income floor)..	982	4,209	5,782	6,245	6,744
Limit charitable deduction for appreciated property.........	62	211	232	255	281
Repeal 50% & 30% individual charitable contribution limits..	-70	-241	-265	-291	-321
Repeal 10% corporate charitable contribution limit Corporate...	-30	-63	-70	-77	-84
Preferred Uses of Income, subtotal:					
Individual...	3,771	25,497	39,611	41,894	45,387
Corporate..	-30	-63	-70	-77	-84

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($millions)

	1986	1987	1988	1989	1990
	Fiscal Years				
D. Tax Abuses					
Restrict entertainment expense deductions and limit deduction for business meals					
Individual	170	551	645	695	746
Corporate	448	887	1,028	1,110	1,191
Limit deduction for meals and lodging away from home					
Individual	41	72	78	84	90
Corporate	16	24	26	28	30
Limit temporary assignments to 1 year					
Individual	13	19	20	22	24
Require allocation of travel expenses					
Individual	18	138	149	161	174
Corporate	27	47	51	56	60
Deny deduction for education travel					
Individual	13	18	18	18	18
Corporate	*	*	*	*	*
Deny deduction for cruise ship seminars					
Individual	1	4	4	4	4
Corporate	*	*	*	*	*
Limit deduction for luxury water travel					
Individual	1	4	4	4	4
Corporate	*	*	*	*	*
Tighten grantor trust rules					
Individual	3	12	16	20	25
Revise taxation of trusts					
Individual	271	848	933	1,025	1,129
Tax unearned income of children under 14 at parent's rate					
Individual	149	462	509	559	615
Tax abuses, subtotal:					
Individual	679	2,128	2,376	2,593	2,828
Corporate	491	958	1,105	1,194	1,281
E. Further Simplification					
IRS non-filing system	--	--	--	--	--
Repeal individual minimum taxes	--	--	--	--	4/
Move miscellaneous deductions above the line and combine employee business expense	215	1,452	1,568	1,694	1,830
Repeal political contribution credit	*	301	309	331	353
Repeal presidential campaign checkoff	--	--	--	--	--
Repeal deduction for adoption expenses	3/	3/	3/	3/	3/
Disallow income averaging for full time students	133	541	589	637	687
Simplification, subtotal	348	2,294	2,466	2,662	2,870
F. Other Miscellaneous Reforms					
Increase limits on moving expenses	-40	-408	-449	-494	-543
Allow some commuting deductions if regular place of work	-18	-119	-122	-134	-138
Other Miscellaneous, subtotal	-58	-527	-571	-628	-681

($millions)

	Fiscal Years 1986	1987	1988	1989	1990
BASIC TAXATION OF CAPITAL AND BUSINESS INCOME					
A. Reduce Corporate Tax Rates					
Reduce maximum corporate rate to 33%					
Corporate	-12,549	-35,343	-46,454	-51,039	-58,393
Repeal graduated corporate rate structure					
Corporate	1,629	5,966	7,924	7,793	7,868
Repeal personal holding company tax					
Corporate	--	--	--	--	--
Reduce corporate tax rates, subtotal:					
Corporate	-10,920	-29,377	-38,530	-43,246	-50,525
B. Taxing Real Economic Income					
Index capital gains, repeal exclusion					
Individual	4	22	463	6,411	-5,579
Corporate	-532	-1,302	-2,052	594	1,836
Economic depreciation (inflation adjusted)					
Individual	713	2,945	6,141	9,706	12,872
Corporate	5,989	18,942	35,618	51,881	68,055
Repeal investment tax credit					
Individual	1,519	4,319	5,043	5,696	6,246
Corporate	12,993	23,510	26,582	29,169	31,650
Repeal collapsible corporation rules					
Corporate	--	--	--	--	--
Allow expensing of first $5,000 of depreciable business property, repeal scheduled increases					
Individual	--	--	77	184	173
Corporate	--	--	132	220	215
Allow indexed FIFO, repeal conformity					
Individual	-91	-283	-289	-282	-277
Corporate	-3,062	-5,962	-6,008	-5,881	-5,767
Index interest receipts and payments					
Individual	--	--	-1,440	-12,814	-12,974
Corporate	--	--	-3,340	-5,703	-6,246
Taxing real economic income, subtotal:					
Individual	2,145	7,003	9,995	8,901	461
Corporate	15,388	35,188	50,932	70,280	89,743
C. Retirement Saving					
Increase IRA limit to $2,500, equalize spousal IRA limit					
Individual	-1,010	-2,764	-3,005	-3,279	-3,618
Uniform distribution requirements					
Individual	*	*	*	*	*
Excise	--	*	*	*	*
Tax on pre-retirement distributions, uniform basis recovery rules					
Individual	-64	-135	61	300	587

($millions)

	Fiscal Years				
	1986	1987	1988	1989	1990
Tax on qualified plan reversions					
Corporate	29	20	20	20	20
Repeal 10 year averaging of lump sum distributions					
Individual	-4	50	134	227	329
Repeal 3 year basis recovery rule for contributory plans					
Individual	742	2,058	2,651	2,669	2,688
Eliminate deferral of appreciation on employer retirement securities					
Individual	50	79	85	92	100
Simplify contribution deduction limits					
Individual	20	55	60	67	74
Excise tax on excess retirement contributions					
Individual	*	*	1	1	2
Excise	--	*	*	*	*
Repeal combined plan limit for non-topheavy plans					
Individual	-89	-248	-276	-310	-347
Tax on retirement distributions in excess of ceiling					
Individual	14	15	16	17	17
Repeal ESOP credit, modify deduction limits					
Individual	*	*	*	*	*
Corporate	1,062	2,113	1,371	550	345
Repeal cash and deferred arrangements					
Individual	603	863	936	1,035	1,154
Retirement saving, subtotal:					
Individual	262	-27	662	819	985
Corporate	1,091	2,133	1,391	570	365
Excise	--	*	*	*	*
D. Neutrality Toward the Form of Business Organization					
Dividend relief					
Individual	--	181	1,526	4,540	7,362
Corporate	--	-9,803	-20,678	-28,983	-38,238
Repeal dividend exclusion					
Individual	191	581	604	627	653
Tax all limited partnerships with more than 35 partners at corporate rates					
Individual	174	453	268	151	76
Corporate	142	232	223	215	207
Neutrality toward business organization, subtotal:					
Individual	365	1,215	2,398	5,318	8,091
Corporate	142	-9,571	-20,455	-28,768	-38,031

($millions)

	Fiscal Years 1986	1987	1988	1989	1990
INDUSTRY SPECIFIC SUBSIDIES, TAX SHELTERS, AND OTHER TAX ISSUES					
A. Other General Issues of Income Measurement					
Match expense and income from multiperiod construction					
Individual	142	716	160	1,836	1,965
Corporate	1,871	5,111	8,790	11,881	13,863
Restrict use of cash accounting method					
Individual	61	184	184	184	184
Corporate	357	594	594	594	594
Limit bad debt deductions to actual loss					
Individual	21	64	67	70	72
Corporate	664	1,129	1,187	1,239	1,257
Limit installment sales treatment					
Individual	140	439	497	563	639
Corporate	98	176	200	227	257
Repeal corporate minium tax					
Corporate	--	--	--	--	--
Income measurement, subtotal:					
Individual	364	1,403	908	2,653	2,860
Corporate	2,990	7,010	10,771	13,941	15,971
B. Subsidies for Specific Industries					
Energy Subsidies:					
Repeal business energy credits					
Individual	-45	-69	-73	-78	-84
Corporate	-151	-260	-274	-287	-283
Excise	213	323	345	369	393
Repeal percentage depletion					
Individual	530	1,226	1,301	1,375	1,430
Corporate	834	1,209	1,332	1,453	1,548
Index basis of certain depletable assets					
Individual	--	-8	-32	-61	-88
Corporate	--	-58	-178	-310	-427
Repeal expensing of intangible drilling costs					
Individual	651	1,605	1,264	1,043	1,014
Corporate	4,760	6,979	5,439	4,729	4,620
Repeal expensing of tertiary injectant expenses					
Individual	--	--	--	--	--
Corporate	21	57	93	132	174
Repeal expensing of hard mineral exploration and development costs					
Individual	--	--	--	--	--
Corporate	*	*	43	73	79
Repeal special treatment of royalty income					
Individual	36	99	106	112	119
Corporate	5	9	9	10	10

($millions)

	Fiscal Years				
	1986	1987	1988	1989	1990
Repeal special rules for mining reclamation reserves					
Individual	7	22	25	27	30
Corporate	22	39	43	47	52
Accelerate phase-out of Windfall Profit Tax					
Individual	--	--	16	71	148
Corporate	--	--	167	620	1,118
Excise	--	--	-476	-2,106	-3,482
Energy, subtotal:					
Individual	1,179	2,875	2,607	2,489	2,569
Corporate	5,491	7,975	6,674	6,467	6,891
Excise	213	323	-131	-1,737	-3,089
Financial Institutions:					
Repeal depository institution's bad debt reserve deductions					
Corporate	996	1,750	1,687	1,669	1,775
Disallow interest incurred to carry tax exempts 5/					
Individual	-1,118	-4,165	-5,302	-4,019	-4,330
Corporate	1,880	5,127	5,046	4,297	4,630
Repeal tax exemption of credit unions					
Corporate	120	212	233	257	282
Repeal merger and carryover rules					
Corporate	3	4	4	4	4
Limit life insurance reserve deductions					
Corporate	379	658	704	753	806
Repeal special percentage of taxable income deduction for life insurance companies					
Corporate	521	907	974	1,046	1,121
Repeal tax exemption of certain life insurance companies					
Corporate	129	224	240	257	275
Limit P&C reserves					
Corporate	1,807	3,070	3,169	3,276	3,391
Repeal P&C insurance company deduction for addition to protection against loss accounts					
Corporate	94	139	111	83	53
Limit deductibility of P&C dividends					
Corporate	63	108	114	119	125
Repeal special tax exemption, rate reductions, and deductions of small mutual P&C companies					
Corporate	16	28	30	32	34
Financial institutions, subtotal:					
Individual	-1,118	-4,165	-5,302	-4,019	-4,330
Corporate	6,008	12,227	12,312	11,793	12,496
Insurance Investment Income:					
Repeal exclusion of inside buildup					
Individual	1,296	3,951	3,627	2,779	2,959
Treat loans as coming first from tax exempt buildup					
Individual	*	*	*	*	*

($millions)

	Fiscal Years				
	1986	1987	1988	1989	1990
Repeal exclusion of current annuity income					
Individual	619	1,889	1,734	1,329	1,415
Insurance investment income, subtotal:					
Individual	1,915	5,840	5,361	4,108	4,374
State and Local Government Debt and Investments:					
Repeal exemption for private purpose bonds					
Individual	133	589	916	1,132	1,297
Corporate	413	1,303	1,574	1,858	2,157
Tighten restrictions on tax exempt bond arbitrage					
Individual	27	70	64	57	54
Corporate	87	139	127	114	111
State and local government, subtotal:					
Individual	160	659	980	1,189	1,351
Corporate	500	1,442	1,701	1,972	2,268
Special Expensing and Amortization Rules:					
Repeal expensing of conservation expenditures and farmers fertilizer and field clearing					
Individual	283	631	197	204	212
Corporate	297	266	116	120	125
Repeal 5 year amortization of expenditures for rehabilitation of low income rental housing					
Individual	1	3	6	7	8
Corporate	1	5	10	12	13
Repeal 5 year amortization of pollution control					
Corporate	*	*	*	*	*
Repeal 50 year amortization of railroad tunnels and bores					
Corporate	*	*	*	*	*
Repeal 5 year amortization of trademark expenses					
Individual	3	8	14	20	26
Corporate	1	4	7	10	14
Repeal 84 month amortization, 10% credit for reforestation					
Individual	*	*	*	*	*
Corporate	*	*	*	*	*
Special expensing and amortization, subtotal:					
Individual	287	642	217	231	246
Corporate	299	275	133	142	152
Other Specific Subsidies:					
Repeal rehabilitation tax credits					
Individual	80	346	876	1,595	2,069
Corporate	44	143	339	521	623
Tighten rules for depreciating leasehold improvements					
Corporate	*	*	*	*	*
Repeal special rules for returns of magazines etc and qualified discount coupons					
Corporate	161	97	*	*	*

($millions)

	Fiscal Years				
	1986	1987	1988	1989	1990
Repeal exclusion of Merchant Marine Capital Construction Fund					
Corporate..	24	40	45	45	50
Modify credit for research and experimentation					
Individual..	-10	-27	-29	-31	-35
Corporate..	-577	-1,169	-1,474	-1,710	-1,928
Other subsidies, subtotal:					
Individual..	70	319	847	1,564	2,034
Corporate..	-348	-889	-1,090	-1,144	-1,255
C. Further Curtailment of Tax Shelters					
Limit interest deductions					
Individual..	403	1,385	1,522	1,778	1,843
Limit artificial losses (at risk rules)					
Individual..	300	749	609	454	281
Tax shelters, subtotal:					
Individual..	703	2,134	2,131	2,232	2,124
D. International Issues					
Use per country limitation for foreign tax credit					
Corporate..	900	2,500	2,980	3,278	3,606
Modify rules concerning source of income and allocation of deductions					
Corporate..	120	310	400	470	540
Replace secondary dividend rule with branch profit tax					
Corporate..	--	10	30	30	30
Replace possessions tax credit with wage credit					
Corporate..	--	400	1,000	1,100	1,210
Treat foreign exchange gains or losses as adjustments in interest					
Corporate..	10	20	20	20	20
International Issues, subtotal:					
Corporate..	1,030	3,240	4,430	4,898	5,406
E. Other Related Tax Issues					
Transfer Taxation:					
Unify estate and gift tax rate structure					
Estate and gift..	208	-145	-159	-131	-103
Revise generation skipping tax, modify credit for tax on prior transfers to a lower generation					
Estate and gift..	--	*	*	*	*
Prevent abuse of minority discounts					
Estate and gift..	--	*	*	*	*
Simplify installment rules based on liquidity, deny deductibility of interest incurred by estate					
Individual..	--	-22	-26	-24	*
Estate and gift..	--	39	41	10	10

($millions)

	Fiscal Years				
	1986	1987	1988	1989	1990
Reduce deduction for claims against estate					
Estate and gift	--	*	*	*	*
Modify state death tax credit					
Estate and gift	--	--	--	--	--
Repeal special rules for redemption of stock to pay tax					
Individual	-*	-*	-*	-*	-*
Transfer Taxation, subtotal:					
Individual	-*	-22	-26	-24	-*
Estate and gift	208	-106	-118	-121	-93
Penalties:					
Simplify information return penalties					
Individual	--	--	--	--	--
Corporate	--	--	--	--	--
Repeal maximum limits for penalties					
Individual	18	18	19	19	19
Corporate	3	3	3	3	3
Estate and gift	*	*	*	*	*
Excise	*	*	*	*	*
Change failure-to-pay penalty to cost-of-collection charge					
Individual	290	295	301	307	313
Corporate	29	31	34	37	39
Estate and gift	12	12	12	12	12
Excise	8	8	8	8	8
Penalties, subtotal:					
Individual	308	313	320	326	332
Corporate	32	34	37	40	42
Estate and gift	12	12	12	12	12
Excise	8	8	8	8	8

($millions)

	Fiscal Years 1986	1987	1988	1989	1990
Total Change in Receipts:					
Individual	-22,138	-36,613	-25,209	-25,908	-37,693
Corporate	22,164	30,582	29,341	38,062	44,720
Estate and gift	220	-94	-106	-109	-81
Excise	221	331	-123	-1,729	-3,081
Total	467	-5,794	3,903	10,316	3,865
Current Service Midsession Review Receipts:					
Individual	373,033	407,705	452,438	493,080	537,373
Corporate	87,942	102,718	111,617	116,998	122,638
Estate and gift	5,401	5,036	4,780	4,778	5,127
Excise	36,111	36,785	35,401	34,708	34,028
Total	502,487	552,244	604,236	649,564	699,166
Proposed Law Receipts:					
Individual	350,895	371,092	427,229	467,172	499,680
Corporate	110,106	133,300	140,958	155,060	167,358
Estate and gift	5,621	4,942	4,674	4,669	5,046
Excise	36,332	37,116	35,278	32,979	30,947
Total	502,954	546,450	608,139	659,880	703,031

Office of the Secretary of the Treasury
Office of Tax Analysis

November 25, 1984

* - negligible
1/ Individual unless otherwise noted.
2/ Included in individual rate schedule estimate.
3/ The effect of repeal of these provisions is assumed to be offset by increased expenditures. The receipts generated by these provisions are not shown in this table.
4/ Included in tax preference provisions.
5/ The proposal would effectively eliminate the use of deposits by banks for leveraged holdings of tax exempt bonds. These bonds would then be held primarily by individuals.

Note A: The estimates are based on the Midsession Review of the 1985 Budget. The effects of the reduced corporate and individual rates are estimated assuming all other provisions are enacted. The revenue effects of all other provisions reflect current law tax rates.

Note B: The individual rate schedule estimate assumes that the relationship between collections and tax liability is unchanged from current law. The 1986 level revenue effect may be significantly altered depending on the prescribed changes in the withholding tables and the estimated tax rules.

APPENDIX C

SUMMARY INTERNATIONAL COMPARISONS

The attached tables summarize some highlights of the tax systems of several major U.S. trading partners.

The tables should be read with caution, as many of the features which determine the impact or burden of a tax cannot be accurately presented in such a summary form. For example, it requires a great deal of information to define the base of an income tax; but without doing so, little can be learned from a comparison of tax rates. Even if one could measure the base and rate for a selected pattern of income and deductions, it is difficult to select income levels which represent comparable living standards in different countries and lines of activity.

For such reasons, the tables select certain aspects of foreign tax systems which can be more easily compared in a summary fashion, seeking to minimize both complex qualifications and inaccuracy. The foreign countries included in the comparison are France, Germany, the Netherlands, Sweden, the United Kingdom, Japan and Canada.

Level and Composition of Taxes

Part I of the table illustrates the share of tax revenues in total domestic production in the respective countries and the extent to which each country relies on different types of taxes.

The figures shown include taxes imposed at all levels of government. Part I shows that the share of tax revenues in domestic production varies substantially among the countries compared. Japan and the United States are at the lower end of the scale with ratios of 27 and 30 percent, respectively. In Canada, Germany, and the United Kingdom, the ratios fall between 35 and 40 percent. And in France, the Netherlands, and Sweden the ratios are roughly 45 to 50 percent.

The composition of tax revenues varies even more markedly. Japan, with the lowest ratio of taxes to output, relies more heavily than any of the other countries on the corporate income tax as a source of tax revenues. Corporate income taxes account for 20 percent of total tax revenues in Japan, compared to only 3 percent in Sweden, which has the highest ratio of taxes to output. Total income taxes (not including social security taxes) account for about 45 percent of tax revenues in the United States, Japan, Canada, and Sweden; but except in Japan, 36 to 40 percent of the total are individual income taxes with corporate income taxes contributing only 3 to 8 percent.

France relies relatively little on income taxation. Social security taxes and sales taxes account for more than 75 percent of total

French tax revenues. Social security taxes are also particularly high in Germany and the Netherlands.

Sales taxes are more important in all of the other countries than in the United States or Japan. However, even if sales taxes were ignored, only in Canada would the tax/output ratio fall below that in the United States; the other countries which have higher ratios than the United States would continue to do so. This suggests that sales taxes are often an additional source of revenue rather than a substitute for other taxes.

Individual Income Taxes

Part II summarizes some features of individual income taxes. Unlike Part I, it describes only national level taxes. Part II shows that the marginal rates of individual income tax in the United States are relatively low under current law and the top rate will be even lower under a proposed broad-based income tax. Recognizing that nominal rates of tax can present a misleading picture, section B indicates the average tax rate of a "typical" taxpayer in each of the countries, based on 1982 data. The typical taxpayer is defined as the taxpayer with the median income level for that country at that time. The U.S. tax burden ranks 4th in the group of seven countries, with an average tax rate that is higher than that in three of the other countries, but lower than that in the other four.

Five of the seven foreign countries surveyed provide some inflation adjustment for the tax threshold and bracket rates in the personal income tax. Beginning in 1985, the United States will be in line with that practice as well.

Corporate Income Tax

As shown in Part III, five of the seven countries provide tax relief for dividends paid from income that is subject to tax at the corporate level. The proposed U.S. system will also bring our practice into line with other countries on this point.

Part III also summarizes corporate tax rates at the national level and provisions for capital cost recovery. The proposed reduction in the U.S. corporate tax rate will bring that rate below that in any of the other seven countries. (Sweden also has a low national rate but imposes a substantial local corporate income tax.)

The proposed U.S. system will provide more protection against inflation-induced mismeasurement of income than that of our other trading partners. Our treatment of capital cost recovery in general will be more in line with the practice of other countries, with respect to both equipment and structures, under the proposed system than it is under present law.

Part III further illustrates that the proposed adoption of a per-country limitation on the foreign tax credit would be consistent with the typical practice of other countries that employ a foreign tax credit.

Sales Taxes

Finally, Part IV of the table gives some details on the rates and bases of value added taxes imposed in the five European countries considered. The United States, Canada and Japan do not have a national value added tax. However, Canada imposes a Federal general sales tax at the manufacturers' level, and there are provincial sales taxes at the retail level. Many U.S. states also impose general sales taxes.

The table does not attempt to give a comprehensive picture of the scope of value added taxes, but simply points out that, even within the European Economic Community, it has been difficult to standardize the treatment of different transactions.

Table C-1

SUMMARY COMPARISON OF SELECTED ASPECTS OF DIFFERENT COUNTRIES' TAX SYSTEMS

I. Types of Taxes as a Percent of Gross Domestic Product and of Total Tax Revenues, 1982 a/

	U.S. current law	France	Germany	The Netherlands	Sweden	United Kingdom	Japan	Canada
A. As percent of GDP								
Total tax revenues	30.5	43.7	37.3	45.5	50.3	39.6	27.2	34.8
Individual income tax	11.5	5.6	10.8	10.9	20.5	11.2	6.9	12.4
Corporate income tax	2.1	2.2	1.9	3.1	1.7	3.8	5.4	2.8
Social Security taxes	8.4	19.8	13.5	18.9	15.3	8.0	8.3	3.9
employee share b/	4.2	6.2	6.3	10.9	0.6	3.1	4.1	1.4
employer share	4.2	12.6	7.2	8.0	13.4	3.6	4.2	2.5
Property taxes	3.1	1.6	1.2	1.6	0.5	5.0	2.4	3.1
Sales & excise taxes	5.3	13.0	9.9	10.8	12.2	11.5	4.2	12.1
Other taxes	--	1.4	*	0.1	0.1	*	0.1	0.5
B. As percent of total taxes								
Total tax revenues	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Individual income tax	37.8	12.9	28.9	23.9	40.8	28.4	25.3	35.6
Corporate income tax	7.0	5.1	5.1	6.8	3.3	9.6	19.7	8.2
Social Security taxes	27.7	45.4	36.2	41.6	30.5	20.2	30.4	11.3
employee share b	13.8	14.4	16.8	24.0	1.1	7.9	15.0	4.1
employer share	13.8	28.8	19.4	17.6	26.8	9.0	15.4	7.2
Property taxes	10.1	3.7	3.3	3.6	1.0	12.7	8.9	9.0
Sales & excise taxes	17.4	29.7	26.5	23.8	24.2	29.0	15.4	34.6
Other taxes	--	3.2	*	0.3	0.2	0.1	0.3	1.3

* Less than 0.1 percent.
a/ Includes all levels of government.
b/ Includes taxes of self-employed.

Source: Organization for Economic Development and Cooperation, Revenue Statistics of Member Countries, 1965-83, (Paris France), 1984.

SUMMARY COMPARISON OF SELECTED ASPECTS OF DIFFERENT COUNTRIES' TAX SYSTEMS
(continued)

II. Individual Taxation

	United States current law	United States broad-based	France	Germany	The Netherlands	Sweden	United Kingdom (1986)	Japan	Canada
A. Marginal tax rates (national)	11%-50%[a]	15-35%[a]	5%-65%	22%-56%	16%-72%	6%-52%[b]	30%-60%	10.5%-70%	6%-34%[d]
B. Average tax rate of median income taxpayer in 1982[e]									
single	13.8%1	10.7%[g]	0.8%	15.9%	10.3%	30.0%	21.5%	9.6%	14.9%
married[f]	7.0%	4.5%	----	9.2%	8.0%	27.0%	16.8%	1.4%	-0.4%
C. Indexation	Brackets, zero bracket amount and exemptions (1985)	Same	Brackets	No	Brackets	Brackets allowances, adjusted yearly	Brackets,	No	Brackets, personal exemptions, certain deductions
D. Capital Gains									
occasional sales of portfolio securities	40% of net gain taxable	Taxable; basis indexed	Exempt	Exempt	Exempt	Under two years fully taxed; over two years, 40% taxed	30% of gain above indexed exempt amount; basis indexed	Exempt	Generally 50% of net gain taxable; for certain Investment Plans, 12.5% of accrued indexed gain.
sale of principal residence	Deferred; $125,000 exemption if seller over age 55	Same	Exempt	Exempt if held more than 2 years	Exempt	Taxable with reliefs	Exempt	Exempt up to 30 m. yen (approx. $125,000)	Exempt
E. Wealth tax	No	No	Yes	Yes	Yes	Yes	No	No	No
F. General sales tax	No[h]	No[h]	VAT[i]	VAT[i]	VAT[i]	VAT[i]	VAT[i]	No	Yes[j]

a. Does not include state taxes which, where applicable, range from 0.5 to 16%. A few cities also impose income taxes at rates of 0.6-4.3%. These taxes are deductible from the Federal tax base under existing law but not under the proposed broad-based tax.
b. Does not include local tax, estimated at 30%, which is deductible from the national tax base.
c. Does not include prefecture inhabitants tax which applies at 2 or 4% and municipal inhabitants tax at 2.5 to 14 percent, which are not deductible from the national tax base.
d. Does not include surcharges for provincial income tax (48% in Ontario).
e. Compiled by the OECD from national statistics. Income taxes only; does not include social security taxes.
f. Married taxpayer, two children, one wage-earner.
g. Since the 1982 data do not include the full effect of the tax cuts enacted in 1981, a better comparison between the two U.S. set of rates may be obtained by noting that if the current law rules had continued in effect, in 1986 the average tax of the median income taxpayer would have been 11.4% for a single taxpayer and 6.4% for a married taxpayer with two children.
h. However, most states impose sales taxes at the retail or manufacturers' level.
i. Value added tax. For details, see part IV.
j. Imposed at the manufacturers' or importers' level. In addition, most provinces imposes retail sales taxes.

SUMMARY COMPARISON OF SELECTED ASPECTS OF DIFFERENT COUNTRIES' TAX SYSTEMS
(continued)

III. Corporate income tax	U.S. (1984)	U.S. (proposed)	France	Germany	the Netherlands	Sweden	the United Kingdom '86	Japan	Canada
A. National tax rate	46[a]	33[a]	50	56[b]	43	32[c]	35	43.3/33.3[d]	46[e]
B. Dividend relief to shareholders									
credit or reduced rate	No	Reduced rate[f]	Credit	Both	No	No	Credit	Both	Credit
percentage of double tax relieved	0	50%	50%[g]	100%[h]	0	0	80%[i]	38%[j]	40%[k]
C. Indexing									
depreciable assets	No[l]	Yes	Occasional revaluation	No[l]	Yes[l]	No	No	No	No
inventory	No[l]	Yes		No[l]	No[l]	No	No	Yes[m]	Yes[n]
liabilities	No	Interest[o]	No	No	No	No	No	No	No
D. Sample depreciation calculation									
Equipment									
first year	14.24[p]		35%	30%	Negotiated	30%	25%	25%	50%
years 1-3	55.1[p]		72.5%	65.7%		51%	57.8%	57.8%	100%
write-off period	5 years		q	q		q	q	q	--
investment credit	10%	No	No	No	12%	No	No	No	15.7%
present value, depreciation and credit, as % of investment expense[r]									
6% inflation	100%	76%	78%	75%	N.A.	75%	71%	71%	129%[s]
4% inflation	103%	76%	81%	79%		79%	76%	76%	130%
Structures									
first year	9%		12.5%	2.5%	Negotiated	3%	4%	2.3%	5.0%
years 1-3	26%		33.0%	7.5%		9%	11.5%	6.9%	14.3%
write-off period	18 years		o	40 years		33 years	o	44 years	o
investment credit	No	No	No	No	No	No	No	No	No
present value, depreciation and investment expense[p]									
6% inflation	54	42	56	25	N.A.	30	29	23	33
4% inflation	59	42	61	30		36	33	28	38
E. Treatment of foreign income and taxes[t]									
exemption	No	No	Generally[u]	No	Generally[u]	No	No	No	No
credit	Overall	Per-country	No	Per-country	No	Per-country	Per-country and item	Overall	Per-country
deduction	Election[v]	Election[v]	Yes	Election[v]	Yes	Election[v]	Election[v]	Election[v]	Election[v]

N.A. Not available.

a. State income taxes range from 0 to 12%. Some local income taxes also apply, typically at 1 or 2 percent, but at 9 percent in New York City. The state and local taxes are deductible from the Federal tax base.

b. A 36 percent tax imposed on distributed profits is creditable to shareholders. There is also a local tax of about 15 percent which is deductible from the national tax base.

c. There is a 30 percent local tax, deductible from the national tax base.

d. The lower rate applies on distributed profits. There are also a prefectural inhabitants tax and a local inhabitants tax (5% and 12.3%, respectively, of the national tax) and a prefectural enterprise tax of 12 percent of taxable income. Only the latter is deductible from the national tax base.

e. There are also provincial taxes of about 10-15 percent of which 10 percentage points is credited against the Federal tax. The Federal tax shown is not reduced by that credit.

f. Corporations will be permitted to deduct a portion (50% when fully phased in) of the dividends they distribute out of taxed profits.

g. 25 percentage points of the corporate tax (= 1/2 of the dividend received) is added to the taxable income of the shareholder, who claims a refundable credit of the same amount.

h. The 36% percent tax on distributed profits (= 56.25% of the dividend received) is added to the taxable income of the shareholder, who claims a refundable credit of the same amount.

i. 27.86 points of the corporate tax (= 3/7 of the dividend received) is added to the taxable income of the shareholder, who claims a refundable credit of the same amount.

j. The taxpayer claims a credit equal to 10 percent of the dividend received. The credit is not added to taxable income.

k. 18.36 points of the corporate tax (= 34% of the dividend received) is added to the taxable income of the shareholder, who claims a non-refundable credit of the same amount.

l. However, LIFO (last in-first out) valuation of inventories may be used. In the United States, if LIFO is used for tax purposes it must also be used for book purposes.

m. 2.5% of the book value of certain inventories and securities may be allocated to a special reserve fund against price rises, and LIFO may be used to value inventories.

n. An annual 3% inventory write-off is allowed.

o. Inflation premium excluded from interest receipts and payments.

p. Includes effect of basis adjustment for one half of investment tax credit.

q. Declining balance ("open accounts") method used; write-off period not defined.

r. Assumes 4 percent real interest; considers equity investment only.

s. Investment credit translated into a deduction at a 46 percent corporate rate.

t. Statutory rules; may be modified in tax treaties. Similar rules apply with respect to foreign income and taxes of individuals.

u. Business income is generally exempt from tax; passive investment income is generally taxable with a deduction for foreign taxes paid.

v. Taxpayers may elect to deduct otherwise creditable foreign income taxes paid. In general, the election applies to all creditable foreign taxes paid or accrued that year.

SUMMARY COMPARISON OF SELECTED ASPECTS OF DIFFERENT COUNTRIES' TAX SYSTEMS
(continued)

IV. Value added taxes: rates and principal exemptions

	France	Germany	The Netherlands	Sweden	United Kingdom
A. Rates (percent)					
Basic rate	18.6	14	19	23.46	15
Higher rates	33.3	--	--	--	--
Lower rates	7, 5.5	6.5	5	12.87, 3.95	--
B. Principal exemptions[a]					
Exports	Yes	Yes	Yes	Yes	Yes
Real property Transfers	Some	Yes	Yes	Yes	Yes
Financial transactions	Most	Yes	Yes	Yes	Yes
Transfers of a business	---	Yes	Yes	Yes	Yes
Professional services	Many	---	---	---	---
Communications	---	---	Yes	---	---
Construction	---	---	---	---	Yes
Periodicals	---	---	---	Yes	---
Medicine	---	---	5%	Yes	Yes
Food	5.5%	6.5%	5%	---	Yes
Books	7.0%	6.5%	5%	---	Yes
Fuel	---	---	---	Yes	Yes
Transportation	7.0%	---	---	---	---

a. Some of the transactions classified as exempt may be taxable at a zero rate. The difference is that an exemption does not necessarily give rise to a refund of tax paid at prior stages, whereas a zero rate does carry a full credit. Exports, for example, are taxed at a zero rate with a refund of tax previously paid.

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