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DISCUSSION OF ISSUES RELATING TO "FLAT" TAX RATE PROPOSALS

SCHEDULED FOR A PUBLIC HEARING

BEFORE THE

SENATE COMMITTEE ON FINANCE

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on April 5, 1995, on issues relating to "flat" tax rate proposals. This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides an overview of the present-law Federal income tax structure, background on flat tax proposals, a description of S. 488 (introduced by Senator Specter), and a discussion of issues.

Part I of the pamphlet is an overview of the present-law Federal income tax structure. Part II provides background on the flat tax and the choice of a tax base. Part III is a description of S. 488. Part IV discusses certain general issues relating to proposals for a flat tax rate, and Part V discusses technical issues in the design of a flat tax and technical issues relating to the provisions of S. 488. The Appendix provides tables showing the projected distribution of certain Federal individual tax deductions for 1995.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Discussion of Issues Relating to Flat Tax Rate Proposals* (JCS–7–95), April 3, 1995.

I. PRESENT-LAW INCOME TAX

A. Individual Income Tax

In general

A United States citizen or resident alien generally is subject to the U.S. individual income tax on his or her worldwide taxable income.[2] Taxable income equals the taxpayer's total income less certain exclusions, exemptions, and deductions. The appropriate tax rates are then applied to a taxpayer's taxable income to determine his or her individual income tax liability. A taxpayer may reduce his or her income tax liability by any applicable tax credits.

Adjusted gross income

Under the Internal Revenue Code (the "Code"), gross income means "income from whatever source derived" except for certain items specifically exempt or excluded by statute. Sources of income include compensation for services, interest, dividends, capital gains, rents, royalties, alimony and separate maintenance payments, annuities, income from life insurance and endowment contracts (other than certain death benefits), pensions, gross profits from a trade or business, income in respect of a decedent, and income from an S corporation, partnership, trust or estate. Statutory exclusions from gross income include death benefits payable under a life insurance contract, interest on State and local bonds, employer-provided health insurance, employer-provided pension contributions, and certain other employer-provided fringe benefits.

An individual's adjusted gross income ("AGI") is determined by subtracting certain "above-the-line" deductions from gross income. These deductions include deductions for trade or business expenses, capital losses, contributions to a tax-qualified retirement plan by a self-employed individual, contributions to individual retirement arrangements ("IRAs"), certain moving expenses, and alimony payments.

Taxable income

In order to determine taxable income, an individual may reduce AGI by any personal exemptions and either the applicable standard deduction or his or her itemized deductions. Personal exemptions generally may be deducted for the taxpayer, his or her spouse, and any dependents. For 1995, the amount deductible for each personal exemption is $2,500. This amount is indexed annually for inflation. The deduction for personal exemptions is reduced or eliminated for taxpayers with incomes over certain thresholds.

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[2] Foreign tax credits generally are available against U.S. income tax imposed on foreign source income to the extent of foreign income taxes paid on that income. A nonresident alien generally is subject to the U.S. individual income tax only on income with a sufficient nexus to the United States.

A taxpayer also may reduce AGI by the amount of the applicable standard deduction. The basic standard deduction varies depending upon a taxpayer's filing status. For 1995, the amount of the standard deduction is $3,900 for single individuals; $5,750 for heads of households; $6,550 for married individuals filing jointly; and $3,275 for married individuals filing separately. Additional standard deductions are allowed with respect to any individual who is elderly or blind.[3] The amounts of the basic standard deduction and the additional standard deductions are indexed annually for inflation.

In lieu of taking the applicable standard deductions, an individual may elect to itemize deductions for certain expenses. The deductions that may be itemized include State and local income taxes, real property taxes and certain personal property taxes, home mortgage interest, charitable contributions, certain investment interest, medical expenses (in excess of 7.5 percent of AGI), casualty and theft losses (in excess of 10 percent of AGI and in excess of $100 per loss), and certain miscellaneous expenses (in excess of 2 percent of AGI). The total amount of itemized deductions allowed is subject to reduction for taxpayers with incomes over certain thresholds.

Tax liability

To determine tax liability, a taxpayer generally must apply the tax rate schedules (or the tax tables) to his or her taxable income. The rate schedules are broken into several ranges of income, known as income brackets, and the marginal tax rate increases as a taxpayer's income increases. Separate rate schedules apply based on an individual's filing status. For 1995, the individual income tax rate schedules are as follows:

Table 1.—Federal Individual Income Tax Rates for 1995

If taxable income is	Then income tax equals
	Single individuals
$0–$23,350	15 percent of taxable income.
$23,351–$56,550	$3,503, plus 28% of the amount over $23,350.
$56,551–$117,950	$12,799, plus 31% of the amount over $56,550.
$117,951–$256,500	$31,833, plus 36% of the amount over $117,950.
Over $256,500	$81,711, plus 39.6% of the amount over $256,500.
	Heads of households
$0–$31,250	15 percent of taxable income.
$31,251–$80,750	$4,688, plus 28% of the amount over $31,250.
$80,751–$130,800	$18,548, plus 31% of the amount over $80,750.
$130,801–$256,500	$34,063, plus 36% of the amount over $130,800.
Over $256,500	$79,315, plus 39.6% of the amount over $256,500.
	Married individuals filing joint returns
$0–$39,000	15 percent of taxable income.
$39,001–$94,250	$5,850, plus 28% of the amount over $39,000.
$94,251–$143,600	$21,320, plus 31% of the amount over $94,250.
$143,601–$256,500	$36,619, plus 36% of the amount over $143,600.
Over $256,500	$77,263, plus 39.6% of the amount over $256,500.
	Married individuals filing separate returns
$0–$19,500	15 percent of taxable income.
$19,501–$47,125	$2,925, plus 28% of the amount over $19,500.
$47,126–$71,800	$10,660, plus 31% of the amount over $47,125.
$71,801–$128,250	$18,309, plus 36% of the amount over $71,800.
Over $128,250	$38,631, plus 39.6% of the amount over $128,250.

The individual may reduce his or her tax liability by any available tax credits. Tax credits are allowed for certain business expenditures, certain foreign income taxes paid or accrued, certain child care expenditures, and with respect to certain elderly or disabled individuals. In addition, a refundable earned income tax credit is available to low-income workers who satisfy certain requirements.

Capital gains and losses

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of capital assets, the net capital gain generally is taxed at the same rate as ordinary income, except that the maximum marginal rate is limited to 28 percent of the net capital gain. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

Capital losses generally are deductible in full against capital gains. In addition, individual taxpayers may deduct capital losses against up to $3,000 of ordinary income in each year. Any remaining unused capital losses may be carried forward indefinitely to another taxable year.

A capital asset generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, and (5) certain publications of the Federal Government.

In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain. Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances. Gain from the disposition of depreciable real property generally is not treated as capital gain to the extent of the depreciation allowances in excess of the allowances that would have been available under the straight-line method.

The Revenue Reconciliation Act of 1993 added Code section 1202, which provides a 50-percent exclusion for gain from the sale of certain small business stock acquired at original issue and held for at least five years. One-half of the excluded amount is a minimum tax preference (see below).

Minimum tax

An individual is subject to an alternative minimum tax which is payable, in addition to all other tax liabilities, to the extent that it exceeds the taxpayer's regular income tax owed. The tax is imposed at rates of 26 and 28 percent on alternative minimum taxable income in excess of an exemption amount.[4] The various credits

[4] The exemption amount is $45,000 in the case of joint returns and surviving spouses, $33,750 in the case of a single individual, and $22,500 in the case of a married individual who files a

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that are allowed to offset an individual's regular tax liability generally are not allowed to offset his or her minimum tax liability. If an individual pays the alternative minimum tax, a portion of the amount of the tax paid may be allowed as a credit against the regular tax of the individual in future years.

Alternative minimum taxable income is the taxpayer's taxable income increased by the taxpayer's tax preferences and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items. Among the preferences and adjustments applicable to the individual alternative minimum tax are accelerated depreciation on certain property used in a trade or business, circulation expenditures, research and experimental expenditures, certain expenses and allowances related to oil and gas and mining exploration and development, certain tax-exempt interest income, and one half of the amount of gain excluded with respect to the sale or disposition of certain small business stock. In addition, personal exemptions, the standard deduction, and certain itemized deductions are not allowed to reduce alternative minimum taxable income.

B. Corporate Income Tax

Taxable income

Corporations organized under the laws of any of the 50 States (and the District of Columbia) generally are subject to the U.S. corporate income tax on their taxable income.[5]

The taxable income of a corporation generally is comprised of gross income, less allowable deductions. Gross income generally is income derived from any source, including gross profit from the sale of goods and services to customers, rents, royalties, interest (other than interest from certain indebtedness issued by State and local governments), dividends, gains from the sale of business and investment assets, and other income.

Allowable deductions include ordinary and necessary business expenditures, such as salaries, wages, contributions to profit-sharing and pension plans and other employee benefit programs, repairs, bad debts, taxes (other than Federal income taxes), contributions to charitable organizations (subject to an income limitation), advertising, interest expense, certain losses, selling expenses, and other expenses. Expenditures that benefit future accounting periods (such as the purchase of plant and equipment) generally are capitalized and recovered over time through depreciation, amortization or depletion allowances. A net operating loss incurred in one taxable year may be carried back 3 years or carried forward 15 years and allowed as a deduction in another taxable year. Deductions are also allowed for certain amounts despite the lack of an underlying expenditure. For example, a deduction is allowed for all

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separate return. The exemption amount is phased out for individuals with income above certain thresholds.

[5] Foreign tax credits generally are available against U.S. income tax imposed on foreign source income to the extent of foreign income taxes paid on that income. A foreign corporation generally is subject to the U.S. corporate income tax only on income with a sufficient nexus to the United States.

A qualified small business corporation may elect, under subchapter S of the Code, not to be subject to the corporate income tax. If an S corporation election is made, the income of the corporation will flow through to the shareholders and be taxable directly to the shareholders.

or a portion of the amount of dividends received by a corporation from another corporation.

The Code also specifies certain expenditures that may not be deducted, such as dividends paid to shareholders, expenses associated with earning tax-exempt income,[6] certain entertainment expenditures, certain executive compensation in excess of $1,000,000 per year, a portion of the interest on certain high-yield debt obligations that resemble equity, and fines, penalties, bribes, kickbacks and illegal payments.

Tax liability

A corporation's regular income tax liability generally is determined by applying the following tax rate schedule to its taxable income.

Table 2.—Federal Corporate Income Tax Rates

If taxable income is	Then the income tax rate is
$0–$50,000	15 percent of taxable income.
$50,001–$75,000	25 percent of taxable income.
$75,001–$10,000,000	34 percent of taxable income.
Over $10,000,000	35 percent of taxable income.

The first two graduated rates described above are phased out for corporations with taxable income between $100,000 and $335,000. As a result, a corporation with taxable income between $335,000 and $10,000,000 effectively is subject to a flat tax rate of 34 percent. Also, the application of the 34-percent rate is gradually phased out for corporations with taxable income between $15,000,000 and $18,333,333 such that a corporation with taxable income of $18,333,333 or more effectively is subject to a flat rate of 35 percent.

The maximum rate of tax on the net capital gains of a corporation is 35 percent. A corporation may not deduct the amount of capital losses in excess of capital gains for any taxable year. Disallowed capital losses may be carried back three years or carried forward five years.

Like individuals, corporations may reduce their tax liability by any applicable tax credits. Tax credits applicable to businesses include credits for producing fuels from nonconventional sources, the investment tax credit (applicable to investment in certain reforestation, renewable energy property, and the rehabilitation of certain real property), the alcohol fuels credit (applicable to production of certain alcohol fuels), the research credit (applicable to the incremental investment in certain research and experimental activities), the low-income housing credit (applicable to the investment in certain low-income housing projects), the enhanced oil recovery credit (applicable to the recovery of certain difficult-to-extract oil reserves), the empowerment zone employment credit (applicable to wages paid to certain residents of empowerment zones), and the disabled access credit (applicable to expenditures by certain small

[6] For example, the carrying costs of tax-exempt State and local obligations and the premiums on life insurance policies are not deductible.

businesses to make the business accessible to disabled individuals). The credits generally are determined based on a percentage of the cost associated with the underlying activity and generally are subject to certain limitations.

Affiliated group

Domestic corporations that are affiliated through 80 percent or more corporate ownership may elect to file a consolidated return in lieu of filing separate returns. Corporations filing a consolidated return generally are treated as a single corporation; thus, the losses (and credits) of a corporation can offset the income (and thus reduce the otherwise applicable tax) of other affiliated corporations.

Minimum tax

A corporation is subject to an alternative minimum tax which is payable, in addition to all other tax liabilities, to the extent that it exceeds the corporation's regular income tax liability. The tax is imposed at a flat rate of 20 percent on alternative minimum taxable income in excess of a $40,000 exemption amount.[7] The various credits that are allowed to offset a corporation's regular tax liability generally are not allowed to offset its minimum tax liability. If a corporation pays the alternative minimum tax, the amount of the tax paid is allowed as a credit against the regular tax in future years.

Alternative minimum taxable income is the corporation's taxable income increased by the corporation's tax preferences and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items. In addition, corporations are subject to a second set of adjustments known as the adjusted current earnings adjustment.

Among the preferences and adjustments applicable to the corporate alternative minimum tax are accelerated depreciation on certain property, certain expenses and allowances related to oil and gas and mining exploration and development, certain amortization expenses related to pollution control facilities, and certain tax-exempt interest income. In addition, corporate alternative minimum taxable income is increased by 75 percent of the amount by which the corporation's "adjusted current earnings" exceeds its alternative minimum taxable income (determined without regard to this adjustment). Adjusted current earnings generally are determined with reference to the rules that apply in determining a corporation's earnings and profits.

Treatment of corporate distributions

The taxation of a corporation generally is separate and distinct from the taxation of its shareholders. A distribution by a corporation to one of its shareholders generally is taxable as a dividend to the shareholder to the extent of the corporation's current or accu-

[7] The exemption amount is phased out for corporations with income above certain thresholds, and is completely phased out for corporations with alternative minimum taxable income of $310,000 or more.

mulated earnings and profits.[8] Thus, the amount of a corporate dividend generally is taxed twice: once when the income is earned by the corporation and again when the dividend is distributed to the shareholder. Conversely, amounts paid as interest to the debtholders of a corporation generally are subject to only one level of tax (at the recipient level) since the corporation generally is allowed a deduction for the amount of interest expense paid or accrued.

Amounts received by a shareholder in complete liquidation of a corporation generally are treated as full payment in exchange for the shareholder's stock. A liquidating corporation recognizes gain or loss on the distributed property as if such property were sold to the distributee for its fair market value. However, if a corporation liquidates a subsidiary corporation of which it has 80 percent or more control, no gain or loss generally is recognized by either the parent corporation or the subsidiary corporation.

Accumulated earnings and personal holding company taxes

Taxes at a rate of 39.6 percent (the top marginal rate applicable to individuals) may be imposed upon the accumulated earnings or personal holding company income of a corporation. The accumulated earnings tax may be imposed if a corporation retains earnings in excess of reasonable business needs. The personal holding company tax may be imposed upon the excessive passive income of a closely held corporation. The accumulated earnings tax and the personal holding company tax are designed to ensure that both a corporate tax and a shareholder tax are effectively imposed on corporate earnings.

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[8] A distribution in excess of the earnings and profits of a corporation generally is a tax-free return of capital to the shareholder to the extent of the shareholder's adjusted basis (generally, cost) in the stock of the corporation; such distribution is a capital gain if in excess of basis. A distribution of property other than cash generally is treated as a taxable sale of such property by the corporation and is taken into account by the shareholder at the property's fair market value. A distribution of stock of the corporation generally is not a taxable event to either the corporation or the shareholder.

II. BACKGROUND ON FLAT TAX AND CHOICE OF TAX BASE

A. Choice of Individual Tax Base: Consumption vs. Income

The flat tax label generally applies to any tax system with only one marginal tax rate and a broad base.[9] For example, one could construct a flat tax out of the current individual income tax by eliminating all but one marginal rate bracket and repealing provisions that impose higher marginal rates by reducing other deductions or exclusions (e.g., the personal exemption phaseout and the limitation on itemized deductions). While such a tax would be a flat tax on the basis of its single rate bracket, it would still contain dozens of tax expenditure provisions, including the home mortgage interest deduction, the charitable contribution deduction, the deduction for State and local income taxes, the earned income tax credit, and the dependent care credit. These special provisions (including exclusions for certain kinds of income, tax credits and deductions, and tax deferral provisions) were added by Congress to the tax code over the years to provide incentives for particular kinds of activities or to provide relief to particular kinds of taxpayers.

Many of the flat tax proposals that have been developed do more than simply apply one rate to the current individual income tax base. In addition, they redefine the base of the tax. There are two main approaches: a consumption base and an income base. The gross income of a taxpayer in any year is simply the sum of the taxpayer's consumption and gross saving. Thus, the difference between these two bases is in the treatment of saving. An income-based tax includes the return to saving in the tax base; a consumption-based tax does not.

There are a number of equivalent ways to construct a consumption base. One is to measure directly all acts of consumption by the taxpayer. While straightforward in theory, it would be difficult in practice, since it would require an entirely new reporting and auditing framework and a definition of what activities constitute taxable consumption.

An equivalent way to measure consumption that would build on current practice and definitions is suggested by the fact that consumption equals income minus saving. A base that includes income from all sources and then allows deductions for saving results in only consumption being subject to tax. Such an approach is similar to the treatment of deductible IRAs under present law. Taxpayers deduct contributions to qualified accounts in the year the contributions are made, but upon withdrawal include in income the entire amount withdrawn. A consumption tax of this type would treat all

[9] A bracket with a marginal rate of zero could also be provided by allowing a standard deduction and personal exemptions As long as only one bracket has a marginal tax rate greater than zero, the tax could be called a flat tax

saving as if it were done in a qualified account. The effect of this treatment is that the taxpayer receives a tax-free return on his or her savings.

The following example illustrates how the initial deduction plus the inclusion of all proceeds results in the exemption from tax of the return to saving. Assume that the marginal tax rate is 20 percent and the taxpayer saves $1,000 of his $25,000 income in a savings account. The $1,000 of savings gives the taxpayer a $1,000 deduction and thereby reduces the taxpayer's tax liability by $200 (20 percent of $1,000). Assume that the taxpayer withdraws the savings (plus interest) one year later. If the account yielded a five percent rate of return, the taxpayer withdraws $1,050. The withdrawal is included in the tax base and is taxed at the 20-percent rate, for an extra tax liability of $210, leaving the taxpayer with net proceeds of $840. Notice that if the taxpayer had initially paid the tax of $200 (tax on the $1,000 deposited in the savings account if saving were not deductible) and invested the remaining $800 at five percent, he also would have had net proceeds of $840 if interest income is not subject to tax. The combination of a deduction for saving and inclusion of all proceeds in the base upon withdrawal from the qualified savings account has the same result as exempting from tax the return on saving.

A third way to implement a consumption tax is to include in the base only earned income. Taxpayers claim no deduction for savings, but their returns to saving, whether in the form of interest, dividends, rents, royalties, or capital gains, are excluded from the base of the tax and thus are received tax-free. In terms of the previous example, a taxpayer initially pays tax of $200 on the $1,000 he sets aside from current consumption. When he withdraws the $840 in the following year (the $800 he was able to put in the account plus a five-percent return), none of that is included in the tax base. This third way to tax consumption is generally the approach used in the flat tax proposal of Robert E. Hall and Alvin Rabushka,[10] in which the individual portion of the tax includes only wage and salary income plus pensions [11] in the tax base.

An alternative to the consumption base is a comprehensive income base. The Treasury described such a base in its study of tax reform in the early 1980s.[12] A comprehensive income base would include income from all sources, whether labor income or returns to saving. Capital gains would be treated the same as ordinary income. Sources of income currently excluded from tax, such as employer-provided health insurance, would be included in the base. Items currently given consumption-base treatment in the individual income tax would be put on an income base.

Either a consumption base or a comprehensive income base would represent a significant departure from the present-law individual income tax base, which contains elements of both income

[10] See Robert E. Hall and Alvin Rabushka, *Low Tax, Simple Tax, Flat Tax*, (New York: McGraw-Hill), 1983.

[11] The treatment of pensions in the Hall-Rabushka flat tax differs from the approach of no deduction for saving and no inclusion of returns to saving. Pensions follow the principles of the second approach to a consumption base: the contributions to the pension during the individual's working years are excluded from the tax base and the pension payouts are included in the base when received.

[12] Department of the Treasury, *Tax Reform for Fairness, Simplicity and Economic Growth, Vol. 1*, 1984

and consumption bases. For interest on savings accounts and dividends on stocks, there is income-base treatment: inclusion of the receipts in income. For deductible IRAs, as described above, there is consumption-base treatment: current deduction and inclusion of the proceeds upon withdrawal. Pension plans are generally treated similar to deductible IRAs in that the amounts contributed are not included in income but payouts from the plan are included in income. Life insurance paid out on the death of the insured receives consumption tax treatment of the third approach (no deduction for saving and no inclusion of returns to saving): there is no deduction for the premiums paid to purchase the policy, the returns to saving accumulate in the policy without inclusion in the tax base, and the payment of the proceeds on the death of the insured is not subject to tax.

B. Integration of Business and Individual Taxes

Many flat tax proposals, including the Hall-Rabushka proposal and S. 488, introduced by Senator Specter (described in Part III), do more than just change the rates and the base of the individual income tax. These proposals also integrate business taxation and individual taxation through the application of a consumption tax on all businesses at the same marginal rate as that applied to individuals. Under present law, partnerships, subchapter S corporations, and sole proprietorships are already integrated into the individual income tax because of their passthrough treatment. For businesses organized under subchapter C, however, a separate, generally income-based, tax applies in addition to any taxation at the individual level of the returns from the business.

What makes a given business tax a consumption tax is its reliance on cash-flow accounting principles to define the tax base. By contrast, income taxes use accrual accounting principles to measure the base.[13] Cash-flow accounting principles treat real business activity similar to one of the approaches to constructing a consumption-based individual tax: saving is deducted from the base and returns to saving are included upon withdrawal.[14] In the business context, expenses in the current period that yield revenues in future periods are saving; those future revenues are the return to saving.

The differences between the cash-flow accounting principles and accrual accounting principles can be seen in the treatment of inventories and durable goods purchases. For example, if a brewer produces cases of non-alcoholic beer in a particular year that it does not sell in that year, under an income base the cost of producing the unsold beer is capitalized and a deduction for the capitalized cost is not allowed until the beer is sold. Under cash-flow accounting, the production costs of unsold beer are deducted in the year of production, not in the year of sale. The addition to inventory is a form of saving and a full deduction is allowed from the

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[13] Even if the taxpayer is allowed to use the cash receipts and disbursements method of accounting under the Code, the determination of depreciation still rests on a notion that accrual principles define the base

[14] The business tax analogue of the consumption-based individual tax that allows no deduction for saving and explicitly exempts from tax the returns to saving would result in no business-level tax

base of a cash-flow, consumption-based tax. Similarly, if the brewer purchases a new fermentation kettle that has a useful life longer than one year, an income base will subtract from the value of the brewer's output only the value of the kettle that is used up during that year. The remainder of the value of the kettle is deducted in future years.[15] Under accrual accounting, the net income during each year of the fermentation kettle's useful life is the value of the output it produces minus the decline in the value of the kettle minus the value of other inputs used to produce the root beer. Under cash-flow accounting, the taxpayer deducts the entire purchase price of the kettle from the annual output of the business in the year the kettle is purchased. The purchase of a durable good is a form of saving and a full deduction is allowed from the base of a cash-flow, consumption-based tax.

In general, consumption-based taxes allow the immediate deduction "expensing" of the cost of capital purchases. Under an income base, businesses are allowed deductions each year for only an allocable portion of the cost of capital purchases. If the deduction allowed matches the decline in the value of the capital good, then the deduction is called economic depreciation. To the extent that depreciation deductions allowed under present law exceed economic depreciation, the current corporate income tax moves in the direction of a consumption-based tax.[16]

The treatment of capital expenditures is one distinguishing feature between a consumption-based business tax and an income-based business tax. A second is the treatment of interest expense, which is deductible under an income-based tax as a cost of producing income. There are two options for treating interest expense under a consumption-based tax, which correspond to two alternative approaches to financial cash flows under such a tax. The approach that is generally used is to account only for cash flows based on real non-financial activity. Thus, financial receipts such as proceeds from a stock sale or a bank loan are not included in the base and outflows such as loan repayments and payments of interest and dividends are not subtracted from the base. The second alternative is to account for cash flows based on both real and financial activity. Under this approach, any receipt by the business is included in the base and any outflow is deducted from the base. For example, stock sale proceeds and bank loans are included in the base and outflows for loan repayments and payments of interest and dividends are subtracted from the base.

Under either cash-flow base, a consumption-based flat tax on businesses results in an expected tax collection of zero on the returns to new, marginal capital. In a competitive market, the price of the marginal unit of a capital good would be the expected present discounted value of the flow of services provided over the lifetime of the capital good. The business deducts that price in the

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[15] Because the kettle has a useful life of more than one year, the amount of the kettle that is used up in a given year is the decline in the value of the kettle over the course of that year. Depreciation rules are generally used as a means to reflect this decline in value over the life of a kettle

[16] Under Code section 179, taxpayers other than estates, trusts or certain noncorporate lessors may elect to expense up to $17,500 ($8,750 for married individuals filing separate returns) of qualifying capital property The $17,500 limit is reduced (but not below zero) by the amount by which the cost of such property placed in service during the taxable year exceeds $200,000.

89-605 O - 95 - 2

year of purchase. Assume future returns from the capital good are equal to those expected by the taxpayer at the time of purchase. Then, the returns the business receives from using the marginal unit of a capital good increase its tax base in the future, but only by as much in present value as the amount expensed at the time of purchase. Thus, similar to the treatment under the individual tax for deductible IRA contributions, the expensing of the cost of a capital good is equivalent to exempting from tax the expected returns generated by such good. Any net collections of the cash-flow tax arise from returns in excess of those expected at the time of the purchase of a marginal unit of the capital good or from inframarginal units of capital.[17]

[17] Inframarginal units of capital are those for which the business *expects* a return in excess of the return that it could make on the next-best use of the funds. For such units of capital, the present value of the expected returns would exceed the cost of the unit of capital. If the actual returns match the expected returns, there will be a net collection of tax on those returns.

III. DESCRIPTION OF PROPOSAL (S. 488)

A. Summary

On March 2, 1995, Senator Arlen Specter introduced S. 488, a bill that would amend the Internal Revenue Code of 1986 (the "Code") to impose a tax at a rate of 20 percent upon the taxable incomes of individuals and persons engaged in business activities. On January 4, 1995, Congressman Philip Crane introduced H.R. 214, "The Tithe Tax," in the House of Representatives. In the 103rd Congress, on January 26, 1993, Senator Jesse Helms introduced S. 188, "The Tithe Tax," and on June 16, 1994, Congressman Richard Armey introduced H.R. 4585, "The Freedom and Fairness Restoration Act of 1994." Each of these bills may generally be described as flat taxes. The subsequent discussion provides a description of S. 488. The bill may be generally described as a consumption-based flat tax.[18]

For purposes of the bill, the taxable income of an individual would be "taxable earned income" (generally, compensation for personal services, such as wages) less a "standard deduction." The standard deduction would be the sum of a "basic standard deduction" plus the "additional standard deduction." In addition, it is intended that an individual would be allowed to deduct annually up to $2,500 of charitable contributions and interest on up to $100,000 of principal on a home mortgage.

The taxable income of a person engaged in a business activity would be the gross active income of the business less certain specified deductions. These specified deductions generally would include the cost of business inputs for the business activity, compensation expense, and the cost of tangible personal and real property used in the activity. Thus, the bill would allow the cost of capital inputs to be expensed in the period the inputs are acquired. The present-law income tax requires such costs to be capitalized and recovered over time.

In computing its taxable income, it appears that a business generally would not be allowed to deduct interest expense. Investment income, including interest, dividends, and gains from the sale of investment assets generally would not be includible in taxable income by either individuals or businesses.

The amendments made by the bill would apply to taxable years beginning after December 31, 1995.

A more detailed description of the bill is provided below.

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[18] As discussed in Part II of this pamphlet, the bill contains a flat tax because the tax would be imposed at a single rate on taxable income. This flat tax may be described as consumption-based because in determining taxable income, returns on investment assets would be excluded and businesses would be allowed to expense the cost of capital assets.

B. Taxation of Individuals

The bill would amend section 1 of the Code [19] to impose a tax equal to 20 percent of the excess (if any) of: (1) the taxable earned income received or accrued during the taxable year over (2) the standard deduction for the year. For this purpose, "taxable earned income" would mean the excess (if any) of earned income (as defined in Code sec. 911(d)(2)) over foreign earned income (as defined in Code sec. 911(b)(1)).[20] Present-law Code section 911(d)(2) provides that "earned income" means wages, salaries, or professional fees and other amounts received as compensation for personal services actually rendered, but does not include that part of the compensation derived by the taxpayer for personal services rendered by him to a corporation that represents a distribution of earnings and profits rather than a reasonable allowance as compensation for the personal services actually rendered. In the case of a taxpayer engaged in a trade or business in which both personal services and capital are material income-producing factors, under regulations prescribed by the Secretary, a reasonable allowance as compensation for the personal services rendered by the taxpayer, not in excess of 30 percent of his share of the net profits of the trade or business, is considered earned income.

Under the bill, the "standard deduction" would be the sum of a "basic standard deduction" plus the "additional standard deduction." As under present law, the amount of the basic standard deduction would be determined based on the individual's filing status as provided in Table 3 below. (For the sake of comparison, the amounts of standard deductions allowable under present law are also provided in the table.)

Table 3.—Comparisons of "Standard Deductions" Under S. 488 and Present Law

Filing status [1]	S. 488 basic standard deduction	Present-law standard deduction [2]
Joint return	$16,500	$6,550
Surviving spouse	16,500	6,550
Head of household	14,000	5,750
Married filing separately	9,500	3,275
Single	9,500	3,900

[1] The determination of an individual's filing status under the bill is the same as under present law.

[2] The amounts shown for present-law standard deductions apply for calendar year 1995. These amounts are indexed annually for inflation.

In addition, individuals that are blind or age 65 or older may increase their standard deductions under present law. These additional deduction amounts are not provided under the bill.

Under the bill, the "additional standard deduction" would be an amount equal to $4,500 times the number of dependents of the tax-

[19] Under present law, Code section 1 imposes the regular income tax upon individuals.

[20] Under present law, Code section 911 provides for an exclusion of up to $70,000 of the foreign earned income of a qualified individual. Section 911(b)(1) describes what portion of an individual's earned income constitutes foreign earned income eligible for the exclusion.

payer. (Under present law, a $2,500 exemption amount is allowed for calendar year 1995 for the taxpayer, his or her spouse, and each dependent of the taxpayer. The exemption amounts are indexed annually for inflation.)

For taxable years beginning after 1995, the basic standard deduction and the additional standard deduction amounts under the bill would be indexed for inflation.

The bill also would allow individuals to deduct up to $2,500 ($1,250 in the case of a married individual filing a separate return) annually for charitable contributions.[21] In addition, the bill would make certain changes to the present-law rules regarding charitable contributions. First, deductions for contributions of property other than cash or its equivalent would not be allowed. Second, the adjusted gross income limitations of present law would not apply.[22]

The bill also would allow individuals to deduct "qualified residence interest." For this purpose, "qualified residence interest" means any interest that is paid or accrued during the taxable year on acquisition indebtedness with respect to a qualified residence (as determined under present law).[23] Under the bill, the aggregate amount that may be treated as acquisition indebtedness for any period may not exceed $100,000 ($50,000 in the case of a married individual filing a separate return).

C. Taxation of Business Activities

The bill would amend section 11 of the Code[24] to impose a tax equal to 20 percent of the business taxable income of a person engaged in a business activity. The tax would be imposed on the person engaged in a business activity, whether such person is an individual, partnership, corporation, or otherwise. For this purpose, "taxable business income" would mean gross active income reduced by specified deductions. "Gross active income" would mean gross income other than investment income.

The bill would allow deductions for (1) the cost of business inputs for the business activity, (2) the compensation (including contributions to qualified retirement plans but not including other fringe benefits) paid for employees performing services in such activity, and (3) the cost of tangible personal and real property used in such activity. For this purpose, "the cost of business inputs" would mean (1) the actual amount paid for goods, services, and materials, whether or not resold during the taxable year, (2) the fair market

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[21] Under present law, individuals are allowed to deduct the greater of their standard deduction or their itemized deductions (including charitable contributions and mortgage interest). The bill appears to allow individuals to deduct charitable contributions and mortgage interest in addition to, rather than in lieu of, the standard deduction.

[22] Under present law, an individual generally may not deduct as a charitable contribution an amount greater than 50 percent (30 percent in the case of certain contributions) of the individual's AGI.

[23] Under present law, "acquisition indebtedness" means any indebtedness that is incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer and is secured by the residence. Acquisition indebtedness also includes indebtedness secured by the residence resulting from the refinancing of qualified acquisition indebtedness. The aggregate amount of acquisition indebtedness that may be taken into account for any period under present law may not exceed $1,000,000 ($500,000 in the case of a married individual filing a separate return). For this purpose, "qualified residence" means the principal residence of the taxpayer (as defined under sec. 1034) and one other residence selected by the taxpayer and used by the taxpayer as a residence.

[24] Under present law, section 11 of the Code imposes the regular income tax upon corporations.

value of business inputs brought into the United States, and (3) the actual cost, if reasonable, of travel and entertainment expenses for business purposes. Business inputs would not include purchases of goods or services provided to employees or owners.

If a taxpayer's aggregate deductions for any taxable year exceed its gross active income for the year, the amount of deductions allowed for the succeeding taxable year would be increased by the sum of (1) the excess, plus (2) the product of the excess and the three-month Treasury rate for the last month of the taxable year.

IV. DISCUSSION OF GENERAL ISSUES RELATING TO FLAT TAXES

A. Simplification

At its most elementary level, a flat tax eliminates multiple tax rate brackets or different tax rates for different types of income.[25] For many taxpayers, multiple tax rate brackets create no complications under present law. Those taxpayers determine their tax liability by reference to a published table included in the instructions to Form 1040, prepared by the Internal Revenue Service. Some taxpayers, however, are subject to multiple tax rates. For example, taxpayers with income from realized capital gains may apply a maximum 28-percent tax rate on such gain income even if their other income is taxed at higher marginal tax rates. Still other taxpayers must calculate their tax liability under both the regular tax and the alternative minimum tax. A single marginal tax rate would reduce complexity and computations for such taxpayers. However, gains in simplicity and reduced calculations could be achieved even under multiple tax rate bracket regimes. For example, income from realized capital gains could be taxed as ordinary income or entirely exempt from tax, and the alternative minimum tax could be repealed.

Some of the benefits of simplicity attributed to flat rate taxes arise from proposed changes in what sources of income are included in the tax base rather than from replacement of a multiple tax rate system with a single tax rate. Consider a taxpayer who holds Federal bonds and State bonds. Under present law, the interest earned on Federal bonds is fully taxable while the interest earned on certain State bonds is tax-exempt and the interest earned on certain other State bonds is taxable under the alternative minimum tax. The taxpayer must maintain records distinguishing the different sources of interest income and report it appropriately at various points on his Federal income tax return. The complexity in this situation arises from the manner in which present law includes different sources of nonwage income in the tax base. Consumption-based flat tax proposals would achieve simplicity in this area by excluding all interest income from the tax base. Some income-based flat tax proposals would achieve simplicity in this area by including all interest income, regardless of source, in the tax base. In either case, it is the modification of the tax base rather than the marginal tax rate structure that provides the simplification.

At the level of the individual tax filer, advocates of flat taxes suggest that further significant simplicity can be achieved by eliminating all current itemized deductions, thereby broadening the tax

[25] The term "income" will be used in this discussion, but the discussion is not limited to income-based taxes.

base. The elimination of itemization as an option would free many taxpayers from certain recordkeeping and filing Schedule A to Form 1040 as required of itemizers under present law. The Appendix contains tables that report projections by the staff of the Joint Committee on Taxation ("JCT staff") of the extent of use of itemized deductions for the various types of deductions available for 1995.[26] The JCT staff projects that, in 1995, approximately 34 million returns out of 107 million returns will be filed in which the taxpayer chooses to itemize. The most common deductions claimed by itemizers are the deduction for contributions to charitable organizations (30.5 million returns), the deduction for real property taxes paid (29.9 million returns), the deduction for mortgage interest paid (28.1 million returns), the deduction for State and local income taxes paid (27.8 million returns), and the deduction for other State and local taxes paid (17.1 million returns). Excepting the deduction for charitable contributions, the recordkeeping burden imposed by the most common deductions probably is modest for most taxpayers. Mortgage lenders regularly report the interest paid and remaining balance due to borrowers as a part of their normal business practice. Similarly, income and property taxes[27] paid generally are easily documented. Medical expenses, miscellaneous expenses, investment interest expense, and moving expenses, as well as charitable contributions, generally involve more recordkeeping, but with the exception of the charitable deduction, these more time-consuming, recordkeeping-intensive deductions are claimed by fewer than 8.5 million taxpayers out of 107 million taxpayers filing individual returns. Looked at from another perspective, 21.1 million taxpayers claim one or more of the deductions for mortgage interest, State and local taxes of all types and charitable deductions and no other deductions. Much of the simplification inherent in the modest use of other deductions is a result of the Tax Reform Act of 1986. That Act eliminated the deduction for sales taxes, which could entail extensive recordkeeping, and created or increased floors on eligible medical expenses, casualty losses, and miscellaneous deductions.

Many complications of present law relate to the definition of the tax base, rather than the calculation of the tax liability itself. For example, the inclusion of realized capital gain in income and the limitation on the extent to which capital losses can be offset against other income have led to numerous disputes about the characterization of gain or loss as capital or ordinary. Providing a flat rate and retaining the current rules would not change the nature of many such disputes. At the business level, under present law, many large subchapter C corporations effectively are subject to a flat 35-percent tax rate, but tax filing still proves to be a complex endeavor. Under a flat income-based tax, determinations would still have to be made about which assets are depreciable and under what method or would qualify for expensing, the basis in as-

[26] The projections are of taxpayers who file returns claiming either itemized deductions or the standard deduction. Non-filers and dependent returns are not included in the projections. The Appendix also reports projects for deductions from income claimed for moving expenses, which under present law is an above the line exclusion.

[27] There is some taxpayer confusion regarding the deductibility of user fees imposed by local governments, particularly when such user fees are collected concomitantly with regular property taxes.

sets, the extent to which interest on debt is deductible, which employee benefits are qualifying tax-exempt benefits as opposed to taxable compensation, and other issues that lead to administrative and computational complexity. While broadening the tax base, whether income or consumption, may eliminate some of the present complexities, it may create new complexities. For example, if all employee compensation were to be taxed as income to the employee, employers would have to determine the value to employees of employer-provided benefits for which no such determinations are now required.

Choosing a consumption base for a flat tax also might eliminate many of the areas of complexity of present law. However, defining the new tax base may lead to complexities of its own. Much confusion might arise merely from the choice of a new tax base for which past practice and case law provide no guidance. The taxation of financial institutions may be particularly complex under a consumption-based tax. For example, for some financial services the provider charges an explicit fee, but for others consumers pay an implicit fee in the form of reduced earnings on deposits. Treating such pricing practices neutrally may involve substantial complexity.

Additionally, some advocates of a consumption-based flat tax argue that filing requirements can be significantly simplified under a flat tax.[28] However, many proposals merely move certain tax filings that now occur as part of the individual return to business filings that will require their own separate return. For example, sole proprietors and farmers would be required to file as businesses and also file as individuals for any wages they pay themselves. Similarly, owners of partnerships, subchapter S corporations, and other passthrough entities would still have to file tax returns as businesses.

Simplicity is only one of several policy goals when creating tax policy. Some of what is viewed as complication under present law is the result of Congressional decisions to pursue other policy goals. For example, the research and experimentation tax credit was enacted to spur increased research efforts by taxpayers. In such a case, simplicity is traded off against economic policy. Also, many States impose an income tax. Simplification may be diluted if these States do not adjust their tax bases accordingly.

B. Economic Efficiency

Overview

Any tax imposed on economic decisions of taxpayers, be it on the decision to work, the decision to save, or the decision to consume, will create nonneutralities and distort taxpayer behavior. A tax system that taxes different individuals or different sources of income at different tax rates is not neutral between individuals or between sources of income. Such nonneutralities can distort taxpayer behavior. Such distortions can reduce taxpayer welfare and diminish the performance of the economy. In general, the higher the marginal tax rates, the greater the reductions in taxpayer welfare and economic performance. In addition, nonneutralities may induce

[28] Hall and Rabushka, *Low Tax, Simple Tax, Flat Tax*.

taxpayers to engage in activities that, while they offer a positive private return, produce no net return to the economy. One helpful way to characterize nonneutralities is to classify them as "intratemporal" (nonneutralities that arise within the current year) or "intertemporal" (nonneutralities that arise across different years).

Intratemporal nonneutrality

The present Federal income tax imposes different tax rates on different individuals. Taxing different individuals at different marginal tax rates creates opportunities for bracket arbitrage and clientele effects. For example, if a taxpayer's receipts and expenses may be realized with some discretion (as is the case with taxpayers using the cash receipts and disbursements method of accounting), it is advantageous to recognize income when his marginal tax rate would otherwise be low and pay expenses when his marginal tax rate would otherwise be high. Such bracket arbitrage is profitable for the taxpayer, but may require the use of his time or resources from which the economy as a whole receives no benefit. Also, the delay or acceleration of economic activity merely to affect a taxpayer's tax liability may create inefficiencies in the market. A single marginal tax rate generally reduces the potential for private profit from bracket arbitrage and may free the taxpayer's time and resources for other endeavors.

Clientele effects represent a different sort of bracket arbitrage. With different taxpayers facing different tax rates it may be advantageous for one group of taxpayers, a "clientele," to hold one type of asset and another group of taxpayers to hold another type of asset. For example, because interest is deductible it is cheaper for a high-tax bracket taxpayer to borrow than for a low-tax bracket taxpayer.[29] Thus, high-tax bracket taxpayers might be more likely to borrow, and to borrow from low- or zero-bracket taxpayers. This nonneutrality could distort credit markets by effectively charging different interest rates to different taxpayers, depending upon a factor that has nothing to do with the taxpayer's creditworthiness.

Tax clienteles also may result in reduced tax collections. If reduced tax collections lead to higher overall tax rates, all existing nonneutralities may be magnified. Under the present income tax, interest income is taxable and corporations may deduct interest expense. If all taxpayers faced the same tax rate, the aggregate tax collected from interest income recognized from corporate interest payments would be offset by corporate interest deductions.[30] However, if taxpayers in tax rate brackets lower than that of corporations hold the debt, the government on net collects less in tax from interest income than it forgoes in interest deductions. Having only one marginal tax rate would mitigate these clientele effects. However, to the extent that some taxpayers remain not subject to tax, potential clientele effects may continue to exist.

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[29] The after-tax interest cost when the interest rate is r is $r(1-t)$, where t is the taxpayer's marginal tax rate The greater the value of t, the lower the after-tax interest cost.

[30] This discussion ignores certain other provisions of the income tax. For example, denial of net operating losses in excess of other income and the denial of a portion of the interest paid on certain high-yield debt obligations may limit the ability of a corporation to deduct interest expense in the current year

The present Federal income tax also imposes different effective tax rates on different sources of income. For example, income from investments in corporate equity generally are subject to a corporate-level tax when earned and to individual-level tax when the income is distributed to individuals. Interest from certain State and local securities is exempt from tax. Such nonneutralities may distort investor decisions, thereby reducing the efficiency of the capital market in allocating capital to its most highly valued uses.

Similarly, certain forms of employee compensation, such as employer-provided health benefits, are not taxed. Some economists suggest that the exclusion of certain health benefits from taxable employee compensation leads employees to consume more health care and less of other goods than they otherwise would.[31] Taxpayers may also arrange their affairs to increase tax-preferred sources of income, leading to an erosion of the tax base. For example, employees might negotiate for a larger proportion of their income to be paid in the form of nontaxed fringe benefits. Erosion of the tax base could necessitate higher rates of tax and higher rates of tax exacerbate existing economic distortions.

A flat tax would not necessarily eliminate all such distortions. As the preceding discussion suggests, distortions arise both from the breadth of the tax base and the rate of tax applied to different parts of the tax base. Providing one rate of tax does not eliminate distortions to the extent that some items remain outside the tax base. As taxpayers' leisure time always is untaxed, higher tax rates under either an income-based tax or a consumption-based tax could distort taxpayers' choices between work and leisure.

Intertemporal nonneutrality

One criticism of any income tax, whether a flat tax or not, is that it is not neutral between present and future consumption. If a taxpayer earns wage income today and uses his wage income to consume today, the tax he pays relative to that consumption is equal to the tax on his wages. If the taxpayer earns wage income today and saves it to consume tomorrow, the tax he pays relative to that future consumption is equal to the tax on his wage income plus the tax owed on any interest earned by his saving. The total tax is greater if the consumption is deferred.[32] The potential distortion in favor of present, rather than future, consumption may be important because it may give the taxpayer a disincentive to save, and saving is necessary for economic growth.

Economists disagree whether, in fact, an income tax does discourage saving. At issue is the extent to which taxpayers change their saving in response to the net, after-tax return to their saving. Some studies have argued that one should expect substantial increases in saving from increases in the net return.[33] Other studies have argued that large behavioral response to changes in the after-

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[31] See the discussion in Joint Committee on Taxation, *Description and Analysis of Title VII of H.R 3600, S. 1757, and S. 1775 (Health Security Act)* (JCS-20-93), December 20, 1993, pp. 49-56

[32] To be more precise, the present value of the tax paid is greater if some of the wage income is saved and the earnings from that saving subsequently are taxed as income.

[33] Lawrence H. Summers, "Capital Taxation and Accumulation in a Life Cycle Growth Model," *American Economic Review*, 71, September 1981.

tax rate of return need not occur.[34] Empirical investigation of the responsiveness of personal saving to the taxation of investment earnings provides no conclusive results. Some find personal saving responds strongly to increases in the net return to saving,[35] while others find little or a negative response.[36]

C. Tax Equity

Equal treatment of equals

The present income tax may effectively impose different total tax liabilities on taxpayers who otherwise have the same economic income if they have different sources of income or types of expenses. In addition to whatever economic distortions these nonneutralities might create, some view this outcome as unfair. The principle of a flat tax is to apply the same rate of tax to all similarly situated individuals. However, it is sometimes difficult to determine when two individuals are similarly situated. For example, people disagree over whether two taxpayers are similarly situated if they have the same income but different medical expenses, or different work-related expenses, or different dietary expenses, or whether they rent or own their home. These are disagreements about the tax base. Any noncomprehensive tax base potentially imposes different tax liabilities on any two taxpayers—who some might consider to be similarly situated. So too, a comprehensive tax base might impose different tax liabilities on any two taxpayers who—some might consider to be similarly situated, if, for example, one believes that medical expenses reduce the taxpayer's ability to pay.

Progressivity

When discussing tax rates, analysts distinguish "average tax rates" from "marginal tax rates." An average income tax rate is the taxpayer's total income tax liability divided by his total income. A marginal income tax rate is the rate of tax imposed on an additional, or marginal, dollar of income earned by the taxpayer. Statutory tax rates in the Code are marginal tax rates. A tax is "progressive" if the average tax rate rises as the tax base rises. The present Federal individual income tax is a progressive tax. Flat taxes also are progressive taxes because they exempt some initial level of income or consumption from taxation. If a tax exempts an initial level of income or consumption from taxation, it does not require increasing marginal tax rates in order to be progressive.[37] For example, if a flat income tax exempted the first $20,000 of income from tax and imposed a marginal tax rate of 20 percent on all income over $20,000, the average tax rate would rise from zero at an income of $20,000, to 6.7 percent at an income of $30,000, to 14.7

[34] David A. Starrett, "Effects of Taxes on Saving," in Henry J. Aaron, Harvey Galper, and Joseph A. Pechman (eds.), *Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax*, (Washington, D.C.: Brookings Institution), 1988.

[35] Michael Boskin, "Taxation, Saving, and the Rate of Interest," *Journal of Political Economy*, 86, April 1978.

[36] George von Furstenberg, "Saving," in Henry Aaron and Joseph Pechman (eds.), *How Taxes Affect Economic Behavior*, (Washington, D.C.: Brookings Institution), 1981.

[37] Mathematically, if the marginal tax rate is greater than the average tax rate, the average tax rate increases as income increases. A tax that exempts an initial level of income or consumption commences with an average tax rate of zero. Hence, any positive marginal tax rate will cause the average tax rate to increase as income increases.

percent at an income of $75,000, to 19.6 percent at an income of $1 million.[38]

The tax liability imposed under a flat tax can be represented by a straight line whose slope is the marginal tax rate. For each additional dollar of income[39] earned, the taxpayer's tax liability increases at the marginal tax rate. The present-law income tax is better described by a curve. The taxpayer's tax liability first increases at the 15-percent marginal tax rate, then increases more steeply at the 28-percent marginal tax rate, and ultimately increases more steeply at the 39.6-percent marginal tax rate.[40] Figure 1 illustrates this difference. The curving line labelled "Graduated Rates" in the figure is modelled on the present-law individual income tax. It assumes a joint filing status claiming four personal exemptions and the standard deduction ($2,500 personal exemption and $6,550 standard deduction for 1995). It assumes all income is taxable at the ordinary income tax rates of 15, 28, 31, 36, and 39.6 percent. For simplicity, it ignores the earned income tax credit, other tax credits, and the phaseout of personal exemptions. The line labelled "Flat Rate" assumes that all income beyond a $20,000 exemption is taxed at a flat marginal tax rate of 20 percent.

[38] In general, the average tax rate under the hypothetical flat income tax described in the text would be zero for incomes of $20,000 or less and $[(.2)(Y - 20,000)]/Y$, where Y is income, for incomes in excess of $20,000. The average tax rate always increases as income (Y) increases.

[39] The term "income" will be used here to describe the tax base, whether the tax is an income-base tax or a consumption-base tax.

[40] This discussion ignores preferences for certain types of income under present law, such as income from realized gains.

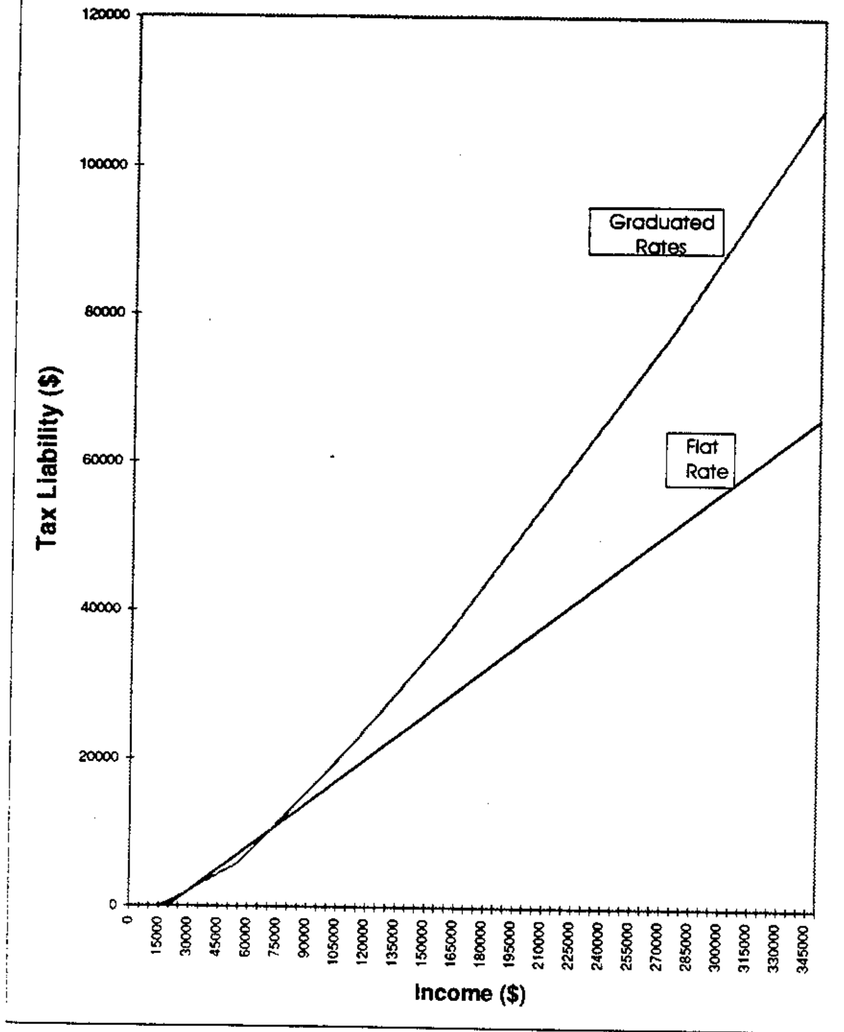
FIGURE 1
Tax Liability ($)
120000
100000
80000
60000
40000
20000
0
Graduated Rates
Flat Rate
0
15000
30000
45000
60000
75000
90000
105000
120000
135000
150000
165000
180000
195000
210000
225000
240000
255000
270000
285000
300000
315000
330000
345000
Income ($)

The difference in the pattern of liability under a tax system with increasing marginal tax rates and a tax system with one marginal tax rate can thus be thought of in terms of how well a straight line approximates a curve. A straight line, of course, can never exactly match a curve. The flatter the curve, the more closely a straight line can approximate a curve. The more convex its curve, the less well a straight line serves as an approximation. In general, the substitution of a flat tax system (one marginal tax rate) would be expected to substantially alter the tax liabilities of many taxpayers compared to their liability under a tax system with increasing marginal rates.

The preceding discussion has implicitly assumed that the tax base is unchanged while the marginal tax rate structure is altered. However, if the tax base is changed at the same time the rate structure is altered, it is not possible to make a general statement about how tax liability would change. For example, a flat tax might lower the marginal tax rate and total tax liability on higher-income taxpayers. If, however, the tax base were broadened to include interest from State and local bonds, and if higher-income taxpayers held substantial stocks of those bonds, then the tax liabilities of higher-income taxpayers might increase even as their marginal tax rate fell.

Simple calculations of taxes paid may not show who truly benefits or who is harmed by fundamental tax restructuring. The burden of taxation often is not well represented by a tabulation of who pays the tax. For example, the statutory incidence of Federal alcoholic beverage excise taxes is on the producers of such beverages, but most analysts believe that consumers bear the burden of such taxes in the form of higher prices for alcoholic beverages. Similarly, analysts debate who bears the burden of the current corporate income tax. Assigning the collection of a new tax at the corporate level or at the individual level in a way to approximate the tax remitted by individuals and corporations under present law does not mean that burden of taxation has been distributed across taxpayers in the same manner as present law.

D. Transition Issues

If a comprehensive tax reform proposal were enacted and made effective overnight, taxpayers would experience pronounced swings in after-tax income, wealth, and cash flow. Contracts and investments that were profitable under the old tax rules could be rendered unprofitable under new tax rules. Taxpayers who made tax-preferred investments under the old tax rules would experience an abrupt decline in their current after-tax income and in wealth—the capitalized value of future income. For example, taxpayers who had purchased tax-exempt State and local bonds would find those bonds' value sharply reduced if the interest from such investments suddenly became subject to tax. Other taxpayers might experience increases in their current after-tax income and wealth. These changes in taxpayer wealth might be regarded as inequitable, particularly when some such changes would result from investments that Congress had encouraged through tax preferences in order to achieve certain social or economic policy objectives. Sudden changes in taxpayers' incomes also may create a perception of inequity be-

cause taxpayers may find it difficult to adjust their spending patterns to sudden changes in their after-tax incomes. Even a more gradual phase in of a new tax may be expected to lead to substantial revaluation of those assets that lose their tax preference. Transition to a new tax system may cause substantial uncertainty among taxpayers. Also, the government and taxpayers might incur substantial expense in adjusting to a new tax system.

V. DISCUSSION OF TECHNICAL ISSUES IN THE DESIGN OF A FLAT TAX AND S. 488

A. In General

It appears that the intent of S. 488 is to replace the present-law corporate and individual income taxes with a flat tax.[41] As with any proposal to institute a new tax regime, a detailed, section-by-section analysis of present law should be undertaken in order to determine which current provisions are compatible with the proposal (and should be retained) and which are not compatible (and should be repealed). However, as drafted, S. 488 simply amends present-law Code sections 1, 11, 63, 163, and 170 and leaves it unclear whether and to what extent other present-law sections are to apply. For example, the bill does not repeal such present-law provisions as the alternative minimum taxes on individuals and corporations, the personal holding company tax, and the accumulated earnings tax; although it appears that it is intended that these provisions should be repealed. Likewise, the various present-law income tax credits are not repealed under the bill.

Although the following discussion uses S. 488 as a frame of reference, it is not intended to be limited to an analysis of the compatibility of the entire present-law Internal Revenue Code with this particular bill or any other similar proposal. Rather, this discussion will highlight certain issues that should be considered in the development of any alternative tax system. These issues primarily involve: (1) who are taxable persons, (2) what are taxable transactions, (3) what is gross income subject to tax, (4) what are allowable deductions that may offset such gross income, (5) the international aspects of the tax, and (6) what transition should be provided from the present-law tax regime to the proposed system. Some of these issues are discussed specifically below.

B. Taxation of Individuals

The bill imposes tax on the earned income of individuals. For this purpose, earned income is determined under Code section 911. As described above, section 911 provides a general definition of earned income that would tend to cover most of the income earned by individuals. However, section 911 applies only to a limited number of taxpayers under present law, so it is not clear that it provides the appropriate model for purposes of defining "earned income" in all cases. In addition, certain other issues exist, including the treatment of contributions and distributions from tax qualified retirement plans and the coordination between the individual tax and the business activities tax.

[41] See, statement of Senator Specter accompanying the introduction of S. 488, contained in the Congressional Record, Vol. 141, No. 39 (104th Cong., 1st Sess.), March 2, 1995, p. 3416.

Tax qualified retirement plans

Under present law, a plan of deferred compensation that meets the qualification standards of the Code (a "qualified plan") is accorded favorable tax treatment. Employees do not include qualified plan benefits in gross income until the benefits are distributed even though the plan is funded and the benefits are nonforfeitable. Within limits, the employer is entitled to a current deduction for contributions to a qualified plan even though an employee's income inclusion is deferred. There are two basic types of qualified plans: defined benefit plans, under which plan participants receive benefits pursuant to a formula specified in the plan; and defined contribution plans, under which plan participants receive benefits based solely on the contributions (and earnings thereon) allocated to separate accounts maintained for each plan participant.

The treatment of qualified plan benefits under the individual tax of the bill is unclear. If the objective is to treat such benefits the same as other income under the bill, then benefits or contributions would be includible in income when earned or made and earnings would be exempt from tax (just as investment income is exempt from tax under the bill). Eliminating the present-law special tax treatment for qualified plans could achieve some simplification, because the qualification rules could be repealed. However, there would also be some administrative problems involved in taxing benefits currently. For example, in the case of defined benefit plans, no account is maintained for each participant. Rather, employees accrue benefits under the plan each year based on the formula set forth in the plan. If accrued benefits are taxed currently, employers would be required to determine and report the amount of benefits to plan participants so they could include the amount in income.

Under both defined benefit plans and defined contribution plans, issues arise as to the timing of any income inclusion. Plan participants generally do not have an absolute right to plan benefits at any time. Rather, benefits vest over a period of time. Taxing benefits when earned and contributions when made could impose a tax burden on an individual who never has a right to receive the amount includible in income. Current income tax principles could be applied to avoid this result.[42]

Favorable tax treatment is provided for qualified plans under present law in order to encourage employers to provide retirement income for their employees, particularly rank-and-file employees. Arguably, such incentives would not be as necessary under a tax system that does not tax investment income. On the other hand, repealing present-law rules for qualified plans raises retirement policy issues. Such rules are designed to provide some benefit security. For example, defined benefit plan benefits are guaranteed. This security could be undermined if the employer retirement plan system is replaced completely with individual savings.

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[42] In some cases, taxing benefits when earned may result in a greater income inclusion than if benefits are taxed when received. For example, in a defined benefit plan, actual benefits received may vary depending on the form of benefit chosen. If a defined benefit plan terminates without sufficient assets, then plan participants may receive less benefits than they have earned under the plan. In the case of defined contribution plans, the amount of contributions may be reduced by investment losses in the account.

Different rules for defined benefit plans and defined contribution plans may be necessary to ensure that one type of plan does not receive more favorable tax treatment than another.

Coordination between the individual tax and the business activities tax

Under the bill, self-employment income (i.e., income from sole proprietorships, general partnerships, etc.) appears to be subject to the individual portion of the flat tax. Such income would also appear to be subject to the business activities tax as well. Because it appears that this double tax result was not intended, some coordination between the individual and business activities taxes of the bill are needed. Other flat tax proposals would address this issue by allowing a business a compensation deduction and only taxing wages at the individual level.[43] In such a system, income is either taxed as business income (determined after a compensation deduction) under the business activities tax or as compensation under the individual tax. In that way, income is taxed only once at the same flat rate (although all or a portion of the compensation subject to tax at the individual level may be offset by whatever standard deductions or exemptions that are so provided.)

Another issue regarding the coordination between the individual tax and the business activities tax with respect to compensation involves the coordination between the deductibility of compensation at the business level and the inclusion of such compensation at the individual level. This issue is discussed in detail in Part V.C. below.

C. Taxation of Business Activities

Taxable persons and activities

The bill imposes tax on "every person engaged in a business activity." For this purpose, "business activity" is not defined. Thus, it is not clear whether the tax applies to activities that may be classified as "hobbies" under present law or to casual activities such as garage or yard sales, sales of used automobiles by consumers, or sales of personal residences by occupants. Likewise, it is unclear whether all the activities of tax-exempt entities such as section 501(c)(3) entities are subject to the tax or whether such entities would be subject to tax under the present-law rules applicable to unrelated business income. A similar analysis could be applied to government agencies that provide services (e.g., municipal-owned utility systems).

Moreover, the jurisdictional scope of the tax is not defined. For example, it is unclear whether the tax applies only to business activity conducted in the United States, whether or not by a U.S. person (however defined) or to any business activity conducted by a U.S. person, whether such activity occurs in the United States or abroad. If the tax applies to activity conducted abroad, it is unclear whether present-law foreign tax credits are allowable.

Transactions that generate taxable gross receipts are not defined. The present-law income tax contains various provisions that allow

[43] See, for example, Hall and Rubushka, *Low Tax, Simple Tax, Flat Tax.*

nonrecognition treatment for certain transactions. For example, certain like-kind exchanges of property and corporate mergers and reorganizations are not subject to Federal income tax. The treatment of these and similar transactions should be addressed in designing a broad-based flat tax.

Gross active income

Under the bill (as well as under most consumption-based taxes), "gross active income" means gross income other than investment income. It is unclear whether "gross income" is defined as it is under the present law income tax (i.e., income from whatever source derived) or whether it has a different meaning. Further, "investment income" is not defined. Generally, investment income is often thought to be income from passive assets held by the taxpayer, such as interest income, dividends, rents, royalties, and capital gains. However, income that may be investment income to one type of taxpayer may be active trade or business income of another. For example, interest income on a Treasury bond may be investment income for a manufacturer, but may be active income for a bank (see the discussion below with respect to financial institutions).

In addition, it is unclear whether the sale of property used in a trade or business (other than inventory) is subject to the tax. For example, assume a corporation operates a business through a wholly-owned subsidiary. If the corporation desires to dispose of the business, it could sell either the stock or the assets of the subsidiary. Under the bill, it is unclear whether the sale of the assets would be subject to the tax (because the sale of the assets give rise to gross income), but the sale of stock would not (because the resulting gain constitutes investment income).

Deductions

The bill allows deductions for "business inputs," compensation paid to employees, and the cost of tangible personal and real property used in a business activity. The bill does not allow deductions for fringe benefits, but does not provide a definition of when such a benefit expressly constitutes compensation. The deduction for compensation under the business activities tax could be coordinated with the inclusion of earned income under the individual tax. That is, a business would be allowed to deduct only those items of compensation that its employees are required to include in their incomes. In addition, a business would not be allowed to deduct those items of compensation that are not includible in the gross incomes employees. Under such a system, potentially all compensation would be includible in income, at some level, exactly once.[44] However, certain compensation could escape taxation. For example, if an entity not subject to tax (say, the Federal Government) supplies a form of compensation not includible in the gross income of its em-

[44] Under the present-law income tax, some items of compensation are not subject to tax while other items are subject to two levels of tax. For example, the cost of employer-provided health care is not includible in the income of an employee but is deductible by the employer. Conversely, in the case of a publicly-held corporation, no deduction is allowed for that portion of annual employee remuneration in excess of $1,000,000 with respect to certain of its executives, even though the executives are required to include the full amount of the remuneration in gross income

ployees (say, employer-provided parking), such compensation would escape taxation because the denial of the deduction has no effect on the tax-exempt entity.

Expensing of the cost of property

It appears that under the bill the cost of intangibles acquired for use in a business activity is not deductible, while the cost of tangible assets is deductible. This raises certain issues. First, it is sometimes unclear whether certain property constitutes tangible or intangible property. For example, computer software has both tangible qualities (the physical diskette), and intangible qualities (the information contained therein). Second, it is unclear why deductions for the cost of intangible property should be disallowed. Assets such as copyrights, distribution rights, formulas, patents, franchise rights, contract rights, trademarks, and trade names are routinely sold by one business to another. It would seem unfair that the seller includes gross receipts from the sale of the intangible assets in gross income but the buyer is not allowed to deduct the cost of acquiring these assets. This treatment also would create a bias against purchased intangible property where the cost of self-produced intangible property is effectively expensed.

Under the bill, the cost of acquiring land is deductible. This raises certain issues. First, under the present-law income tax, the cost of land is neither deductible nor amortizable because land is not a wasting asset. Second, the bill does not tax investment income. Thus, without further guidance, taxpayers would be required to classify assets as either investment or business assets. Land, particularly undeveloped land, may be used in a business or held as an investment. If a taxpayer acquired land and thought it would not appreciate greatly in value, it might classify the land as a business asset in order to deduct its cost. On the other hand, if the business thought the land would greatly appreciate, it would classify the land as an investment asset and exclude the gain upon sale.

Business inputs

The bill allows deductions for business inputs, which are defined as: (1) the actual amount paid for goods, services, and materials whether or not sold during the taxable year; (2) the fair market value of business inputs brought into the United States; and (3) the actual cost, if reasonable, of travel and entertainment expenses for business purposes. A definition of "services" is not provided. Thus, it is unclear whether the cost of services includes amounts paid for the use of tangible or intangible property, such as rents or royalties. Presumably, it does not include amounts paid for the use of money (i.e., interest expense). This raises certain issues. First, it would seem unfair that the cost of acquiring tangible property to be used in a business activity would be deductible while the cost of leasing identical property might not. Similarly, it would seem unfair that the cost of acquiring intangible property to be used in a business activity would not be deductible while the cost of licensing identical property might be. Second, allowing deductions for the cost of acquiring, but not renting, property not only would drive a wedge between the decision to lease or buy, but also would invite

taxpayers to disguise leases as installment sales. Conversely, if lease payments are deductible, but interest expense is not, a taxpayer using property would have an incentive to characterize the transaction as a lease rather than an installment sale.[45]

Imported business inputs

It is unclear what the bill intends by allowing of a deduction for "the fair market value of business inputs brought into the United States." The allowance of this deduction may be redundant, as it would seem that if a taxpayer purchases goods or services from abroad, the acquisition costs would be deductible under the general rules allowing deductions for the purchases of tangible property and other business inputs. However, because the bill allows deductions for inputs "brought" into the United States, a "purchase" of imports from another person may not be necessary to secure a deduction. Thus, to take an extreme case, the mere transportation of inputs from outside the United States into the United States would literally generate a deduction equal to the fair market value of the property. However, without further clarification, it is unclear how to interpret this provision of the bill. In addition, as drafted, this deduction also raises valuation concerns.

Financial institutions

As indicated above, the treatment of financial institutions (e.g., depository institutions such as banks and savings and loans and insurance companies) is unclear under the proposed flat tax. It would appear that depository institutions would include in gross receipts interest income received from borrowers since such income likely could not be classified as excludible investment income. However, the bill does not appear to allow a deduction for interest paid to depositors, or for bad debts. Similarly, insurance companies would be required to include in gross receipts premiums received from policy holders but would not be allowed deductions for claims paid or additions to reserves. Thus, based on a literal reading, the bill seemingly would create a gross receipts tax for financial institutions and, given the relatively small profit margin under which some of these institutions operate, may create an effective tax rate in excess of 100 percent. Similar issues arise with respect to other institutions such as regulated investment companies (RICs), real estate investment trusts (REITs), and other investment vehicles.

Presumably, a gross receipts tax on financial institutions is unintended. However, what is intended is unclear. Options include: (1) excluding financial institutions from the tax or (2) providing a special regime for the taxation of such institutions (e.g., by allowing deductions for interest for financial institutions). However, providing special rules for financial institutions requires a definition of such taxpayers. For example, is a department store that issues its own credit card a financial institution?

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[45] Suppliers of property would have opposite incentives. For instance, assuming interest income is excludible, and rental income is includible in income, supplying taxpayers would have an incentive to characterize transactions as installment sales (with a disproportionate amount of the proceeds from installment sales characterized as interest) rather than as a lease of property.

Accounting methods

The present-law Federal income tax allows, requires, or denies the use of a number of different accounting methods, including the cash receipts and disbursements method, accrual methods, the installment method, long-term contract methods, mark-to-market methods, original issue discount accruals, and hybrid methods. Allowable methods for tax accounting often conform to methods that the taxpayer may use for nontax purposes (e.g., for purposes of financial statement reporting or for regulatory purposes). It is unclear to what extent the bill requires taxpayers to use explicit accounting methods. In some instances, the bill seems to require the use of the cash receipts and disbursements method in certain instances by allowing deductions for "the amount paid" for business inputs and the "actual cost of travel and entertainment." In other instances, the bill is silent as to permissible accounting methods. To the extent a taxpayer is required to use an explicit accounting method under the new tax system, consideration should be given to the recordkeeing burdens that the use of the method would entail. For example, it may be inappropriate to require a taxpayer to use the cash receipts and disbursements method for tax purposes if it uses an accrual method for financial accounting purposes.

In addition, if the intent of the bill is to exclude interest from gross income and deny the deduction for interest expense, special accounting rules may be required to reflect accurately the time value elements of prepayments and deferred payments.

D. Transition Issues

The bill applies to taxable years beginning after December 31, 1995, and does not provide any transition from the present-law income tax to the new tax. Because the bill does not provide for a coordination or a transition between the present-law income tax and the new tax, items of income, deduction or loss may be included or excluded under both taxes. For example, the bill provides for expensing of capital items (e.g., land, buildings, and machinery and equipment) acquired after the effective date, but does not allow for the recovery of the costs of items placed in service before the effective date. Thus, a calendar-year corporation that acquires a building on December 31, 1995, would not be allowed to recover the cost of the building at any time of the under the new tax, while a calendar-year corporation that acquires a building on January 1, 1996, would be allowed to deduct 100 percent of the cost of the building in 1996. Similarly, taxpayers that borrowed money anticipating interest deductions under the present-law income tax would be denied such deductions under the new tax. Other taxpayers (e.g., lenders) may experience a windfall with respect to pre-effective date investments, the returns on which are no longer subject to tax.

APPENDIX: DATA ON PROJECTED 1995 DEDUCTIONS FOR INDIVIDUAL TAXPAYERS

Table A-1.—Tax Returns That Claim the Standard Deduction and Tax Returns That Itemize (1995 Projections)

Income category [1]	Standard deductions		Itemized deductions	
	Number of tax returns (thousands)	Dollars claimed (millions)	Number of tax returns (thousands)	Dollars claimed (millions)
$0-$10,000	10,879	$55,716	165	$2,131
$10,000-$20,000	16,315	78,628	898	9,739
$20,000-$30,000	15,585	79,235	2,071	20,677
$30,000-$40,000	12,120	67,205	3,543	38,173
$40,000-$50,000	7,899	47,326	4,212	47,458
$50,000-$75,000	7,827	49,724	9,797	128,410
$75,000-$100,000	1,775	11,887	6,312	101,851
$100,000-$200,000	691	4,735	5,239	123,262
$200,000 and over	113	743	1,520	107,576
Total	73,204	395,201	33,757	579,276

[1] The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: employer contributions for health plans; employer contributions for the purchase of life insurance; employer share of payroll taxes; workers compensation; tax exempt interest; excluded income of U.S. citizens living abroad; nontaxable social security benefits; insurance value of Medicare benefits; and alternative minimum tax preference items.

Source: Joint Committee on Taxation.

Table A-2—Tax Returns Claiming An Itemized Deduction For A Charitable Contribution (1995 Projections)

Income category[1]	Numbers of tax returns (thousands)	Dollars claimed (millions)
$0–$10,000	100	$53
$10,000–$20,000	603	523
$20,000–$30,000	1,655	1,841
$30,000–$40,000	3,027	3,848
$40,000–$50,000	3,686	5,043
$50,000–$75,000	8,981	13,862
$75,000–$100,000	6,000	11,440
$100,000–$200,000	5,031	14,127
$200,000 and over	1,466	17,630
Total	30,550	68,367

[1] The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: employer contributions for health plans; employer contributions for the purchase of life insurance; employer share of payroll taxes; workers compensation; tax exempt interest; excluded income of U.S. citizens living abroad; nontaxable social security benefits; insurance value of Medicare benefits; and alternative minimum tax preference items.

Source: Joint Committee on Taxation.

Table A-3.—Tax Returns Claiming An Itemized Deduction For Mortgage Interest Paid (1995 Projections)

Income category[1]	Number of tax returns (thousands)	Dollars claimed (millions)
$0–$10,000	118	$1,129
$10,000–$20,000	603	4,152
$20,000–$30,000	1,478	8,755
$30,000–$40,000	2,711	17,492
$40,000–$50,000	3,446	22,988
$50,000–$75,000	8,495	64,772
$75,000–$100,000	5,567	49,417
$100,000–$200,000	4,477	56,579
$200,000 and over	1,216	29,131
Total	28,110	254,415

[1] The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: employer contributions for health plans; employer contributions for the purchase of life insurance; employer share of payroll taxes; workers compensation; tax exempt interest; excluded income of U.S. citizens living abroad; nontaxable social security benefits; insurance value of Medicare benefits; and alternative minimum tax preference items.

Source: Joint Committee on Taxation.

Table A-4.—Tax Returns Claiming An Itemized Deduction For Investment Interest Paid (1995 Projections)

Income category[1]	Number of tax returns (thousands)	Dollars claimed (millions)
$0–$10,000	2	$8
$10,000–$20,000	17	39
$20,000–$30,000	51	149
$30,000–$40,000	72	177
$40,000–$50,000	88	217
$50,000–$75,000	257	531
$75,000–$100,000	245	609
$100,000–$200,000	505	2,118
$200,000 and over	478	9,110
Total	1,715	12,959

[1]The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: employer contributions for health plans; employer contributions for the purchase of life insurance; employer share of payroll taxes; workers compensation; tax exempt interest; excluded income of U.S. citizens living abroad; nontaxable social security benefits; insurance value of Medicare benefits; and alternative minimum tax preference items.

Source: Joint Committee on Taxation.

Table A-5.—Tax Returns Claiming an Itemized Deduction For State and Local Income Taxes Paid (1995 Projections)

Income category[1]	Number of tax returns (thousands)	Dollars claimed (millions)
$0–$10,000	75	$49
$10,000–$20,000	491	290
$20,000–$30,000	1,446	1,271
$30,000–$40,000	2,788	3,424
$40,000–$50,000	3,417	5,894
$50,000–$75,000	8,309	19,822
$75,000–$100,000	5,424	19,139
$100,000–$200,000	4,544	26,802
$200,000 and over	1,327	37,495
Total	27,819	114,186

[1]The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: employer contributions for health plans; employer contributions for the purchase of life insurance; employer share of payroll taxes workers' compensation; tax exempt interest; excluded income of U.S. citizens living abroad; nontaxable social security benefits; insurance value of Medicare benefits; and alternative minimum tax preference items.

Source: Joint Committee on Taxation.

Table A-6.—Tax Returns Claiming an Itemized Deduction For Real Property Taxes Paid (1995 Projections)

Income category [1]	Number of tax returns (thousands)	Dollars claimed millions
$0–$10,000	120	$245
$10,000–$20,000	678	1,202
$20,000–$30,000	1,662	2,809
$30,000–$40,000	2,892	4,588
$40,000–$50,000	3,615	5,741
$40,000–$75,000	8,722	15,521
$75,000–$100,000	5,810	12,356
$100,000–$200,000	4,918	14,639
$200,000 and over	1,440	8,377
Total	29,858	65,479

[1] The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: employer contributions for health plans; employer contributions for the purchase of life insurance; employer share of payroll taxes, workers' compensation; tax exempt interest; excluded income of U.S. citizens living abroad; nontaxable social security benefits; insurance value of Medicare benefits; and alternative minimum tax preference items.

Source: Joint Committee on Taxation.

Table A-7.—Tax Returns Claiming an Itemized Deduction For Other State and Local Taxes Paid (1995 Projections)

Income category [1]	Number of tax returns (thousands)	Dollars claimed (millions)
$0–$10,000	58	$27
$10,000–$20,000	328	135
$20,000–$30,000	841	317
$30,000–$40,000	1,668	646
$40,000–$50,000	2,059	673
$50,000–$75,000	4,985	1,787
$75,000–$100,000	3,429	1,506
$100,000–$200,000	2,901	1,563
$200,000 and over	823	1,001
Total	17,094	7,656

[1] The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: employer contributions for health plans; employer contributions for the purchase of life insurance; employer share of payroll taxes; workers' compensation; tax exempt interest; excluded income of U.S. citizens living abroad; nontaxable social security benefits; insurance value of Medicare benefits; and alternative minimum tax preference items.

Source: Joint Committee on Taxation.

Table A-8.—Tax Returns Claiming an Itemized Deduction For Medical Expenses Incurred in Excess of 7.5 Percent of Adjusted Gross Income (1995 Projections)

Income category [1]	Number of tax returns (thousands)	Dollars claimed (millions)
$0–$10,000	78	$568
$10,000–$20,000	395	2,843
$20,000–$30,000	810	4,245
$30,000–$40,000	1,058	5,407
$40,000–$50,000	872	4,257
$50,000–$75,000	1,212	5,185
$75,000–$100,000	414	2,602
$100,000–$200,000	201	1,818
$200,000 and over	26	712
Total	5,067	27,636

[1] The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: employer contributions for health plans; employer contributions for the purchase of life insurance; employer share of payroll taxes; workers' compensation; tax exempt interest; excluded income of U.S. citizens living abroad; nontaxable social security benefits; insurance value of Medicare benefits; and alternative minimum tax preference items.

Source: Joint Committee on Taxation.

Table A-9.—Tax Returns Claiming an Itemized Deduction for Miscellaneous Expenses in Excess of 2 Percent of Adjusted Gross Income (1995 Projections)

Income category [1]	Number of tax returns (thousands)	Dollars claimed (millions)
$0–$10,000	42	$51
$10,000–$20,000	241	530
$20,000–$30,000	518	1,244
$30,000–$40,000	980	2,581
$40,000–$50,000	1,057	2,651
$50,000–$75,000	2,457	6,883
$75,000–$100,000	1,500	4,894
$100,000–$200,000	1,166	5,973
$200,000 and over	283	4,516
Total	8,245	29,287

[1] The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: employer contributions for health plans; employer contributions for the purchase of life insurance; employer share of payroll taxes; workers' compensation; tax exempt interest; excluded income of U.S. citizens living abroad; nontaxable social security benefits; insurance value of Medicare benefits; and alternative minimum tax preference items.

Source: Joint Committee on Taxation.

Table A-10.—Tax Returns Claiming an "Above the Line" Deduction for Moving Expenses (1995 Projections)

Income category [1]	Number of tax returns (thousands)	Dollars claimed (millions)
$0–$10,000	9	$15
$10,000–$20,000	77	91
$20,000–$30,000	237	249
$30,000–$40,000	285	363
$40,000–$50,000	241	325
$50,000–$75,000	455	689
$75,000–$100,000	234	548
$100,000–$200,000	256	864
$200,000 and over	55	280
Total	1,850	3,425

[1] The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: employer contributions for health plans; employer contributions for the purchase of life insurance; employer share of payroll taxes; workers' compensation; tax exempt interest; excluded income of U.S. citizens living abroad; nontaxable social security benefits; insurance value of Medicare benefits; and alternative minimum tax preference items.

Source: Joint Committee on Taxation.

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