[JOINT COMMITTEE PRINT]

IMPACT ON INDIVIDUALS AND FAMILIES OF REPLACING THE FEDERAL INCOME TAX

SCHEDULED FOR A PUBLIC HEARING

BEFORE THE

HOUSE COMMITTEE ON WAYS AND MEANS

ON APRIL 15, 1997

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The House Committee on Ways and Means has scheduled a public hearing on April 15, 1997, on issues relating to the impact on individuals and families of proposals to replace the Federal tax system. The hearing will focus on the effects of the following possible proposed replacement tax systems: (1) a national retail sales tax; (2) a value-added tax, (3) a consumption-based flat tax; (4) a cash flow tax, and (5) a "pure" income tax. Some of these proposed replacement tax systems have been the subject of introduced legislation in recent Congresses. On March 6, 1996, Messrs. Schaefer, Tauzin, Chrysler, Bono, Hefley, Linder, and Stump introduced H.R. 3039 (104th Cong.), the "National Retail Sales Tax Act of 1996." On May 26, 1994, Senators Boren and Danforth introduced S. 2160 (103rd Cong.), the "Business Transfer Tax," which is a subtraction-method, value-added tax. On July 19, 1995, Mr. Armey and Senator Shelby introduced H.R. 2060 and S. 1050 (104th Cong.), respectively. On March 17, 1997, Mr. Armey introduced H.R. 1040 (105th Cong.), which is substantially similar to H.R. 2060 and S. 1050 (104th Cong.). These bills provide consumption-based flat taxes. On April 25, 1995, Senators Nunn and Domenici introduced S. 722 (104th Cong.), the "USA Tax Act of 1995," which contains two consumption-based taxes—a cash flow tax on individuals and a subtraction-method, value-added tax on businesses.

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, describes present law and various tax restructuring proposals with respect to individuals and families, and provides an analysis of issues relating to tax restructuring and the impact on individuals and families.

Part I of this pamphlet is an overview. Part II provides a description of present-law provisions relating to the individual income tax (regular income tax and alternative minimum tax), payroll taxes, estate and gift taxes, and certain excise taxes. Part III is a description of the proposed tax restructuring alternatives. Part IV is an analysis of issues relating to tax restructuring proposals and the taxation of individuals and families. Appendix A provides data on the marriage penalty or bonus under the Federal income tax. Appendix B provides data on income and payroll tax liabilities of median income families.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Impact on Individuals and Families of Replacing the Federal Income Tax* (JCS-8-97), April 14, 1997.

I. OVERVIEW

The current U.S. Federal tax system

The current Federal income tax system consists primarily of the regular income tax imposed on the income of individuals and corporations. An individual's income tax liability is determined by applying a graduated rate schedule to the individual's worldwide taxable income and adjusting for applicable tax credits. In the case of individuals, the rate of tax depends on the individual's filing status (i.e., single, head of household, married filing a joint return, and married filing a separate return) and the individual's taxable income. Generally, the individual's taxable income is gross income (determined with respect to applicable deferrals and exclusions) less personal exemptions and the greater of (1) itemized deductions or (2) the standard deduction. For each filing status, the rate schedules are broken into several ranges of income, known as income brackets, and the marginal tax rate increases as a taxpayer's taxable income increases. The present-law marginal tax rates are 15 percent, 28 percent, 31 percent, 36 percent and, 39.6 percent. Capital gains are subject to a maximum rate of 28 percent. The individual may use various income tax credits to reduce his regular income tax liability. 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 liability.

The U.S. Federal tax system also includes employment taxes which are used, in part, to finance Social Security benefits, Medicare, and unemployment compensation; an estate and gift tax; and excise taxes on selected goods and services. Revenues generated from some of the U.S. excise taxes are dedicated to trust funds to be used for specific purposes.

While there is no Federal broad-based consumption tax, most States and many State political subdivisions impose general sales taxes. Many State and local governments also impose property taxes.

Tax restructuring alternatives

This pamphlet describes five alternatives to replace the current income tax system. These are (1) a national retail sales tax, (2) a value-added tax, (3) a consumption-based flat tax, (4) a cash flow tax, and (5) a "pure" income tax. Other than the "pure" income tax, these alternative tax systems generally are consumption-based, rather than income-based, taxes. The major difference between a consumption-based tax and an income-based tax relates to the treatment of savings. Under an income-based tax, returns on savings (e.g., dividends, interest, and capital gains) generally are subject to tax; under a consumption-based tax, these returns generally are excluded from the tax base. This exclusion may be provided by

taxing consumption directly, excluding investment income from the base, or providing a deduction for increased savings. The current Federal "income" tax contains some features that are consumption-based (e.g., the treatment of qualified retirement plans).

Issues relating to tax restructuring and the taxation of the individual and family

The analysis in the pamphlet provides some background on the alternative tax systems and discusses taxation of the family. The background discussion concludes that each of the major alternatives has the same base, consumption, in contrast to the current income tax base. It further notes that several of the alternative tax systems attempt integration of business and individual taxes. Finally, it offers criteria for an analysis of the alternative tax systems. The issues relating to the taxation of the family include a discussion of: a marriage penalty; distortions of household choice; fairness; compliance; simplification; and other issues. The other issues involve transition and the effects of tax restructuring on housing and charitable giving.

Data relating to Federal income and payroll tax revenues

Table 1 provides information about historic levels of Federal income and payroll tax receipts from 1940 to 1996. Figure 1 shows individual income tax and payroll tax receipts as a percentage of Gross Domestic Product (GDP) from 1940–1996. Prior to World War II, individual income tax receipts were small in comparison to the U.S. economy. Since World War II, individual income tax receipts have constituted about 8 percent of the U.S. GDP annually. Over the postwar era, expansion of covered employees, expansion of the wage base, and increases in the tax rate have increased the importance of the payroll tax in the U.S. economy.

Table 1.—Federal Revenues From Individual Income and Payroll Taxes, 1940–1996

[In billions of nominal dollars]

Year	Individual income tax revenues	Total payroll and self-employment tax revenues
1996	656.4	509
1995	590.2	484
1994	543.1	461
1993	509.7	428
1992	476.0	414
1991	467.8	396
1990	466.9	380
1989	445.7	359
1988	401.2	334
1987	392.6	303
1986	349.0	284
1985	334.5	265
1984	298.4	239

Table 1.—Federal Revenues From Individual Income and Payroll Taxes, 1940–1996—Continued

[In billions of nominal dollars]

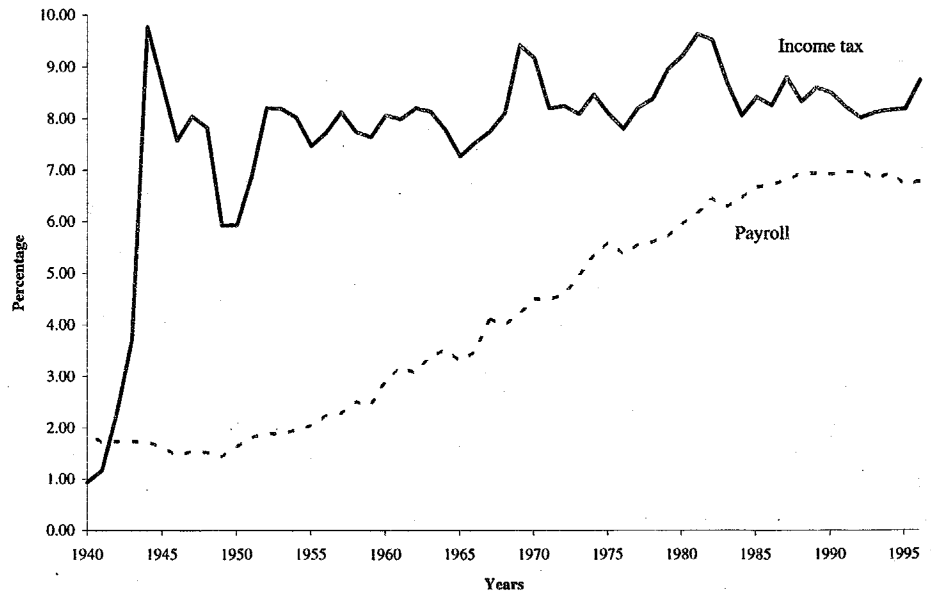
Year	Individual income tax revenues	Total payroll and self-employment tax revenues
1983	288.9	209
1982	297.7	201
1981	285.9	183
1980	244.1	158
1979	217.8	139
1978	181.0	121
1977	157.6	106
1976	131.6	91
1975	122.4	85
1974	119.0	75
1973	103.2	63
1972	94.7	53
1971	86.2	47
1970	90.4	44
1969	87.2	39
1968	68.7	34
1967	61.5	33
1966	55.4	26
1965	48.8	22
1964	48.7	22
1963	47.6	20
1962	45.6	17
1961	41.3	16
1960	40.7	15
1959	36.7	12
1958	34.7	11
1957	35.6	10
1956	32.2	9
1955	28.7	8
1954	29.5	7
1953	29.8	7
1952	27.9	6
1951	21.6	6
1950	15.8	4
1949	15.6	4
1948	19.3	4
1947	17.9	3
1946	16.1	3
1945	18.4	3
1944	19.7	3
1943	6.5	3
1942	3.3	2
1941	1.3	2

Table 1.—Federal Revenues From Individual Income and Payroll Taxes, 1940–1996—Continued

[In billions of nominal dollars]

Year	Individual income tax revenues	Total payroll and self-employment tax revenues
1940	0.9	2

Source: Office of Management and Budget, Historical Tables, *Budget of the United States Government, Fiscal Year 1998.*



Source: JCT staff calculations.

II. PRESENT LAW AND BACKGROUND

A. Individual Income Taxes

1. Sources of income

The current Federal income tax system consists primarily of income taxes imposed on the income of individuals and corporations. 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 gross income less certain exclusions, exemptions, and deductions. Graduated 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.

Under the Internal Revenue Code of 1986 (the "Code"), gross income means "income from whatever source derived" except for certain items specifically exempt or excluded by statute.[3] 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 from the discharge of indebtedness, income in respect of a decedent, and income from S corporations, partnerships, trusts or estates. As described in detail below, statutory exclusions from gross income include death benefits payable under a life insurance contract, interest on certain State and local bonds, employer-provided health insurance, employer-provided pension contributions, and certain other employer-provided fringe benefits.

Broadly speaking, the gross income of most individuals is derived from underlying trade or business activities.[4] Individual gross income may take the form of income from labor (e.g., salaries, wages, and retirement benefits), income from passive investments in businesses (e.g., interest, dividends, and capital gains), or income of business activities that are reported directly by the individual (e.g., rents and royalties, gross profits from sole proprietorship, and income from pass-through entities).

Some income derived from trade or business activities is subject to one level of tax, while other such income is subject to two levels of tax. For Federal income tax purposes, a corporation generally is treated as a separate taxpayer apart from its shareholders. Any net income earned by the corporation is subject to the corporate income

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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 (at a 30-percent rate) only on income derived from sources within the United States and income that is effectively connected with the conduct of a trade or business within the United States.

[3] Code section 61.

[4] Exceptions are amounts received from governmental or charitable organizations.

tax.[5] In determining its taxable income, a corporation generally is allowed deductions for its ordinary and necessary business expenditures. Thus, amounts paid to independent contractors and employees for services and to creditors as interest are subject to one level of tax because such amounts are deductible by the payor corporation, and are includible in the incomes of the recipient service providers or creditors. Conversely, distributions from a corporation with respect to its stock (either as dividends or in liquidation) are subject to two levels of tax because such amounts are not deductible by the corporation, but are includible in the income of the individual shareholders. Some entities (i.e., partnerships, S corporations,[6] and certain trusts, collectively known as "pass-through entities"), on the other hand, generally are not subject to an entity-level tax.[7] Instead, income earned by pass-through entities, whether distributed or not, is taxed directly to the owners in proportion to their interests in the entities, and distributions from the entities generally are tax-free.[8] Similarly, income earned by a sole proprietorship is taxed directly to the individual owner.

Figure 2, below, shows sources of income that are subject to tax for all individuals. The major source of individuals' income subject to tax is wages and salaries, which constitute nearly 75 percent of all such income. The next most significant sources of income for individuals are business and farm income (including income reported on Schedule E), which constitute just over 7 percent, and taxable amounts from pensions and IRAs, which constitute just under 7 percent of such income.

[5] Code section 11. Such corporations generally are referred to as "C corporations" because the tax rules governing the relationship between such corporations and their shareholders are found in subchapter C of the Code.

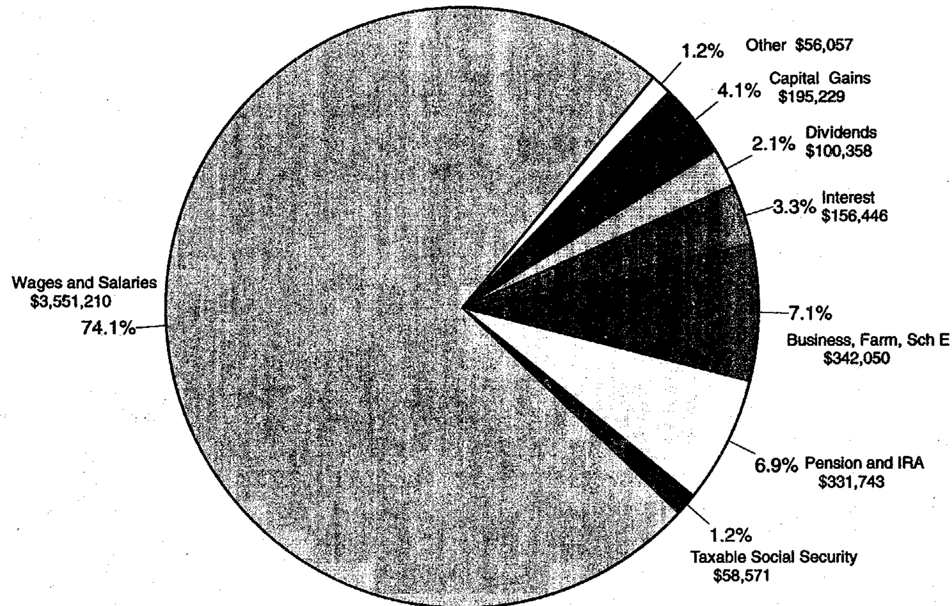
[6] A small business corporation and its shareholders may elect to be treated in a manner similar to the treatment of a partnership and its partners. Such corporations generally are referred to as "S corporations" because the tax rules governing the treatment of such entities are found in subchapter S of the Code.

[7] In addition, a single level of tax is accorded to certain investment vehicles (such as regulated investment companies, real estate investment trusts, real estate mortgage investment conduits, and financial asset securitization investment trusts) under various statutory regimes.

[8] Losses and tax credits from a pass-through entity generally may not be claimed by an individual unless the individual is "at risk" with respect to, and "materially participates" in, the activities of the entity (secs. 465 and 469).

Figure 2
Sources of Gross Income Subject to Tax for All Individual Taxpayers (including Nonfilers) (Estimated 1997 Levels of Income)

(Millions)



Source: Joint Committee on Taxation

2. Exclusions from and deferrals of income

a. Exclusions from income

i. In general

Present law provides specific exclusion from gross income for certain items of income. Exclusions from income are frequently provided for nontax policy reasons, such as to encourage particular behavior or in situations in which income inclusion has been determined to be inappropriate. For example, the exclusion from income for employer-provided health care is provided in order to encourage employers to provide health insurance for their employees and to encourage employees to prefer to receive some part of their compensation in the form of health insurance. Some exclusions are also provided for administrative reasons. For example, property or services provided by an employer are excludable from gross income as a de minimis fringe benefit if the value is so small as to make accounting for it unreasonable or administrably impracticable.

The benefit of an exclusion from income increases as the taxpayer's marginal tax rate increases. That is, the higher an individual's marginal tax rate, the more the individual saves in taxes by reason of an exclusion. In the case of items that are excludable from wages for employment tax purposes, the individual benefits from reduced employment taxes. However, the individual may also have reduced social security benefits in the future as a result of the exclusion.

Certain of the exclusions from income under present law are described in brief below.

ii. Employer-provided fringe benefits

Employer-provided accident or health care.—Contributions for and amounts received under employer-provided accident or health plans (including plans providing long-term care services or insurance) and employer contributions to medical savings accounts generally are excludable from gross income and from wages for employment tax purposes. The exclusion is limited in the case of a self-insured medical reimbursement plan which discriminates in favor of highly compensated employees.

Educational assistance.—Up to $5,250 annually of employer-provided educational assistance is excludable from gross income and wages, if the assistance is provided pursuant to a separate written plan of an employer that does not discriminate in favor of highly compensated employees and certain other requirements are satisfied. The exclusion does not apply to graduate-level courses beginning after June 30, 1996. The exclusion does not apply to courses beginning after May 31, 1997.[9]

In the absence of the exclusion, employer-provided education assistance is excludable from gross income and wages only if the educational assistance relates to the employee's current job.

Dependent care assistance.—Up to $5,000 annually of employer-provided dependent care assistance is excludable from gross income

[9] A technical correction may be necessary so that the statute reflects this intent. As currently drafted, the statute provides that the exclusion expires with respect to courses beginning after June 30, 1997.

and wages if the assistance is provided pursuant to a separate written plan of an employer that does not discriminate in favor of highly compensated employees and meets certain other requirements. The amount excludable cannot exceed the earned income of the employee or, if the employee is married, the lesser of the earned income of the employee or the earned income of the employee's spouse.

Adoption assistance.—Up to $5,000 per child ($6,000 in the case of a child with special needs) of employer-provided adoption assistance is excludable from gross income. The exclusion does not apply for employment tax purposes. The exclusion is phased out between $75,000 and $115,000 of modified adjusted gross income. This exclusion expires with respect to amounts paid or expenses incurred after December 31, 2001.

Group-term life insurance.—Gross income and wages do not include the cost of up to $50,000 of group-term life insurance provided by the employer.

Miscellaneous employee fringe benefits.—The following miscellaneous fringe benefits are excludable from income and wages if certain requirements are satisfied: (1) services provided at no additional cost to the employer, (e.g., free flights to airline personnel); (2) qualified employee discounts; (3) working condition fringe benefits (i.e., items that would be deductible as a business expense if the individual paid for the item); and (4) de minimis fringe benefits. In addition, up to $65 per month (for 1996) of van pooling or transit passes provided by the employer and up to $165 per month (for 1996) of qualified parking are excludable from income and wages. Amounts paid by an employer for moving expenses that would be deductible by the employee are excludable from income (if the employee did not deduct the expenses). The value of the use of certain on-premises gyms and other athletic facilities is excludable from income and wages.

The value of meals or lodging furnished to an employee and his or her spouse or dependents for the convenience of the employer are excludable from income and wages. In the case of meals, the meal must be furnished on the business premises of the employer in order for the exclusion to apply. The exclusion for lodging generally does not apply unless the employee is required to accept the lodging on the business premises of the employer as a condition of employment.

Cafeteria plans.—Under present law, compensation generally is includible in gross income in the year in which it is actually or constructively received. An amount is constructively received if it is made available to the taxpayer. Under one exception to the constructive receipt rules, no amount is includible in the gross income of a participant in a cafeteria plan meeting certain requirements merely because the participant can chose between cash and certain nontaxable benefits (such as health care). This exception generally also applies for purposes of employment taxes. If the individual elects to take cash rather than benefits, then the amount of cash received is includible in income and wages.

iii. Qualified scholarships

Gross income does not include amounts received as a qualified scholarship by an individual who is a candidate for a degree at a qualified education institution or tuition reduction provided to an employee of an educational institution for education below the graduate level. Neither exclusion applies to amounts that are compensation for services required as a condition of receiving the scholarship or tuition reduction, nor does the exclusion apply to amounts attributable to room and board.

iv. Life insurance and accelerated death benefits

Under present law, the investment income ("inside buildup") earned on premiums credited under a life insurance contract is not subject to current taxation. Amounts received under a life insurance contract by reason of the death of the insured or with respect to an insured who is terminally ill or chronically ill are excludable from income. Thus, neither the policyholder nor the policyholder's beneficiary is ever taxed on the inside buildup if the proceeds of the policy are paid to the policyholder's beneficiary by reason of the death of the insured or of the insured being terminally or chronically ill.[10]

v. Gifts and inheritances

Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance. The value of items so acquired may, however, be subject to the estate and gift tax, discussed below.

vi. Military benefits

Gross income does not include certain benefits provided to members of the armed forces and their families.

vii. Education savings bonds

Gross income does not include amounts received under an education savings bond to the extent used to pay qualified higher education expenses. The exclusion is phased out for individuals with modified adjusted gross income between $40,000 and $55,000 in the case of a single taxpayer and $60,000 to $90,000 in the case of a married taxpayer.

viii. Compensation for personal injuries or sickness

Gross income does not include amounts received under workmen's compensation acts as compensation for personal injuries or sickness. In addition, gross income does not include amounts received as damages (other than punitive damages) on account of personal physical injuries or physical sickness.

ix. Step-up of basis at death

Under present law, gain is generally recognized on the sale or exchange of property to the extent the amount received exceeds the individual's basis. In general, the basis is the individual's cost of

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[10] In the case of payments with respect to a chronically ill individual, the exclusion may be limited in certain circumstances.

acquiring the property. In the case of property acquired from a decedent, the basis of the individual receiving the property is equal to the fair market value of the property on the date of death (i.e., there is a "stepped-up basis"). The effect of the stepped-up basis is to provide an exclusion for the amount of gain that would have been recognized had the property been sold at the date of the decedent's death.

x. U.S. citizens living abroad

U.S. citizens generally are subject to U.S. income tax on all their income, whether derived in the United States or elsewhere. A U.S. citizen who earns income in a foreign country also may be taxed on such income by that foreign country. However, the United States generally cedes the primary right to tax income derived by a U.S. citizen from sources outside the United States to the foreign country where such income is derived. Accordingly, a credit against the U.S. income tax imposed on foreign source taxable income is provided for foreign taxes paid on that income.

U.S. citizens living abroad may be eligible to exclude from their income for U.S. tax purposes certain foreign earned income and foreign housing costs. In order to qualify for these exclusions, a U.S. citizen must be either (1) a bona fide resident of a foreign country for an uninterrupted period that includes an entire taxable year or (2) present overseas for 330 days out of any 12 consecutive month period. In addition, the taxpayer must have his or her tax home in a foreign country.

The exclusion for foreign earned income generally applies to income earned from sources outside the United States as compensation for personal services actually rendered by the taxpayer. The maximum exclusion for foreign earned income for a taxable year is $70,000.

The exclusion for housing costs applies to reasonable expenses, other than deductible interest and taxes, paid or incurred by or on behalf of the taxpayer for housing for the taxpayer and his or her spouse and dependents in a foreign country. The exclusion amount for housing costs for a taxable year is equal to the excess of such housing costs for the taxable year over an amount computed pursuant to a specified formula. In the case of housing costs that are not paid or reimbursed by the taxpayer's employer, the amount that would be excludible is treated instead as a deduction.

The combined earned income exclusion and housing cost exclusion may not exceed the taxpayer's total foreign earned income. The taxpayer's foreign tax credit is reduced by the amount of such credit that is attributable to excluded income.

Special exclusions apply in the case of taxpayers who reside in one of the U.S. possessions.

xi. Tax-exempt interest

The Code exempts interest on certain debt obligations of States, territories, and possessions of the United States from the regular individual and corporate income taxes (sec. 103).[11] Interest on debt

[11] Interest on the Federal Government's debt is taxable, but repayment is guaranteed by the United States. With the exception of State and local government bonds guaranteed under cer-

Continued

of local governments generally receives identical treatment to that provided for States. Interest on these "State and local government bonds" may, in certain cases, be includible in calculating the individual and corporate alternative minimum taxes.[12] Additionally, State and local government bond interest is included in determining whether a portion of Social Security benefits is taxable under the regular individual income tax.

The State and local government bond interest exemption applies to two principal types of bonds. First, interest is tax-exempt on bonds issued to finance public activities conducted and paid for by States and local governments themselves ("governmental bonds"). Examples of activities financed with governmental bonds are schools, courthouses, roads, public mass transit systems, and governmentally owned and operated water, sewer, and electric facilities.[13] States and local governments also may issue limited amounts of tax-exempt working capital debt to cover cash-flow shortfalls pending receipt of tax or other revenues ("TRANS"). Further, for Federal income tax purposes, interest paid by these governments under installment sales contracts and finance leases is treated as bond interest.

The second major category of State and local government bonds on which interest is tax-exempt consists of bonds issued by these governmental units acting as a conduit to provide financing for private persons ("private activity bonds"). Unlike governmental bonds, tax-exempt private activity bonds generally may only be issued for purposes specified in the Code. The specified purposes generally relate to privately operated transportation facilities, privately provided municipal services, economic development, and certain social programs. The typical private activity bond issue involves a State or local government as a nominal borrower, with the funds being simultaneously re-lent to the ultimate private borrower. Repayment of most private activity bonds comes exclusively from the ultimate private borrower; bond documents may state that there is neither a legal nor a moral obligation of the issuing governmental unit to repay the bonds.

Private activity bonds are classified into several major categories: exempt-facility bonds; qualified redevelopment bonds; qualified small-issue bonds; mortgage revenue bonds; qualified student loan bonds; bonds for charitable organizations exempt from tax under Code section 501(c)(3), and bonds for businesses located in Federal empowerment zones and enterprise communities. Because these bonds provide financing for private business or personal activities, are repaid or secured by private funds, and would not otherwise be subject to Federal restrictions, the Code includes detailed targeting

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tain grandfathered programs that were in existence before 1985, interest on State and local government bonds is not permitted to be both tax-exempt and Federally guaranteed.

[12] Interest on private activity bonds is a preference item in calculating both the individual and corporate alternative minimum taxes. Interest on all tax-exempt bonds is included in calculating the adjusted current earnings preference of the corporate alternative minimum tax.

[13] State and local government bonds used to finance the acquisition of existing output (e.g., electric utility) property are treated as private activity bonds even if the property is to be governmentally owned and operated, unless (1) the same service was provided to the area to be served by the acquiring governmental entity during the 10-year period before the acquisition, or (2) the area to be served is contiguous to the annexing governmental unit, does not exceed 10 percent of the service area of the acquirer, and is annexed in a qualifying annexation.

provisions. Further, issuance of most private activity bonds is subject to annual State volume limitations.

xii. Sales of principal residence ($125,000 exclusion)

In general, an individual, on a one-time basis, may exclude from gross income up to $125,000 of gain from the sale or exchange of a principal residence if the taxpayer (1) has attained age 55 before the sale, and (2) has owned the property and used it as a principal residence for three or more of the five years preceding the sale (sec. 121).

b. Deferrals of income

Present law provides that the inclusion of certain items of income is deferred until a later year. The benefit of deferral depends largely on the tax rate the individual will face in the future compared with current rates. If an individual expects that his or her tax rate will be lower in the future (e.g., because the individual will have less income in the future) or that tax rates in the future will be lower due to changes in the law, then the individual may wish to defer a portion of his or her income. Even in the case of stable tax rates over time, the deferral of income provides the taxpayer with a time value of money benefit. Many of the provisions providing for the deferral of income are intended to encourage savings by individuals.

i. Individual retirement arrangements

Under present law, under certain circumstances, an individual is allowed to deduct contributions to an individual retirement arrangement ("IRA") up to the lesser of $2,000 or 100 percent of the individual's compensation. In addition, contributions of up to $2,000 can be made for each spouse in a married couple, provided the compensation of the individual is at least equal to the contributed amount. The amounts held in an IRA, including earnings on contributions, generally are not included in taxable income until withdrawn.

The $2,000 IRA deduction limit is phased out over certain levels of adjusted gross income ("AGI") if the individual or the individual's spouse is an active participant in an employer-sponsored retirement plan. The phaseout is between $25,000 and $35,000 of AGI for single taxpayers and $40,000 and $50,000 for married taxpayers. There is no phaseout of the deduction if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan.

An individual may make nondeductible contributions to an IRA to the extent the individual is not permitted to make deductible IRA contributions due to the phaseout of the deduction.

Distributions from IRAs are generally includible in income when withdrawn. Distributions prior to death, disability, or attainment of age 59½ are subject to an additional 10-percent tax. The 10-percent additional tax does not apply to distributions made in the form of an annuity.

The benefit of the provisions relating to deductible and nondeductible IRAs is different. Deductible IRAs effectively exempt

earnings on invested sums from tax, while the nondeductible IRA taxes earnings, but on a deferred basis.[14]

ii. Employer-sponsored retirement plans

Qualified plans and cash or deferred arrangements

A plan of deferred compensation that meets the qualification standards of the Internal Revenue Code (a qualified plan) is accorded special treatment under present law. 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. The employer is entitled to a current deduction (within limits) for contributions to a qualified plan even though the contributions are not currently included in an employee's income. Contributions to a qualified plan are held in a tax-exempt trust.

The tax treatment of contributions under qualified plans is essentially the same as that of present-law deductible IRAs. However, the limits on contributions to qualified plans are much higher than the IRA contribution limits, so that qualified plans provide for a greater accumulation of funds on a tax-favored basis. In return for greater tax benefits, qualified plans are subject to rules that do not apply to IRAs, such as nondiscrimination rules that ensure that a qualified plan benefits a broad group of employees and does not discriminate in favor of highly compensated employees.

Qualified plan benefits are generally subject to tax when received under rules similar to those that apply to IRA withdrawals.

A qualified cash or deferred arrangement is one type of qualified plan commonly used by employers. In general, a cash or deferred arrangement is an arrangement under which an employee can elect to receive an amount in cash or have it contributed to a tax-qualified pension plan. Amounts that are contributed to the plan are not included in income until withdrawn from the plan. Qualified cash or deferred arrangements are subject to the rules applicable to qualified plans generally, and are also subject to additional rules, including special nondiscrimination rules.

The maximum annual amount that an employee can elect to have contributed to a cash or deferred arrangement is limited to $9,500 (for 1997). This dollar limit is indexed for inflation.

Other employer-sponsored retirement plans[15]

Present law contains provisions relating to a variety of other types of employer-sponsored retirement plans which have the same tax benefits as tax-qualified plans. These include SIMPLE retirement plans, simplified employee pensions, and tax-sheltered annuities.

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[14] For further discussion of this issue, see Joint Committee on Taxation, *Description and Analysis of Tax Proposals Relating to Individual Savings and IRAs* (JCS–2–97), March 3, 1997.

[15] Under present law, some individuals defer significant amounts of compensation pursuant to so-called nonqualified deferred compensation plans. These plans are not provided for under specific Code provisions and are not subject to specific rules in the Code as are tax-qualified and similar plans discussed in the text. Rather, the deferral occurs pursuant to the generally applicable income tax rules, discussed above.

iii. Deferred annuities

Present law provides that income credited to a deferred annuity contract is not currently includible in the gross income of the owner of the contract. In addition, the income is not taxed to the insurance company issuing the contract. No deduction is provided for, and no dollar limits are imposed on, amounts used to purchase annuity contracts. In general, amounts received by the owner of an annuity contract before the annuity starting date (including loans under or secured by the contract) are includible in gross income as ordinary income to the extent that the cash value of the contract exceeds the owner's investment in the contract. In addition, a portion of each distribution received after the annuity starting date is treated as ordinary income based on the ratio of the investment in the contract to the total distributions expected to be received.

A 10-percent additional income tax is imposed on certain early withdrawals under an annuity contract. This additional tax does not apply to any distribution made after the owner of the contract attains age 59½, receives annuity payments under the contract, or satisfies certain other requirements.

iv. Life insurance

Under present law, the investment income ("inside buildup") earned on premiums credited under a life insurance policy generally is not subject to current taxation to the owner of the policy or to the insurance company issuing the contract. This favorable tax treatment is available only if a life insurance contract meets certain requirements designed to limit the investment character of the contract. No deduction is provided for, and no dollar limits are imposed on, amounts used by an individual to purchase life insurance contracts.

Life insurance contracts can result in the deferral of income (as well as the exclusion of income, as described above).

Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income, to the extent that the amounts distributed exceed the taxpayer's basis in the contract. (An exclusion applies, however, for certain pre-death payments with respect to a terminally or chronically ill insured person.) Includible distributions generally are treated first as a tax-free recovery of basis, and then as income. In the case of a modified endowment contract, however, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10-percent tax is imposed on the income portion of distributions made before age 59½ and in certain other circumstances.

v. Incentive stock options

An incentive stock option ("ISO") is an option granted to an employee of a corporation in connection with the employee's performance of services for the corporation that meets certain specified requirements. For example, the option must be granted to pursuant to a plan which includes the aggregate number of shares which may be issued under options and the employees (or classed of employees which may receive the options). The option must be grant-

ed within 10 years of the date the plan is adopted, must be exercisable no more than 10 years following the grant of the option, and meet certain other requirements.

In absence of a special rule, upon exercise of an ISO the individual generally[16] would have ordinary income equal to the excess of the fair market value of the stock on the exercise date over the option price (and the corporation would be entitled to a deduction equal to that amount) However, under a special rule, no amount is includible in the income of an individual (and the corporation is not entitled to a deduction) due to the exercise of an ISO. Rather, the individual will have income only to the extent of gain realized upon disposition of the stock acquired pursuant to the stock. At that time, the income realized would generally be capital gain rather than ordinary income.

vi. Sales of stock to employee stock ownership plans

An individual who sells certain stock to an employee stock ownership plan ("ESOP") defers recognition of gain (or loss) on the sale to the extent the individual uses the proceeds to purchase qualified replacement property. In general, qualified replacement property is defined as any security issued by a domestic operating company that does not have passive investment income of more than 25 percent of the gross receipts of the company. Gain (or loss) is deferred until the individual disposes of the qualified replacement property. This treatment applies only to the sale of stock issued by a domestic corporation that does not have any outstanding stock that is readily tradable. This treatment does not apply unless the employee stock ownership plan owns at least 30 percent of the stock of the employee after the sale.

vii. Sales of principal residence (rollover of gain)

Gain is not taxed currently on the sale of a principal residence if a new residence at least equal in cost to the sales price of the old residence is purchased and used by the taxpayer as his or her principal residence within a specified period of time (sec. 1034). This replacement period generally begins two years before and ends two years after the date of sale of the old residence. The basis of the replacement residence is reduced by the amount of any gain not recognized on the sale of the old residence by reason of this gain rollover rule. Such rolled over gain is taxable whenever the gain is no longer rolled over to a next principal residence.

viii. Other nontaxable exchanges

Present law includes a number of provisions under which no gain or loss is recognized on the exchange or transfer of certain types of property. Recognition of gain (or loss) is deferred until the property acquired in the exchange is disposed of. These provisions include: exchanges of like-kind property; involuntary conversions of property; exchanges of insurance policies; and transfers of property incident to divorce.

[16] If the option itself had a fair market value, then the value of the option generally would be includible in income.

C. Estimates for certain exclusions and deferrals

Table 2, below, provides estimates for various exclusions and deferrals from income under present law.

Table 2.—Estimated Amounts Deducted or Excluded From Income Under the Present Income Tax for Various Items, Taxable Years 1997–2001

[In billions of dollars]

Item	1997	1998	1999	2000	2001	1997–01
(1) Net exclusion of pension contributions and earnings (employer plans, individual retirement plans, and Keogh plans)	312.4	324.9	337.5	350.8	341.6	1,667.2
(2) Exclusion of investment income on life insurance and annuity contracts	109.1	112.8	117.5	121.3	125.5	586.2
(3) Exclusion of employer contributions for medical insurance premiums and medical care [1]	257.2	270.1	284.6	299.8	315.9	1,427.6
(4) Exclusion for U.S. citizens living abroad	12.7	13.4	14.0	14.7	15.5	70.3
(5) Exclusion of tax exempt interest	99.6	103.0	107.8	112.8	117.9	541.1
(6) Deferral and exclusion of capital gains on sales of principal residences	67.7	69.8	72.3	74.9	77.6	362.3

[1] Estimate includes employer-provided health insurance purchased through cafeteria plans.

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

Source: Joint Committee on Taxation.

3. Deductions from income

a. Above-the-line deductions

In general.—Once an individual determines his gross income by including those income items that are subject to the individual income tax and omitting those items that are deferred or excluded, the individual determines his adjusted gross income ("AGI"). An individual's AGI is determined by subtracting certain "above-the-line" deductions from gross income. These deductions include trade or business expenses, capital losses, contributions to a tax-qualified retirement plan by a self-employed individual, contributions to individual retirement arrangements ("IRAs"), alimony payments, and certain moving expenses. As an example, the above-the-line deduction for certain moving expenses is described below.

Moving expenses.—A taxpayer is allowed an above-the-line deduction in computing AGI for certain unreimbursed moving expenses (sec. 62). If an employer reimburses the employee for otherwise allowable moving expenses, the employer should exclude those reimbursements from the employee's income and the employee may not deduct them.

Deductible moving expenses are the expenses of transporting the taxpayer and members of his household, as well as his household goods and personal effects, from the old to the new residence. This includes the cost of lodging en route to the new residence.

In order for a taxpayer to claim a moving expense deduction, the taxpayer's new principal place of work must at least 50 miles farther from his former residence than was former principal place of work. If the taxpayer has no former place of work, then the taxpayer's new principal place of work must be at least 50 miles from his former residence.

Table 3.—Tax Returns Claiming an "Above-the-Line" Deduction for Moving Expenses

[1997 projections]

Income category [1]	Number of tax returns (thousands)	Dollars claimed (millions)
Less than $10,000	23	$20
$10,000 to $20,000	187	183
$20,000 to $30,000	395	437
$30,000 to $40,000	445	530
$40,000 to $50,000	381	430
$50,000 to $75,000	614	773
$75,000 to $100,000	266	429
$100,000 to $200,000	305	720
$200,000 and over	57	193
Total	**2,673**	**3,715**

[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.

Note.—Details may not add to totals due to rounding. Excludes individuals who are dependents of other taxpayers and taxpayers with negative income.

Source: Joint Committee on Taxation.

b. Personal exemptions (including the personal exemption phaseout (PEP))

In order to determine taxable income, an individual reduces AGI by any personal exemption, deductions, and either the applicable standard deduction or itemized deductions. Personal exemptions generally are allowed for the taxpayer, his or her spouse, and any dependents (sec. 151). For 1997, the amount deductible for each personal exemption is $2,650. This amount is indexed annually for

inflation.[17] The deduction for personal exemptions is phased out (personal exemption phaseout or "PEP") for taxpayers with incomes over certain thresholds. These thresholds of PEP are indexed annually for inflation. Under PEP, the applicable thresholds for 1997 are $121,200 for single individuals, $181,800 for married individuals filing a joint return, $151,500 for heads of households, and $90,900 for married individuals filing separate returns. For 1997, the point at which a taxpayer's personal exemptions are completely phased-out are $243,700 for single individuals, $304,300 for married individuals filing a joint return, $274,000 for heads of households, and $213,400 for married individuals filing separate returns.

c. Standard deduction

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 1997, the amount of the standard deduction is $4,150 for single individuals, $6,050 for heads of households, $6,900 for married individuals filing jointly, and $3,450 for married individuals filing separately. Additional standard deductions are allowed with respect to any individual who is elderly (age 65 and over) or blind.[18] The amounts of the basic standard deduction and the additional standard deductions are indexed annually for inflation.

d. Itemized deductions

In lieu of taking the applicable standard deductions, an individual may elect to itemize deductions. The deductions that may be itemized include: charitable contributions; home mortgage interest; State and local income, real property, and certain personal property taxes; medical expenses (in excess of 7.5 percent of AGI); certain investment interest; nonbusiness casualty and theft losses; gambling losses; and certain miscellaneous expenses (in excess of 2 percent of AGI).

i. Description of commonly used itemized deductions

Charitable contributions.—Generally, a taxpayer who itemizes deductions may deduct cash contributions to charity, as well as the fair market value of contributions of property (sec. 170). The amount of the deduction allowable for the taxable year with respect to a charitable contribution may be reduced, depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.

Mortgage interest.—Qualified residence interest is deductible notwithstanding the general rule that personal interest is nondeductible (sec. 163(h)). Qualified residence interest generally is interest on (1) debt to acquire, construct, or substantially improve a principal or second residence (up to a total debt of $1 million), plus (2)

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[17] "Indexed for inflation" generally refers to the present-law mechanism for inflation indexing. This measurement is made in reference to the Consumer Price Index ("CPI"). There is currently a discussion about the accuracy of the CPI as a measurement of inflation. See, e.g., Final Report of the Advisory Commission to Study the Consumer Price Index ("Boskin Commission"), *Toward a More Accurate Measure of the Cost of Living,* December 4, 1996.

[18] For 1997, the additional amount for married individuals is $800, while the additional amount for single individuals and heads of households is $1,000.

debt (not in excess of $100,000) secured by a principal or second residence.

State and local taxes.—Itemizers may deduct three types of State and local taxes that are not incurred in a trade or business or in an investment activity—individual income taxes, real property taxes, and personal property taxes (sec. 164).[19]

Medical expenses.—Medical expenses in excess of 7.5 percent of AGI generally are deductible if not reimbursed by insurance or otherwise (sec. 213). Medical expenses eligible for the deduction are amounts paid by the taxpayer for (1) certain health insurance (including employee contributions to employer health plans; (2) the diagnosis, treatment, or prevention of disease or malfunction of the body, (3) transportation primarily for and essential to medical care, and (4) qualified long-term care services (as defined in sec. 7702B(c)).

Investment interest.—The amount of investment interest an individual may deduct in a taxable year is limited to the amount of net investment income for that year (sec.163(d)). Excess amounts of investment interest are carried forward. To the extent that an individual elects to treat long-term capital gain as investment income, for purposes of computing the investment interest limitation, that amount of net capital gain does not qualify for the maximum 28-percent rate.

Nonbusiness casualty and theft losses.—Individuals who itemize deductions may deduct losses of property not connected with a trade or business or a transaction entered into for profit if the loss arises from theft or from fire, storm, shipwreck, or other casualty (sec. 165). Only the amount of the loss in excess of $100 per casualty loss can be deducted. In addition, the casualty losses of a taxpayer for a taxable year (determined after application of the $100 threshold to each loss) may be deducted only to the extent that the sum of such losses (net of casualty gains) exceeds 10 percent of the taxpayer's AGI.

Gambling losses.—Gambling losses are allowed as an itemized deduction only to the extent of gains from gambling (sec. 165).

Miscellaneous itemized deductions.—An individual may claim an itemized deduction for certain miscellaneous expenses in excess of 2 percent of AGI (sec. 67). These expenses include unreimbursed employee expenses such as certain business and professional dues, job search expenses, uniform costs and home office deductions. To be deductible, an unreimbursed employee business expense must be: (1) paid or incurred during the taxable year; (2) for carrying on the trade or business of being an employee; and (3) an ordinary and necessary business expense. Generally, the taxpayer applies the 2-percent AGI limit after any other deduction limit (such as the 50-percent limit on expenses for business-related meals and entertainment).

ii. Data relating to itemized deductions

The following tables show the distribution across income classes of the standard deduction and certain itemized deductions. Table 4

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[19] For more detailed discussion, see JCT pamphlet *"Impact on State and Local Governments and Tax-Exempt Organizations of Replacing the Federal Income Tax"* (JCS–4–96), April 30, 1996.

shows the number of taxpayers and the dollars of deduction claimed as the standard deduction and as itemized deductions. Table 5 shows the distribution of the major itemized deductions: charitable contributions, mortgage interest, real property tax and State and local property tax. Table 6 through Table 13 separately show the distribution, by taxpayers' income levels, of several of the most common itemized deductions. For 1997, the largest of these deductions is estimated to be the home mortgage interest deduction, which is estimated to be nearly $200 billion.

Table 4.—Tax Returns That Claim the Standard Deduction and Tax Returns That Itemize

[1997 projections]

Income Category [1]	Standard deductions		Itemized deductions	
	Number of tax returns (thousands)	Dollar claimed (millions)	Number of tax returns (thousands)	Dollars claimed [2] (millions)
Less than $10,000	9,237	$45,430	130	$1,419
$10,000 to $20,000	16,105	81,635	921	9,212
$20,000 to $30,000	15,582	82,488	2,156	20,076
$30,000 to $40,000	12,250	70,243	3,399	34,785
$40,000 to $50,000	8,371	53,655	3,947	41,799
$50,000 to $75,000	9,554	64,963	10,041	121,498
$75,000 to $100,000	2,266	16,123	6,975	101,502
$100,000 to $200,000	869	6,303	6,441	131,779
$200,000 and over	121	855	1,527	95,560
Total	**74,355**	**421,694**	**35,537**	**557,630**

[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.

[2] Includes the limitation on itemized deductions.

Note.—Details may not add to totals due to rounding. Excludes individuals who are dependents of other taxpayers and taxpayers with negative income.

Source: Joint Committee on Taxation.

Table 5.—Tax Returns Claiming Major Itemized Deductions [1]

[1997 projections, returns in thousands]

Income category [2]	Returns with itemized deductions	Returns with all major itemized deductions	Returns with any major itemized deductions	Returns with only major itemized deductions
Less than $10,000	130	27	121	37
10,000 to 20,000	921	264	888	218

Table 5.—Tax Returns Claiming Major Itemized Deductions[1]—Continued

[1997 projections, returns in thousands]

Income category[2]	Returns with itemized deductions	Returns with all major itemized deductions	Returns with any major itemized deductions	Returns with only major itemized deductions
20,000 to 30,000	2,156	817	2,110	465
30,000 to 40,000	3,399	1,705	3,345	821
40,000 to 50,000	3,947	2,177	3,929	990
50,000 to 75,000	10,041	6,428	10,017	2,694
75,000 to 100,000	6,975	4,880	6,970	1,932
100,000 to 200,000	6,441	4,608	6,440	1,751
200,000 and over	1,527	993	1,525	358
Total, all taxpayers	**35,537**	**21,899**	**35,346**	**9,266**

[1] Major itemized deductions are defined as: charitable contributions, mortgage interest, real property tax, and state and local income tax.

[2] The income concept used to place tax returns into income categories is adjusted gross income ("AGI") plus: (1) tax exempt interest, (2) employer contributions for health plans and life insurance, (3) employer share of FICA tax, (4) worker's compensation, (5) nontaxable social security benefits, (6) insurance value of Medicare benefits, (7) alternative minimum tax preference items, and (8) excluded income of U.S. citizens living abroad.

Note.—Details may not add to totals due to rounding. Excludes individuals who are dependents of other taxpayers and taxpayers with negative income.

Source: Joint Committee on Taxation.

Table 6.—Tax Returns Claiming an Itemized Deduction for a Charitable Contribution

[1997 projections]

Income category[1]	Number of tax returns (thousands)	Dollars claimed[2] (millions)
Less than $10,000	76	$45
$10,000 to $20,000	646	632
$20,000 to $30,000	1,746	2,268
$30,000 to $40,000	2,888	4,056
$40,000 to $50,000	3,485	5,397
$50,000 to $75,000	9,166	15,686
$75,000 to $100,000	6,605	13,918
$100,000 to $200,000	6,205	18,822
$200,000 and over	1,473	22,638

Table 6.—Tax Returns Claiming an Itemized Deduction for a Charitable Contribution—Continued

[1997 projections]

Income category [1]	Number of tax returns (thousands)	Dollars claimed [2] (millions)
Total	**32,289**	**83,462**

[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.

[2] Does not include the limitation on itemized deductions.

Note.—Details may not add to totals due to rounding. Excludes individuals who are dependents of other taxpayers and taxpayers with negative income.

Source: Joint Committee on Taxation.

Table 7.—Tax Returns Claiming an Itemized Deduction for Mortgage Interest Paid

[1997 projections]

Income category [1]	Number of tax returns (thousands)	Dollars claimed [2] (millions)
Less than $10,000	92	$617
$10,000 to $20,000	614	3,296
$20,000 to $30,000	1,437	6,883
$30,000 to $40,000	2,570	13,329
$40,000 to $50,000	3,129	16,565
$50,000 to $75,000	8,530	49,724
$75,000 to $100,000	6,136	39,905
$100,000 to $200,000	5,547	48,257
$200 and over	1,194	20,017
Total	**29,249**	**198,594**

[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.

[2] Does not include the limitations on itemized deductions.

Note.—Details may not add to totals due to rounding. Excludes individuals who are dependents of other taxpayers and taxpayers with negative income.

Source: Joint Committee on Taxation.

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Table 8.—Tax Returns Claiming an Itemized Deduction for State and Local Income Taxes Paid

[1997 projections]

Income category [1]	Number of tax returns (thousands)	Dollars claimed [2] (millions)
Less than $10,000	$48	$28
$10,000 to $20,000	502	329
$20,000 to $30,000	1,431	1,184
$30,000 to $40,000	2,665	3,193
$40,000 to $50,000	3,193	5,499
$50,000 to $75,000	8,576	19,957
$75,000 to $100,000	6,043	21,130
$100,000 to $200,000	5,664	33,437
$200,000 and over	1,339	40,606
Total	**29,460**	**125,365**

[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.

[2] Does not include the limitation on itemized deductions.

Note.—Details may not add to totals due to rounding. Excludes individuals who are dependents of other taxpayers and taxpayers with negative income.

Source: Joint Committee on Taxation.

Table 9.—Tax Returns Claiming an Itemized Deduction for Real Property Taxes Paid

[1997 projections]

Income category [1]	Number of tax returns (thousands)	Dollars claimed [2] (millions)
Less than $10,000	97	$226
$10,000 to $20,000	711	1,429
$20,000 to $30,000	1,706	3,304
$30,000 to $40,000	3,773	4,868
$40,000 to $50,000	3,372	5,919
$50,000 to $75,000	8,919	16,976
$75,000 to $100,000	6,400	14,352
$100,000 to $200,000	6,040	18,537
$200,000 and over	1,444	10,008
Total	**32,463**	**75,619**

[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.

[2] Does not include the limitation on itemized deductions.

Note.—Details may not add to totals due to rounding. Excludes individuals who are dependents of other taxpayers and taxpayers with negative income.

Source: Joint Committee on Taxation.

Table 10.—Tax Returns Claiming an Itemized Deduction for Other State and Local Taxes Paid

[1997 projections]

Income category [1]	Number of tax returns (thousands)	Dollars claimed [2] (millions)
Less than $10,000	44	$22
$10,000 to $20,000	357	278
$20,000 to $30,000	916	462
$30,000 to $40,000	1,509	522
$40,000 to $50,000	1,909	748
$50,000 to $75,000	5,049	2,034
$75,000 to $100,000	3,688	1,631
$100,000 to $200,000	3,588	2,045
$200,000 and over	836	1,259
Total	**17,896**	**9,001**

[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.

[2] Does not include the limitation on itemized deductions.

Note.—Details may not add to totals due to rounding. Excludes individuals who are dependents of other taxpayers and taxpayers with negative income.

Source: Joint Committee on Taxation.

Table 11.—Tax Returns Claiming an Itemized Deduction for Medical Expenses Incurred in Excess of 7.5 Percent of Adjusted Gross Income

[1997 projections]

Income category [1]	Number of tax returns (thousands)	Dollars claimed (millions)
Less than $10,000	73	$437
$10,000 to $20,000	378	2,131
$20,000 to $30,000	829	4,020
$30,000 to $40,000	1,036	5,492
$40,000 to $50,000	864	4,274
$50,000 to $75,000	1,444	7,703
$75,000 to $100,000	514	3,327
$100,000 to $200,000	252	2,645
$200,000 and over	21	665

Table 11.—Tax Returns Claiming an Itemized Deduction for Medical Expenses Incurred in Excess of 7.5 Percent of Adjusted Gross Income—Continued

[1997 projections]

Income category [1]	Number of tax returns (thousands)	Dollars claimed (millions)
Total	**5,410**	**30,695**

[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.

Note.—Details may not add to totals due to rounding. Excludes individuals who are dependents of other taxpayers and taxpayers with negative income.

Source: Joint Committee on Taxation.

Table 12.—Tax Returns Claiming an Itemized Deduction for Investment Interest Paid

[1997 projections]

Income category [1]	Number of tax returns (thousands)	Dollars claimed (millions)
Less than $10,000	3	$2
$10,000 to $20,000	16	62
$20,000 to $30,000	27	62
$30,000 to $40,000	47	71
$40,000 to $50,000	59	83
$50,000 to $75,000	198	376
$75,000 to $100,000	202	416
$100,000 to $200,000	482	1,688
$200,000 and over	403	9,550
Total	**1,437**	**12,310**

[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.

Note.—Details may not add to totals due to rounding. Excludes individuals who are dependents of other taxpayers and taxpayers with negative income.

Source: Joint Committee on Taxation.

Table 13.—Tax Returns Claiming an Itemized Deduction for Miscellaneous Expenses in Excess of 2 Percent of Adjusted Gross Income

[1997 projections]

Income category [1]	Number of tax returns (thousands)	Dollars claimed [2] (millions)
Less than $10,000	36	$35
$10,000 to $20,000	271	936
$20,000 to $30,000	647	1,695
$30,000 to $40,000	954	2,955
$40,000 to $50,000	1,076	3,132
$50,000 to $75,000	2,707	8,421
$75,000 to $100,000	1,739	6,621
$100,000 to $200,000	1,477	7,758
$200,000 and over	310	5,592
Total	**9,217**	**37,144**

[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.

[2] Does not include the limitation on itemized deductions.

Note.—Details may not add to totals due to rounding. Excludes individuals who are dependents of other taxpayers and taxpayers with negative income.

Source: Joint Committee on Taxation.

e. Limitation on itemized deductions

The total amount of itemized deductions allowed is reduced but not eliminated for taxpayers with incomes over a certain threshold amount, which is indexed annually for inflation (sec. 68). The threshold amount for 1997 is $121,200 ($60,600 for married individuals filing separate returns). All itemized deductions are subject to the limit except: (1) medical expenses; (2) investment interest expenses; (3) nonbusiness casualty and theft losses; and (4) gambling losses. For those deductions that are subject to the limit, the total amount of itemized deductions is reduced by 3 percent of AGI over the threshold amount, but not by more than 80 percent of itemized deductions subject to the limit. Therefore, all individuals subject to the limitation may deduct at least 20 percent of those deductions if they choose to itemize their deductions.

4. Regular income tax rates

a. Rate structure and capital gains

Income tax rate structure

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. The income bracket amounts are in-

dexed for inflation. Separate rate schedules apply based on an individual's filing status. In order to limit multiple uses of a graduated rate schedule within a family, the net unearned income of a child under age 14 is taxed as if it were the parent's income. For 1997, the individual income tax rate schedules are shown in Table 14.

Table 14.—Federal Individual Income Tax Rates for 1997

If taxable income is	Then income tax equals
	Single individuals
$0–$24,650	15 percent of taxable income.
$24,651–$59,750	$3,698, plus 28% of the amount over $24,650.
$59,751–$124,650	$13,526, plus 31% of the amount over $59,750.
$124,651–$271,050	$33,645, plus 36% of the amount over $124,650.
Over $271,050	$86,349, plus 39.6% of the amount over $271,050.
	Heads of households
$0–$33,050	15 percent of taxable income.
$33,051–$85,350	$4,958, plus 28% of the amount over $33,050.
$85,351–$138,200	$19,602, plus 31% of the amount over $85,350.
$138,201–$271,050	$35,985, plus 36% of the amount over $138,200.
Over $271,050	$83,811, plus 39.6% of the amount over $271,050.
	Married individuals filing joint returns
$0–$41,200	15 percent of taxable income.
$41,201–$99,600	$6,180, plus 28% of the amount over $41,200.
$99,601–$151,750	$22,532, plus 31% of the amount over $99,600.
$151,751–$271,050	$38,698, plus 36% of the amount over $151,750.
Over $271,050	$81,646, plus 39.6% of the amount over $271,050.
	Married individuals filing separate returns
$0–$20,600	15 percent of taxable income.
$20,601–$49,800	$3,090, plus 28% of the amount over $20,600.
$49,801–$75,875	$11,266, plus 31% of the amount over $49,800.
$75,876–$135,525	$19,349, plus 36% of the amount over $75,875.
Over $135,525	$40,823, plus 39.6% of the amount over $135,525.

Table 15 shows the projected distribution of Federal tax liability for 1997 by income levels. Taxpayers with incomes above $100,000 per year pay 55.6 percent of the Federal individual income tax and 39.7 percent of total Federal taxes. On the other hand, taxpayers with incomes below $20,000 have a negative total individual income tax and pay 3.0 percent of total Federal taxes.

Table 15.—Distribution of Federal Tax Liability

[1997 projections]

Income category[1]	Individual income tax		Total federal taxes[2]	
	Billions	Percent	Billions	Percent
Less than $10,000	−$5	−0.8	$5	0.4
10,000 to 20,000	−4	−0.6	31	2.6
20,000 to 30,000	16	2.5	68	5.7
30,000 to 40,000	34	5.3	95	7.9
40,000 to 50,000	41	6.4	100	8.3
50,000 to 75,000	109	17.1	243	20.2
75,000 to 100,000	93	14.6	183	15.2
100,000 to 200,000	146	22.9	237	19.7
200,000 and over	208	32.7	240	20.0
Total, all taxpayers	**637**	**100.0**	**1,202**	**100.0**

[1] The income concept used to place tax returns into income categories is adjusted gross income ("AGI") plus: (1) tax exempt interest, (2) employer contributions for health plans and life insurance, (3) employer share of FICA tax, (4) workers compensation, (5) nontaxable social security benefits, (6) insurance value of Medicare benefits, (7) alternative minimum tax preference items, and (8) excluded income of U.S. citizens living abroad.

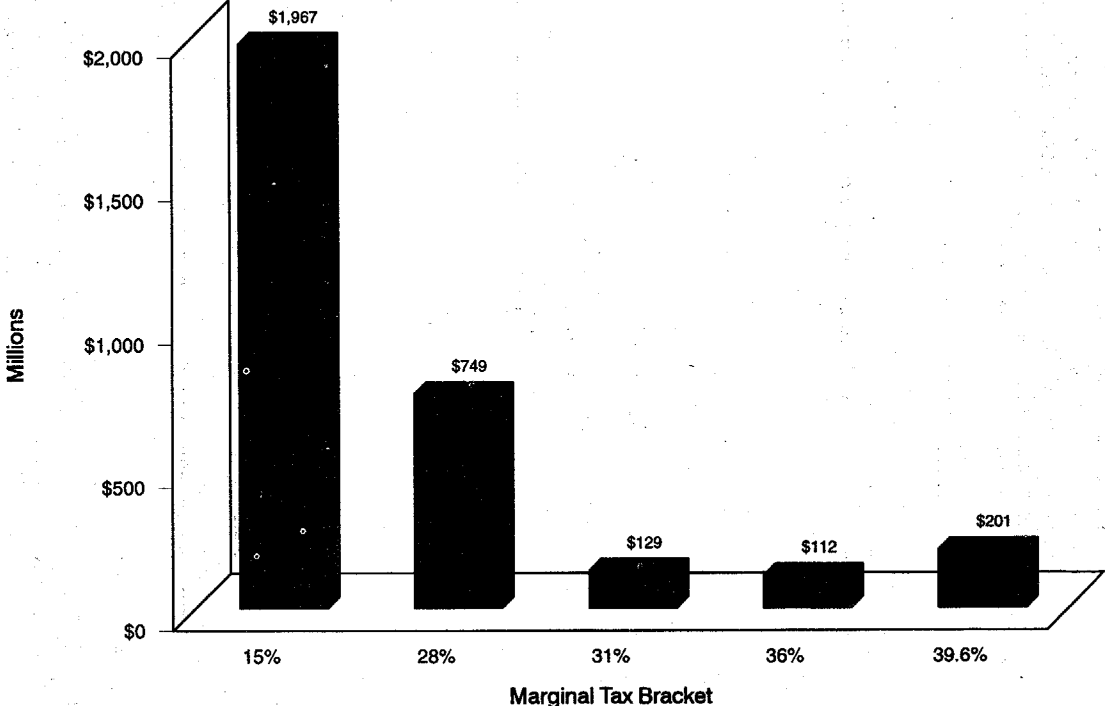
[2] Federal taxes are equal to individual income tax (including the outlay portion of the EIC), employment tax attributed to employees, and excise taxes (attributed to consumers). Corporate income tax is not included due to uncertainty concerning the incidence of the tax.

Source: Joint Committee on Taxation.

Note.—Details may not add to totals due to rounding. Excludes individuals who are dependents of other taxpayers and taxpayers with negative income.

Figure 3 shows, for 1997 projected levels of income, the amount of taxable income taxed at each marginal tax rate. Thus, for 1997, $1.967 trillion of taxable income will be taxed at a 15-percent rate, $749 billion will be taxed at a 28-percent rate, $129 billion will be taxed at a 31-percent rate, $112 billion will be taxed at a 36-percent rate, and $201 billion will be taxed at a 39.6-percent rate.

Figure 3
Taxable Income Taxed at Each Tax Rate
(Projected 1997 Levels of Income)



Figures 4 and 5 provide information (projected for 1997) for classes of taxpayers by marginal income tax bracket. Figure 4 shows that there are approximately 42 million taxpayers with no Federal income tax liability. In addition, approximately 88 million taxpayers are taxed at either the 15-percent or 28-percent marginal tax rate. Thus, the vast majority of taxpayers are subject to tax at no greater than a 28-percent marginal tax rate. There are only 547,000 taxpayers who are subject to tax at a 39.6 percent marginal tax rate.

Figure 5 shows the breakdown of total taxable income by taxpayers in each marginal rate bracket. The table provides information both on the total taxable income by marginal rate bracket and the rate bracket taxable income. Thus, for example, taxpayers in the 31-percent marginal rate bracket have $50 million of bracket taxable income (i.e., taxable income subject to the 31-percent tax rate) and $284 million of total taxable income. Thus, these taxpayers have approximately $200 million of taxable income taxed at the 15- and 28-percent rates.

Figure 4
Number of Taxpayers By Marginal Tax Rate
(Estimated 1997 Levels of Income)

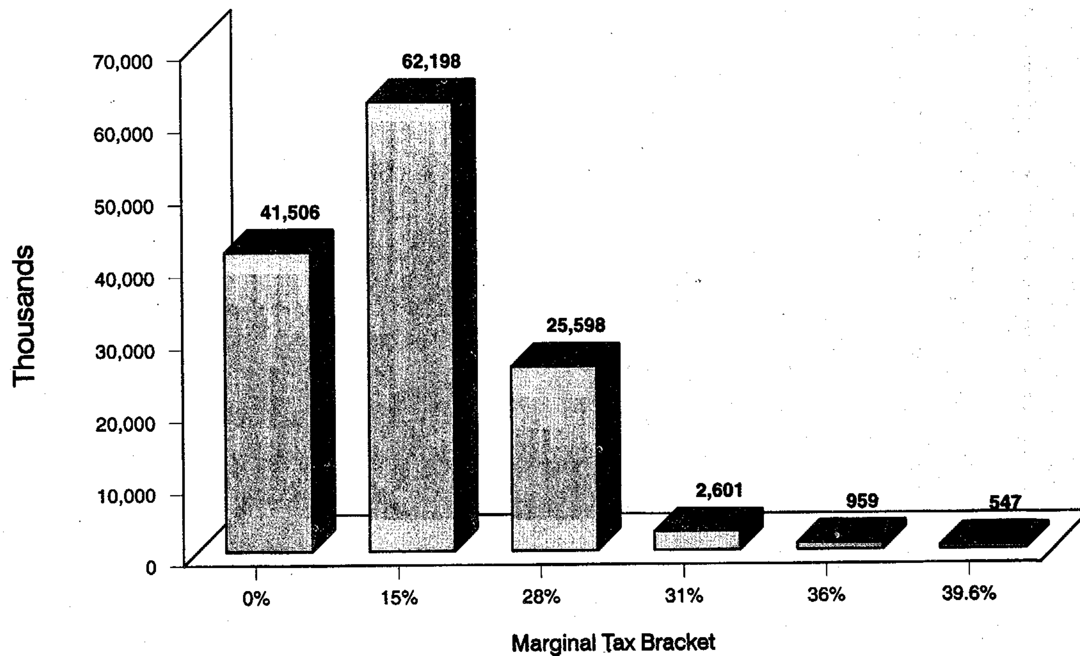
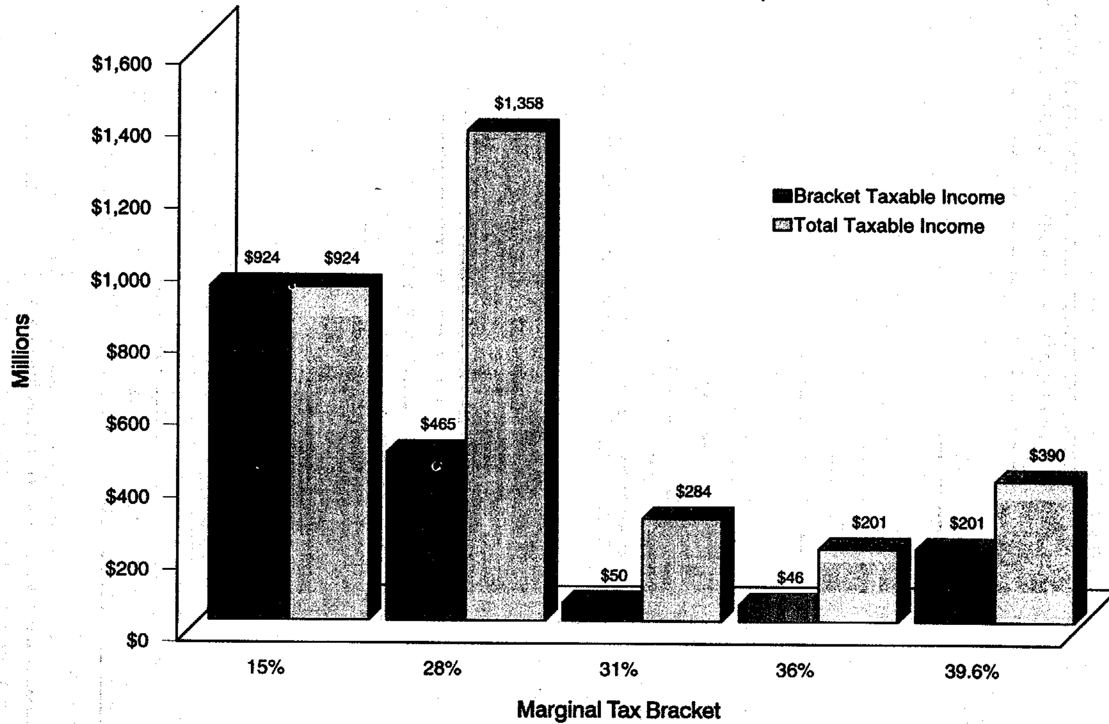


Figure 5
Total Taxable Income of Taxpayers in Each Marginal Rate Bracket
(Estimated 1997 Levels of Income)



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 of an individual generally is taxed at the same rate as ordinary income, except that the maximum rate of tax is limited to 28 percent of the net capital gain.[20] 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.

b. Marriage penalty and bonus

In general

A marriage penalty exists when the sum of the tax liabilities of two unmarried individuals filing their own tax returns (either single or head of household returns) is less than their tax liability under a joint return (if the two individuals were to marry). A marriage bonus exists when the sum of the tax liabilities of the individuals is greater than their combined tax liability under a joint return.

While the size of any marriage penalty or bonus under present law depends upon the individuals' incomes, number of dependents, and itemized deductions, as a general rule married couples whose earnings are split more evenly than 70–30 suffer a marriage penalty. Married couples whose earnings are largely attributable to one spouse generally receive a marriage bonus. Although the marginal tax rate breakpoints[21] and the standard deduction are typically considered the major elements of the Federal income tax system that create marriage penalties and bonuses, other provisions

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[20] 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).

[21] A bracket breakpoint is the dividing point between two marginal rate brackets.

of present law also contribute to the amount of marriage penalty or bonus any couple will face.

Rate brackets and standard deduction

For taxpayers in the 15-, 28-, and 31-percent marginal tax rate bracket, the bracket breakpoints and the standard deduction for single filers are roughly 60 percent of those for joint filers and those for head of household filers are about 83 percent of those for joint filers. For the 36-percent bracket, the breakpoint for single filers and for head of household filers are 82 percent and 91 percent, respectively, of the breakpoint for joint filers. For the 39.6-percent bracket, the bracket breakpoint is $271,050 (for 1997), regardless of filing status.

Marriage penalty for low-income individuals under present law

There are three features of the current individual income tax system that create a marriage penalty for low-income individuals: the variation of the size of the standard deduction by filing status; the phaseout of the earned income credit ("EIC") as income increases; and the variation of the size of the EIC by number of dependent children.

Under present law, the size of the standard deduction and the bracket breakpoints follow certain customary ratios across filing statuses. The standard deduction and bracket breakpoints for single filers are roughly 60 percent of those for joint filers. The standard deduction and bracket breakpoints for head of household filers are about 83 percent of those for joint filers. With these ratios, unmarried individuals have standard deductions whose sum exceeds the standard deduction they would receive as a married couple filing a joint return. Thus, their taxable income as joint filers may exceed the sum of their taxable incomes as unmarried individuals. Furthermore, because of the way the bracket breakpoints are structured, taxpayers filing joint returns may have some of their taxable income pushed into a higher marginal tax bracket than when they were unmarried.

Even if the marriage penalty caused by the rate structure could be eliminated, other features of the Code conditioned on income can still cause marriage nonneutrality. For low-income individuals with dependent children, the EIC is one such feature. Because the EIC increases over some range of income and then is phased out over another range of income, the aggregation of incomes that occurs when two individuals marry may reduce the amount of EIC for which they are eligible.[22]

Marriage may reduce the size of a couple's EIC not only because their incomes are aggregated, but also because the number of dependent children is aggregated. Because the amount of EIC does not increase when a taxpayer has more than two dependent children, marriages that cause the resulting family to have more than two dependent children will result in a smaller number of children

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[22] In the case of two individuals with very low wage income, marriage may *increase* the amount of their EIC available for a dependent child. If the individual with the dependent child is in the phase-in range of the ETC, the aggregation of incomes upon marriage could increase the amount of the EIC.

giving rise to the EIC than when their parents were unmarried. Even when each unmarried individual brings just one dependent child into the marriage there is a reduction in the amount of EIC, because the maximum credit for two children is generally much less than twice the maximum credit for one child.

These three features can cause unmarried individuals who are eligible for the EIC to face significant marriage penalties. For example, in 1997, two individuals each with one dependent child, one with wage income of $14,000 and the other with wage income of $10,000, faced a marriage penalty of $2,975.[23]

Other marriage penalties and bonuses under present law

A marriage penalty or bonus can occur under other provisions of present law. For example, a marriage penalty or bonus can occur when a provision allows for different thresholds for the treatment of married taxpayers relative to single taxpayers. For example, the provision of present law that requires a portion of social security benefits to be included in income can create either a marriage penalty (because it is possible that one spouse's taxable income may require the other spouse's social security benefits to be included in income) or a marriage bonus (because spouses with relatively unequal incomes may have fewer social security benefits included in income than if the spouses were not married).

A marriage penalty or bonus can also be created under present law when a provision does not provide different treatment for married couples relative to single individuals. For example, the present-law dependent care credit phases down beginning at adjusted gross income of $10,000, irrespective of whether the taxpayer is married or not. The dependent care credit can create a marriage penalty because the combined income of a married couple may make the couple eligible for a smaller credit than if the couple were both single taxpayers. The dependent care credit can create a marriage bonus because a full-time student with no earned income may be entitled to the credit if married to a taxpayer with earned income, but would not be entitled to the credit if single.

Data relating to marriage penalty under present law

There is no precisely accurate measure of the size of the marriage penalty or bonus under present law. The amount of penalty or bonus that any married couple will face depends on the particular characteristics of the couple's income, deductions, credits, etc, and how such items of income, etc., are assumed to be divided between the spouses.

Under Congressional Budget Office calculations prepared in 1995, the marriage penalty under present law under one set of assumptions was estimated to be $39.3 billion for 22.9 million returns for 1996. The marriage bonus was estimated to be $34.0 billion for 24.4 million returns, and 2.2 million returns were estimated to have neither a marriage penalty or bonus. Under this set of assumptions, the 22.9 million returns with a marriage penalty had

[23] The amount of the marriage penalty would have been even larger if each individual had two or more children.

an average penalty of $1,720 and the 24.4 million returns with a marriage bonus had an average bonus of $1,400.

Under an alternative set of assumptions, the marriage penalty for 1996 was estimated to be $29.6 billion and the marriage bonus was estimated to be $44.0 billion. Under a third set of assumptions, the marriage penalty for 1996 was estimated to be $18.3 billion and the marriage bonus was estimated to total $45.5 billion.

5. Tax credits

a. Earned income credit

Certain eligible low-income workers are entitled to claim a refundable earned income credit on their income tax return (sec. 32). A refundable credit is a credit that not only reduces an individual's tax liability but allows refunds to the individual in excess of income tax liability. The amount of the credit an eligible individual may claim depends upon whether the individual has one, more than one, or no qualifying children, and is determined by multiplying the credit rate by the individual's[24] earned income up to an earned income amount. The maximum amount of the credit is the product of the credit rate and the earned income amount. The credit is phased out above certain income levels. For individuals with earned income (or AGI[25], if greater) in excess of the beginning of the phaseout range, the maximum credit amount is reduced by the phaseout rate multiplied by the amount of earned income (or AGI, if greater) in excess of the beginning of the phaseout range. For individuals with earned income (or AGI, if greater) in excess of the end of the phaseout range, no credit is allowed. Also, an individual is not eligible for the earned income credit if the aggregate amount of "disqualified income" of the taxpayer for the taxable year exceeds $2,200. Disqualified income is the sum of: (1) interest (taxable and tax-exempt); (2) dividends; (3) net rent and royalty income (if greater than zero); (4) capital gain net income; and (5) net passive income (if greater than zero) that is not self-employment income.

The parameters for the credit depend upon the number of qualifying children the individual claims. For 1997, the parameters are given in Table 16.

Table 16.—Earned Income Credit Parameters

[1997 projection]

	Two or more qualifying children	One qualifying child	No qualifying children
Credit rate (percent)	40.00	34.00	7.65
Earned income amount ..	$9,120	$6,500	$4,330
Maximum credit	$3,648	$2,210	$331

[24] In the case of a married individual who files a joint return with his or her spouse, the income for purposes of these tests is the combined income of the couple.

[25] The definition of AGI used for phasing out the earned income credit disregards certain losses. The losses disregarded are: (1) net capital losses (if greater than zero); (2) net losses from trusts and estates; (3) net losses from nonbusiness rents and royalties; and (4) 50 percent of the net losses from business, computed separately with respect to sole proprietorships (other than in farming), sole proprietorships in farming, and other businesses.

Table 16.—Earned Income Credit Parameters—Continued

[1997 projection]

	Two or more qualifying children	One qualifying child	No qualifying children
Phaseout begins	$11,910	$11,910	$5,420
Phaseout rate (percent) ..	21.06	15.98	7.65
Phaseout ends	$29,232	$25,740	$9,750

In order to claim the credit, an individual must either have a qualifying child or meet other requirements. A qualifying child must meet a relationship test, an age test, an identification test, and a residence test. In order to claim the credit without a qualifying child, an individual must not be a dependent and must be over age 24 and under age 65.

An individual with qualifying children may elect to receive the credit on an advance basis by furnishing an advance payment certificate to his or her employer. For such an individual, the employer makes an advance payment of the credit at the time wages are paid. The amount of advance payment allowable in a taxable year is limited to 60 percent of the maximum credit available to an individual with one qualifying child.

The following tables show various aspects of the earned income credit. Table 17 shows a projection of the earned income credit by type of household; 55 percent of the credit goes to households with two or more qualifying children, 43 percent to households with one qualifying child and 2 percent to households with no qualifying children. Table 18 shows the distribution of the earned income credit by income class. Finally, Table 19 shows a breakdown of the refundable and non-refundable components of the earned income credit. Nearly 86 percent of the credit represents amounts in excess of the individual's reduction in tax liability.

Table 17.—Earned Income Credit by Type of Household

[1997 projections]

Type of household	Number of returns (thousands)	EIC (millions)	Percentage of dollars
No qualifying children	3,639	635	2
One qualifying child ...	7,949	11,463	43
Two or more qualifying children	7,064	14,821	55
All households	18,652	26,919	100

Table 18.—Distribution of Earned Income Credit

[1997 projections]

Income class	Number of returns (thousands)	EIC (millions)
Less than $10,000	5,173	5,740
$10,000 to $20,000	6,438	12,862
$20,000 to $30,000	5,106	6,773
$30,000 to $40,000	1,650	1,313
$40,000 to $50,000	130	111
$50,000 to $75,000	33	47
More than $75,000	([1])	([2])

[1] Less than 500 returns.
[2] Less than $500,000.

The income concept used to place tax returns into income categories is AGI plus (1) tax-exempt income, (2) employer contributions for health and life insurance, (3) employer share of FICA tax, (4) workers' compensation, (5) nontaxable Social Security benefits, (6) insurance value of Medicare benefits, (7) alternative minimum tax preference items, and (8) excluded income of citizens living abroad. Returns with negative income are not included in any of the income categories.

Table 19.—Earned Income Credit: Projections of Credit Offsetting Tax Liability and Refunded to Individuals

[1997 projections]

	EIC (millions)	Percentage of dollars
Reduction in tax liability	3,794	14.1
Refunds to individuals	23,125	85.9
Total	26,919	100.0

b. Dependent care credit

A nonrefundable credit against income tax liability is available for up to 30 percent of a limited dollar amount of employment-related child and dependent care expenses (sec. 21). The credit may be claimed by an individual who maintains a household that includes one or more qualifying individuals. A qualifying individual is a child or other dependent who is under the age of 15, a physically or mentally incapacitated dependent, or a physically or mentally incapacitated spouse.

Employment-related expenses are expenses for the care of a qualifying individual, if incurred to enable the taxpayer to be gainfully employed. The amount of employment-related expenses that may be taken into account in computing the credit generally may not exceed an individual's earned income or, in the case of married taxpayers, the earned income of the spouse with the lesser earn-

ings. Thus, if one spouse is not employed, no credit is generally allowed. Eligible employment-related expenses are limited to $2,400 if there is one qualifying individual, and $4,800 if there are two or more qualifying individuals.

The 30-percent credit rate is reduced by one percentage point for each $2,000 (or fraction thereof) of AGI above $10,000. Because married couples must file a joint return to claim the credit, a married couple's combined AGI is used for purposes of this computation. Individuals with more than $28,000 of AGI are entitled to a credit equal to 20 percent of allowable employment-related expenses.

Table 20 shows a distribution of the dependent care credit by income class. Nearly 69 percent of the credit accrues to taxpayers with less than $75,000 of income.

Table 20.—Tax Returns Claiming the Dependent Child Care Credit

[1997 projections]

Income category[1]	Number of tax returns (thousands)	Dollars claimed (millions)
Less than $10,000	0	$0
$10,000 to $20,000	346	118
$20,000 to $30,000	756	347
$30,000 to $40,000	973	443
$40,000 to $50,000	697	288
$50,000 to $75,000	1,566	673
$75,000 to $100,000	978	476
$100,000 to $200,000	658	326
$200,000 and over	78	41
Total	**6,052**	**2,712**

[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.

Note.—Details may not add to totals due to rounding. Excludes individuals who are dependents of other taxpayers and taxpayers with negative income.

Source: Joint Committee on Taxation.

c. Other individual tax credits

i. Credit for the elderly and disabled

Present law provides a nonrefundable credit against income tax liability for individuals who are age 65 or over, or who have retired on permanent and total disability (sec. 22). For this purpose, an individual is considered permanently and totally disabled ("disabled") if he or she is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death, or which has lasted or can be expected to last for a continuous period of not less than

12 months. The individual must furnish proof of disability to the IRS.

The credit equals 15 percent of an amount which equals an initial base amount, as specified in the statute, that is then reduced by the amount of certain tax-free income received by the taxpayer and by one-half of the taxpayer's AGI exceeding a specified threshold.

The initial base amount is $5,000, in the case of an unmarried elderly or disabled individual or in the case of a married couple filing a joint return if only one spouse is eligible for the credit; $7,500, in the case of a married couple filing a joint return with both spouses eligible for the credit; or $3,750, in the case of a married couple filing separate returns. For a disabled individual who is under age 65, however, the initial base amount is the lesser of the applicable specified amount or the individual's disability income for the year. Consequently, the maximum credit available is $750 (15 percent x $5,000), $1,125 (15 percent x $7,500), or $562.50 (15 percent x $3,750), depending on the initial base amount applicable to the taxpayer.

The initial base amount is reduced by the amount of certain nontaxable income of the taxpayer, such as nontaxable pension and annuity income or nontaxable social security, railroad retirement, or veterans' nonservice-related disability benefits. In addition, the initial base amount is reduced by one-half of the taxpayer's AGI in excess of $7,500, in the case of a single individual; $10,000, in the case of married taxpayers filing a joint return; or $5,000, in the case of married taxpayers filing separate returns.

ii. Adoption tax credit

Taxpayers are entitled to a maximum nonrefundable credit against income tax liability of $5,000 per child for qualified adoption expenses paid or incurred by the taxpayer (sec. 23). In the case of a special needs adoption, the maximum credit amount is $6,000 ($5,000 in the case of a foreign special needs adoption). A special needs child is a child who the State has determined: (1) cannot or should not be returned to the home of the birth parents, and (2) has a specific factor or condition because of which the child cannot be placed with adoptive parents without adoption assistance. The adoption of a child who is not a citizen or a resident of the United States is a foreign adoption.

Qualified adoption expenses are reasonable and necessary adoption fees, court costs, attorneys' fees, and other expenses that are directly related to the legal adoption of an eligible child. All reasonable and necessary expenses required by a State as a condition of adoption are qualified adoption expenses. Otherwise qualified adoption expenses paid or incurred in one taxable year are not taken into account for purposes of the credit until the next taxable year unless the expenses are paid or incurred in the year the adoption becomes final.

An eligible child is an individual (1) who has not attained age 18 or (2) who is physically or mentally incapable of caring for himself or herself. After December 31, 2001, the credit will be available only for domestic special needs adoptions. No credit is allowed for expenses incurred (1) in violation of State or Federal law, (2) in

carrying out any surrogate parenting arrangement, (3) in connection with the adoption of a child of the taxpayer's spouse, (4) that are reimbursed under an employer adoption assistance program or otherwise, or (5) for a foreign adoption that is not finalized.

The credit is phased out ratably for taxpayers with modified (AGI) above $75,000, and is fully phased out at $115,000 of modified AGI. For these purposes modified AGI is computed by increasing the taxpayer's AGI by the amount otherwise excluded from gross income under Code sections 911, 931, or 933.

d. General business tax credits

i. Low-income housing tax credit

A tax credit having a 70-percent present value is allowed on qualified low-income rental housing (sec. 42). The credit is reduced to 30 percent for housing receiving most other Federal subsidies. In certain difficult-to-develop areas, the credit is increased by 30 percent (e.g., from 70 to 91 percent). The credit applies to the eligible basis of low-income housing units.

Credits are subject to annual allocations of $1.25 per resident of each State. State housing agencies allocate this amount to eligible projects. Credit amounts that are not allocated in the year in which the cap amount arises may be carried forward by the State for allocation in the following year. Any amounts remaining unallocated after that time revert to a national pool and are reallocated among States that allocated their entire credit amount in the preceding year.

ii. Rehabilitation tax credit

An income tax credit is provided for certain expenditures incurred in the rehabilitation of certified historic structures and certain nonresidential buildings placed in service before 1936 (sec. 47). The amount of the credit is determined by multiplying the applicable rehabilitation percentage by the basis of the property that is attributable to qualified rehabilitation expenditures. The applicable rehabilitation percentage is 20 percent for certified historic structures and 10 percent for qualified rehabilitated nonresidential buildings (other than certified historic structures) that were originally placed in service before 1936.

B. Individual Alternative Minimum Tax (AMT)

An individual is subject to an alternative minimum tax ("AMT") 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. The various credits 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 ("AMTI") 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 individuals are accelerated depreciation on certain property used in a trade or business, circulation expenditures, certain research and experimental expenditures, the special rules applicable to incentive stock options, certain expenses and allowances related to oil and gas and mining exploration and development, tax-exempt interest income on private activity bonds issued after August 6, 1986, 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. The disallowed itemized deductions are: (1) State, local, and foreign real property taxes; State and local personal property taxes; and State, local, and foreign income, war profits, and excess profits taxes; (2) medical expenses except to the extent in excess of ten percent of the taxpayer's adjusted gross income; and (3) miscellaneous itemized deductions (e.g., investment expense, employee business expenses, tax preparation fees).

For lower income taxpayers, an exemption amount of $33,750 ($45,000 for joint returns and surviving spouses) is allowed against AMTI. The amount is phased out for taxpayers with AMTI in excess of $150,000. Unlike the personal exemptions, standard deductions, and income tax rate bracket thresholds of the regular tax, the AMT exemption amount is not indexed for inflation. As a result, with income growth over time, the AMT exemption amount becomes less effective in exempting taxpayers from the AMT.

As the following tables illustrate, more taxpayers are subject to the AMT over time. Table 21 shows that after a peak in 1986 in which 609,000 returns had AMT liability of $6.7 billion, only 140,000 taxpayers in 1987 had an AMT liability of $1.7 billion. Since 1987, the number of taxpayers and the total AMT liability has consistently increased. Table 22 shows that in 2007, 8.4 million taxpayers are estimated to have an AMT liability of $1.4 billion dollars. Those taxpayers will represent 6.3 percent of all tax returns filed for 2007.

Table 21.—Minimim Tax and Alternative Minimum Tax Liability, Calendar Years 1974–1994

Calendar year	Tax returns with minimum tax liability (thousands)	Percentage of tax returns filed	Minimum tax liability ($ billions)
1974	19	(1)	0.1
1975	20	(1)	0.1
1976	247	0.3	1.0
1977	399	0.5	1.3
1978	495	0.6	1.5
1979	222	0.2	1.2
1980	211	0.2	1.3
1981	251	0.3	1.8
1982	225	0.2	1.5
1983	266	0.3	2.5
1984	370	0.4	4.5
1985	428	0.4	3.8
1986	609	0.6	6.7
1987	140	0.1	1.7
1988	114	0.1	1.0
1989	117	0.1	0.8
1990	132	0.1	0.8
1991	244	0.2	1.2
1992	287	0.3	1.4
1993	335	0.3	2.1
1994	369	0.3	2.2

[1] Less than .05 percent.
Source: Joint Committee on Taxation.

Table 22.—Projected Alternative Minimum Tax Liability, Calendar Years 1997–2007

Calendar year	Tax returns with minimum tax liability (thousands)	Percentage of tax returns filed	Minimum tax liability ($ billions)
1997	611	0.5	3.6
1998	733	0.6	4.0
1999	901	0.7	4.4
2000	1,140	0.9	4.9
2001	1,443	1.1	5.6
2002	2,006	1.6	6.6
2003	2,671	2.1	8.0
2004	3,557	2.7	9.7
2005	4,737	3.6	11.8
2006	6,308	4.8	14.3
2007	8,400	6.3	17.4

Source: Joint Committee on Taxation.

C. Employment Taxes

1. Social Security tax

As part of the Federal Insurance Contributions Act ("FICA"), a tax is imposed on employees and employers up to a maximum amount of employee wages. The tax is composed of two parts: old-age, survivor, and disability insurance ("OASDI") (i.e., Social Security) and Medicare hospital insurance. The OASDI tax rate is 6.2 percent on both the employer and employee (for a total rate of 12.4 percent). The OASDI tax rate applies to wages up to the OASDI wage base, which is $65,400 for 1997. "Wages" generally includes all remuneration for employment, but there are specific exemptions. The wage base cap is indexed for changes in averages. Revenues from the OASDI tax are credited to the Social Security Trust Fund.

2. Medicare tax

The second part of the FICA tax imposed on employees and employers is for Medicare hospital insurance ("HI"). The HI tax rate is 1.45 percent on both the employee and employer (for a total rate of 2.9 percent). There is no limit on the amount of wages subject to the HI portion of the FICA tax. Revenues from the HI tax are credited to the Hospital Insurance Trust Fund.

3. Self-employment tax

Under the Self–Employment Contributions Act ("SECA"), a tax is imposed on an individual's net earnings from self-employment. The SECA tax rate is the same as the total FICA tax rates for employers and employees and is capped at the same levels. Thus, the OASDI tax rate is 12.4 percent and the HI tax rate is 2.9 percent. The OASDI tax rate applies to the first $65,400 (for 1997) of net earnings and the HI tax rate applies to all net earnings. A self-employed individual is entitled to deduct one-half of his or her self-employment taxes.

4. Unemployment compensation tax

The Federal Unemployment Tax Act ("FUTA") imposes a 6.2-percent gross tax rate on the first $7,000 paid annually by covered employers to each employee. Employers in States with programs approved by the Federal Government and with no delinquent Federal loans may credit 5.4 percentage points against the 6.2-percent tax rate, making the minimum, net Federal unemployment tax rate 0.8 percent. Because all States have approved programs, 0.8 percent is the Federal tax rate that generally applies. This Federal revenue finances administration of the system, half of the Federal–State extended benefits program, and a Federal account for State loans. The States are supposed to use the revenue turned back to them by the 5.4-percent credit to finance their regular State programs and half of the Federal–State extended benefits program.

In 1976, Congress passed a temporary surtax of 0.2 percent of taxable wages to be added to the permanent FUTA tax rate. Thus, the current 0.8-percent FUTA tax rate has two components: a permanent tax rate of 0.6 percent, and a temporary surtax rate of 0.2

percent. The temporary surtax subsequently has been extended through 1998.

5. Treatment of household employees

The employment tax treatment of household employees has received considerable attention, and the rules relating to such workers substantially were revised in 1994 in order to simplify administration and increase compliance. Under present law, if a household employee receives cash wages of $1,000 or more (for 1997) during a calendar year, all the individual's wages are subject to FICA taxes. An employer may pay the household employee's liability for FICA taxes without deduction from the employee's wages. If an employer pays the household employee's FICA liability, those payments are not wages for FICA purposes but are wages for income tax withholding purposes.

FUTA taxes are imposed on the employer if a household employee receives cash wages of $1,000 or more in a calendar quarter in the current or preceding calendar year. If the employer pays the household employee's FICA liability without deducting those taxes from the employee's wages, the amounts paid by the employer are not wages for FUTA purposes.

FICA and FUTA taxes for household employees are payable annually with the employer's individual tax return. For years beginning after 1998, in certain circumstances an individual employing household employees may be subject to estimated taxes as a result of employment taxes due with respect to such employees.

Table 23, below, shows a history of the FICA/SECA taxes for the years 1937–1997.

Table 23.—History of FICA/SECA Taxes, 1937–1997 [1]

Calendar year	Wage base	Tax rates, employer and employee, each			Maximum employee tax	Tax rate, self-employed			Maximum self-empl. tax
		OASDI	HI	Total		OASDI	HI	Total	
1997	$65,400	6.2	1.45	7.65	[2]	12.4	2.9	15.3	[2]
1996	62,700	6.2	1.45	7.65	[2]	12.4	2.9	15.3	[2]
1995	61,200	6.2	1.45	7.65	[2]	12.4	2.9	15.3	[2]
1994	60,600	6.2	1.45	7.65	[2]	12.4	2.9	15.3	[2]
1993 [3]	57,600	6.2	1.45	7.65	$5,528.70	12.4	2.9	15.3	$9,343.50
1992 [3]	55,500	6.2	1.45	7.65	5,328.90	12.4	2.9	15.3	9,005.84
1991 [3]	53,400	6.2	1.45	7.65	5,123.30	12.4	2.9	15.3	8,658.38
1990	51,300	6.2	1.45	7.65	3,924.45	12.4	2.9	15.3	6,553.83
1989	48,000	6.06	1.45	7.51	3,604.80	12.12	2.9	15.02	6,249.60
1988	45,000	6.06	1.45	7.51	3,379.50	12.12	2.9	15.02	5,859.00
1987	43,800	5.70	1.45	7.15	3,131.70	11.4	2.9	14.30	5,387.40
1986	42,000	5.70	1.45	7.15	3,003.00	11.4	2.9	14.30	5,166.00
1985	39,600	5.70	1.35	7.05	2,791.80	11.4	2.7	14.10	4,672.80
1984	37,800	5.70	1.3	7.00	2,532.60	11.4	2.6	14.0	4,271.40
1983	35,700	5.40	1.3	6.70	2,391.90	8.05	1.3	9.35	3,337.95
1982	32,400	5.40	1.3	6.70	2,170.80	8.05	1.3	9.35	3,029.40
1981	29,700	5.35	1.3	6.65	1,975.05	8.00	1.3	9.3	2,762.10
1980	25,900	5.08	1.05	6.13	1,587.67	7.05	1.05	8.1	2,097.90
1979	22,900	5.08	1.05	6.13	1,403.77	7.05	1.05	8.1	1,854.90
1978	17,700	5.05	1.0	6.05	1,070.85	7.1	1.0	8.1	1,433.70
1977	16,500	4.95	.9	5.85	965.25	7.0	.9	7.9	1,303.50
1976	15,300	4.95	.9	5.85	895.05	7.0	.9	7.9	1,208.70
1975	14,100	4.95	.9	5.85	824.85	7.0	.9	7.9	1,113.90
1974	13,200	4.95	.9	5.85	772.20	7.0	.9	7.9	1,042.00
1973	10,800	4.85	1.0	5.85	631.80	7.0	1.0	8.0	874.00
1972	9,000	4.6	.6	5.2	468.00	6.9	.8	7.5	675.00

Table 23.—History of FICA/SECA Taxes, 1937–1997 [1]—Continued

Calendar year	Wage base	Tax rates, employer and employee, each			Maximum employee tax	OASDI	Tax rate, self-employed		Maximum self-empl. tax
		OASDI	HI	Total			HI	Total	
1971	7,800	4.6	.6	5.2	405.60	6.9	.6	7.5	585.00
1970	7,800	4.2	.6	4.8	374.40	6.3	.6	6.9	538.20
1969	7,800	4.2	.6	4.8	374.40	6.3	.6	6.9	538.20
1968	7,800	3.8	.6	4.4	343.20	5.8	.6	6.4	499.20
1967	6,600	3.9	.5	4.4	290.40	5.9	.5	6.4	422.40
1966	6,600	3.85	.35	4.2	277.20	5.8	.35	6.15	405.90
1963–65	4,800	3.625	....	3.625	174.00	5.4	....	5.4	259.20
1962	4,800	3.125	....	3.125	150.00	4.7	....	4.7	225.60
1960–61	4,800	3.0	....	3.0	144.00	4.5	....	4.5	216.00
1959	4,800	2.5	....	2.5	120.00	3.75	....	3.75	180.00
1957–58	4,200	2.25	....	2.25	94.50	3.375	....	3.375	141.75
1955–56	4,200	2.0	....	2.0	84.00	3.0	....	3.0	126.00
1954	3,600	2.0	....	2.0	72.00	3.0	....	3.0	108.00
1951–53	3,600	1.5	....	1.5	54.00	2.25	....	2.25	81.00
1950	3,000	1.5	....	1.5	45.00	....	....	....	....
1937–49	3,000	1.0	....	1.0	30.00	....	....	....	....

[1] Sources: Kollman, Geoffrey, CRS Report for Congress, "Summary of Major Changes in the Social Security Cash Benefits Program: 1935–1993, 94–36 EPW"; Joint Committee on Taxation. The dollar amounts for maximum self-employment tax do not equal two times the maximum employee tax because of deductions or credits available to self-employed individuals in some years.

[2] After 1993, the cap on wages and self-employment income subject to the HI tax was removed.

[3] For 1991, the cap on wages and self-employment income subject to the HI tax was $125,000. For 1992, the cap for HI purposes was $130,200 and for 1993, the cap for HI purposes was $135,000.

D. Reporting and Withholding Requirements

Income tax withholding and reporting

The Code requires that employers making payments of wages to employees withhold Federal income taxes from those wage payments in accordance with tables or computational procedures prescribed by the IRS (sec. 3402). Each employee must file with his or her employer a Withholding Allowance Certificate (Form W–4) on which the employee claims a specific number of withholding allowances based on family size, employment status, itemized deductions, and other matters. The employer then utilizes tables issued by the IRS to compute the correct amount of Federal income tax withholding. This computation is based on the number of withholding allowances claimed, the taxpayer's wages, and the frequency of payroll payments. The amount of wages paid and the amount of income taxes withheld must be reported to the IRS and to the employee on Form W–2 (sec. 6051).

No income tax withholding is required on payments made to independent contractors.[26] Independent contractors are required to make quarterly estimated tax payments.

Reporting requirements with respect to independent contractors

The Code contains a number of information reporting requirements. One requires that a person engaged in a trade or business who makes payments during the calendar year of $600 or more to a person for rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income, must file an information return with the IRS reporting the amount of such payments, as well as the name, address and taxpayer identification number of the person to whom such payments were made.[27] A similar statement must also be furnished to the person to whom such payments were made.[28]

The Code contains a separate provision (sec. 6041A) specifically dealing with payments of remuneration for services. Under this provision, a service recipient engaged in a trade or business who makes payments of remuneration in the course of that trade or business to any person for services performed must file with the Internal Revenue Service an information return (Form 1099) reporting such payments (and the name, address, and taxpayer identification number of the payee) if the remuneration paid to the person during the calendar year is $600 or more. Also, the service recipient must furnish to the person receiving such payments a statement setting forth the name, address, and taxpayer identification number of the service recipient, and the aggregate amount of payments made to the payee during the year.

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[26] Payments to independent contractors may be subject to backup withholding under certain circumstances (sec. 3406).

[27] Section 6041(a). A number of exceptions to this requirement are provided in Treasury regulations. In addition, to the extent the general information reporting requirements of this provision overlap specific information reporting requirements elsewhere in the Code, taxpayers are generally required to report only once, under the more specific information reporting provision.

[28] Section 6041(d).

Estimated tax requirements for individuals

An individual taxpayer generally is subject to an addition to tax for any underpayment of estimated tax (sec. 6654). An individual generally does not have an underpayment of estimated tax if he or she makes timely estimated tax payments at least equal to: (1) 100 percent of the tax shown on the return of the individual for the preceding year (the "100 percent of last year's liability safe harbor") or (2) 90 percent of the tax shown on the return for the current year. The 100 percent of last year's liability safe harbor is modified to be a 110 percent of last year's liability safe harbor for any individual with an AGI of more than $150,000 as shown on the return for the preceding taxable year. Income tax withholding from wages is considered to be a payment of estimated taxes. In general, payment of estimated taxes must be made quarterly.

E. Excise Taxes

Various Federal excise taxes are imposed on consumer products and services such as alcoholic beverages, tobacco products, motor fuels, air transportation, and telephone service. Revenues from many of these excise taxes are dedicated to the financing of Federal Trust Fund programs from which consumers paying the taxes benefit. The preponderance of the taxes on consumer products is imposed at levels in the distribution chain of the products away from the consumer; the taxes on services typically are retail taxes. In general, the taxable event for the taxes on consumer products is a sale, entry into, or removal from a specified premise, or the importation of intermediate or finished products. The following description provides an overview of the major excise taxes, in terms of Federal revenues produced, by Trust Fund and General Fund categories.

1. Excise taxes dedicated to trust funds

Various excise taxes are dedicated to specific Trust Funds. The two largest (in terms of revenue) Trust Funds financed with dedicated excise taxes are the Highway Trust Fund and the Airport and Airway Trust Fund.[29]

Highway Trust Fund taxes.—The Federal Highway Trust Fund is financed in part with revenues from excise taxes imposed on gasoline, diesel fuel, and special motor fuels used in highway vehicles and by taxes imposed on the sale of heavy trucks and trailers and tires for those vehicles. The taxes on gasoline and diesel fuel are imposed on removal of those fuels from pipeline storage terminals (generally at least two levels removed from the consumer); the special motor fuels and truck taxes (other than the manufacturers tax on tires) are imposed on retail sale. The Highway Trust Fund tax rate on gasoline and special motor fuels is 14 cents per gallon; the diesel fuel tax rate is 20 cents per gallon. These excise taxes are currently scheduled to expire after September 30, 1999.

Airport and Airway Trust Fund taxes.—Commercial air passenger transportation is subject to a 10-percent excise tax; a 6.25 percent excise tax is imposed on domestic transportation of cargo. Both of these taxes are imposed on consumers with the transportation provider being liable for collecting the tax and remitting it to the Federal Government. General aviation (e.g., transportation in private aircraft for which no fare is charged) is subject to a fuels tax, imposed on removal from a pipeline terminal or on wholesale sale: 15 cents per gallon on aviation gasoline and 17.5 cents per gallon on aviation jet fuel. Receipts from these excise taxes, which are scheduled to expire after September 30, 1997, are dedicated to the Airport and Airway Trust Fund.

2. General Fund excise taxes

Transportation motor fuels.—In addition to any tax rates that support Federal trust funds, gasoline, diesel fuel, and special motor

[29] Other current excise tax Trust Funds are the Aquatic Resources Trust Fund (motorboat gasoline and fishing equipment excise taxes and tariffs on fishing tackle and yachts and pleasure boats), Harbor Maintenance Trust Fund (harbor maintenance excise tax), Inland Waterways Trust Fund (inland waterways tax on commercial fuels), Vaccine Injury Compensation Trust Fund (tax on certain vaccines), and Black Lung Disability Trust Fund (coal excise tax).

fuels used in most transportation modes (highway, rail, inland waterway, motorboat, and aviation) are subject to a 4.3-cents-per-gallon General Fund excise tax. Rail diesel fuel is subject to an additional 1.25 cents-per-gallon rate, revenues from which also are retained in the General Fund. The transportation motor fuels excise tax is collected along with the relevant trust fund tax rates that are imposed on the fuels. The tax on rail transportation generally is imposed at the retail level. The General Fund tax on transportation motor fuels is permanent.

Alcoholic beverages.—Distilled spirits, wine, and beer are subject to taxes imposed on removal of the beverages from the production premises, or on importation. The distilled spirits tax rate is $13.50 per proof gallon;[30] wine is taxed at effective rates ranging from $0.17 per gallon to $3.40 per gallon depending on alcohol content and type of wine (e.g., sparkling or table); and beer is taxed at $18 per barrel ($7 per barrel for beer produced by "small breweries").[31]

Tobacco products.—Most tobacco tax revenues are derived from a 24-cents-per-pack tax on cigarettes. Taxes also are imposed on cigars, cigarette papers, snuff, chewing tobacco, and pipe tobacco. These taxes are collected on removal of the product from the premises where manufactured.

Telephone service.—An excise tax equal to 3 percent of the amount charged is imposed on local and long-distance telephone services. Like the air passenger excise tax, this tax is imposed on consumers, with service providers being liable for collecting and remitting the revenues to the Federal Government.

Luxury tax on passenger vehicles.—A retail excise tax is imposed on passenger vehicles having a price in excess of $36,000 for 1997 (indexed for inflation). For 1997, the rate of tax is 8 percent on the excess of the price over the threshold. This tax rate is scheduled to decline by one percentage point per year until it expires. This tax is scheduled to expire after December 31, 2002.

Other excise taxes.—There are also General fund excise taxes imposed on certain ozone-depleting chemicals, "gas guzzler" automobiles, certain wagers, and international ship passenger departures ($3 per person).

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[30] A proof gallon is a U.S. gallon consisting of 50 percent alcohol.

[31] A barrel contains 31 gallons, producing a maximum beer tax rate of $0.58 per gallon ($0.226 per gallon for "small breweries"). The small brewer rate applies to the first 60,000 gallons removed each year by domestic breweries producing fewer than two million barrels of beer during the calendar year.

F. Estate and Gift Taxes

1. Description of present law

In general

Under present law, a unified estate and gift tax is imposed on lifetime transfers and transfers at death. A unified credit of $192,800 is provided against the estate and gift tax, which effectively exempts the first $600,000 in cumulative taxable transfers from tax (sec. 2010). For transfers in excess of $600,000, estate and gift tax rates begin at 37 and reach 55 percent on cumulative taxable transfers over $3 million (sec. 2001(c)). In addition, a 5-percent surtax is imposed upon cumulative taxable transfers between $10 million and $21,040,000, to phase out the benefits of the graduated rates and the unified credit (sec. 2001(c)(2)).[32]

The amount of gift tax payable for any calendar year generally is determined by multiplying the applicable tax rate (from the unified rate schedule) by the cumulative lifetime taxable transfers made by the taxpayer and then subtracting any gift taxes payable for prior taxable periods. This amount is reduced by any available unified credit (and other applicable credits) to determine the gift tax liability for the taxable period. A taxpayer may exclude $10,000 of gifts made by an individual ($20,000 per married couple) to any one donee during a calendar year (sec. 2503). This annual exclusion does not apply to gifts of future interests (e.g., reversions or remainders).

The amount of estate tax payable generally is determined by multiplying the applicable tax rate (from the unified rate schedule) by the cumulative post–1976 taxable transfers made by the taxpayer during his lifetime or at death and then subtracting any gift taxes payable for prior calendar years (after 1976). This amount is reduced by any available unified credit (and other applicable credits) to determine the estate tax liability.

An unlimited marital deduction generally is permitted for the value of property transferred between spouses. In addition, a charitable deduction generally is permitted for the value of property transferred to charitable organizations.

Valuation

Generally for Federal transfer tax purposes, the value of property is its fair market value, i.e., the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. Fair market value is determined as of either (1) the time of the decedent's death, or (2) the "alternate" valuation date of six months after the decedent's death (sec. 2032).

Under Code section 2032A, an executor may elect for estate tax purposes to value certain "qualified real property" used in farming or another qualifying closely-held trade or business at its current use value, rather than its highest and best use value. Currently,

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[32] Thus, if a taxpayer has made cumulative taxable transfers equaling $21,040,000 or more, his or her average transfer tax rate is 55 percent. The phaseout has the effect of creating a 60-percent marginal rate on transfers in the phaseout range.

the maximum reduction in the value of such real property resulting from an election under Code section 2032A is $750,000.

In general, to qualify for current use valuation, the value of the farm or closely held business assets (including both real and personal property) must be at least 50 percent of the decedent's gross estate. In addition, the real property qualifying for current use valuation must pass to a member of the decedent's family, and the decedent (or a member of the decedent's family) must have owned and materially participated in the farm or closely held business for 5 of the last 8 years immediately preceding the decedent's death.

If, after an election is made to specially value property at its current use value, the heir who acquired the real property ceases to use it in its qualified use within 10 years (15 years for individuals dying before 1982) of the decedent's death, an additional estate tax is imposed in order to "recapture" the benefit of the special use valuation.

Generation-skipping transfer tax

A generation-skipping transfer tax ("GST tax") generally is imposed on transfers, either directly or through a trust or similar arrangement, to a "skip person" (i.e., a beneficiary in a generation more than one generation below that of the transferor). Transfers subject to the GST tax include direct skips, taxable terminations and taxable distributions.[33] The generation-skipping transfer tax is imposed at a flat rate of 55 percent on cumulative generation-skipping transfers in excess of $1 million. Because both the generation-skipping transfer tax and the estate or gift tax can apply to the same transfer, the combined marginal tax rate on a generation-skipping transfer can be as high as 80 percent.

Installment payment of estate tax

In general, the estate tax is due within nine months of a decedent's death. Under Code section 6166, an executor generally may elect to pay the Federal estate tax attributable to an interest in a closely held business in installments over, at most, a 14-year period. If the election is made, the estate pays only interest for the first four years, followed by up to 10 annual installments of principal and interest. Interest is generally imposed at the rate applicable to underpayments of tax under section 6621 (i.e., the Federal short-term rate plus 3 percentage points). Under section 6601(j), however, a special 4-percent interest rate applies to the amount of deferred estate tax attributable to the first $1,000,000 in value of the closely-held business. All interest paid on the deferred estate tax is allowed as a deduction against either the estate tax or the estate's income tax obligation. If the deduction is taken against the estate tax, supplemental returns must be filed each year to recompute the value of the taxable estate.

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[33] For this purpose, a direct skip is any transfer subject to estate or gift tax of an interest in property to a skip person (e.g., a gift from grandparent to grandchild). A taxable termination is a termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, immediately after such termination, a non-skip person has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person. A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination or a direct skip).

To qualify for the installment payment election, the business must be an active trade or business and the value of the decedent's interest in the closely held business must exceed 35 percent of the decedent's adjusted gross estate. An interest in a closely held business includes: (1) any interest as a proprietor in a business carried on as a proprietorship; (2) any interest in a partnership carrying on a trade or business if the partnership has 15 or fewer partners, or if at least 20 percent of the partnership's assets are included in determining the decedent's gross estate; or (3) stock in a corporation if the corporation has 15 or fewer shareholders, or if at least 20 percent of the value of the voting stock is included in determining the decedent's gross estate.

If the installment payment election is made, a special estate tax lien applies to any property on which tax is deferred for the installment payment period.

2. Background data relating to estate and gift taxes

Estates subject to the estate tax

Table 24 details the percentage of decedents subject to the estate tax for selected years since 1940. The percentage of decedents liable for the estate tax grew throughout the postwar era reaching a peak in the mid–1970s. The substantial revision to the estate tax in the mid–1970s and subsequent further modifications in 1981 reduced the percentage of decedents liable for the estate tax to less than one percent in the late 1980s. Since that time, the percentage of decedents liable for the estate tax has gradually increased.

Table 24.—Number of Taxable Estate Tax Returns Filed as a Percentage of Adult Deaths, Selected Years, 1940–1995

Year	Deaths	Taxable estate tax returns filed [1]	
		Number	Percent of deaths
1940	1,237,186	12,907	1.04
1945	1,239,713	13,869	1.12
1950	1,304,343	17,411	1.33
1955	1,379,826	25,143	1.82
1961	1,548,665	45,439	2.93
1966	1,727,240	[2] 67,404	3.90
1970	1,796,940	[2] 93,424	5.20
1973	1,867,689	[2] 120,761	6.47
1977	1,819,107	[2] 139,115	7.65
1982	1,897,820	[2,3] 41,620	2.19
1983	1,945,913	[2,3] 35,148	1.81
1984	1,968,128	[2,3] 31,507	1.60
1985	2,086,440	[2,3] 30,518	1.46
1986	2,105,361	23,731	1.13
1987	2,123,323	21,335	1.00
1988	2,167,999	18,948	0.87
1989 [4]	2,150,466	20,856	0.97
1990 [4]	2,148,463	23,215	1.08

Table 24.—Number of Taxable Estate Tax Returns Filed as a Percentage of Adult Deaths, Selected Years, 1940–1995—Continued

Year	Deaths	Taxable estate tax returns filed[1]	
		Number	Percent of deaths
1991[4]	2,169,518	24,897	1.15
1992[4]	2,175,613	27,187	1.25
1993[4]	2,268,553	27,506	1.21
1994[4]	2,278,994	31,918	1.40
1995[4]	[5]2,312,180	31,564	1.37

[1] Estate returns need not be filed in the year of the decedent's death.

[2] Not strictly comparable with pre–1966 data. For later years, the estate tax after credits was the basis for determining taxable returns. For prior years, the basis was the estate tax before credits.

[3] Although the filing requirement was for gross estates in excess of $225,000 for 1982 deaths, $275,000 for 1983 deaths, and $325,000 for 1984 deaths, the data are limited to gross estates of $300,000 or more.

[4] Taxable estate data from 1989 on from Internal Revenue Service, *Statistics of Income*.

[5] Preliminary.

Sources: Joseph A. Pechman, *Federal Tax Policy* (Washington Brookings Institution), 1987; Internal Revenue Service, *Statistics of Income*; and U.S. National Center for Health Statistics.

The increasing percentage of decedents liable for estate tax in the period from 1940 through the mid–1970s and the similar increasing percentages since 1989 are the result of the interaction of three factors: a fixed nominal exemption; the effect of price inflation on asset values; and real economic growth. The amount of wealth exempt from the Federal estate tax always has been expressed at a fixed nominal value. If the general price level in the economy rises from one year to the next and asset values rise to reflect this inflation, the "nominal" value of each individual's wealth will increase. With a fixed nominal exemption, annual increases in the price level will imply that more individuals will have a nominal wealth that exceeds the tax threshold. Alternatively stated, inflation diminishes the real, inflation-adjusted, value of wealth that is exempted by a nominal exemption. Thus, even if no one individual's real wealth increased, more individuals would be subject to the estate tax. This interaction between inflation and a fixed nominal exemption helps explain the pattern in Table 23.[34]

[34] The 1988 percentage of decedents liable for estate tax of 0.87 may overstate the nadir achieved by the increase in the unified credit to an exemption equivalent amount of $600,000. This is because the 1981 legislation also increased the marital exemption to an unlimited exemption. An increase in the marital exemption would be expected to reduce the percentage of decedents liable for the estate tax, both permanently and during a temporary period following the increase. The permanent effect results from some married couples having neither spouse liable for estate tax. The temporary reduction in the percentage of decedents liable for estate tax arises as follows. A married couple may have sufficient assets to be subject to the estate tax. During the transition period in which husbands and wives first take advantage of the unlimited marital exemption, the number of decedents liable for estate tax falls as the first spouse to die takes advantage of the expanded marital deduction, despite the fact that the surviving spouse subsequently dies with a taxable estate. In the long run, the number of new couples utilizing the unlimited marital deduction may be expected to approximately equal the number of surviv-

The fixed nominal exemption was increased effective for 1977 and again between 1982 and 1987. Prior to 1977 and subsequent to 1987, the exemption was unchanged while the economy experienced general price inflation.

However, even if the exemption were modified annually to reflect general price inflation, one would still expect to see the percentage of decedents liable for estate tax rise because of the third factor, real growth. If the economy is experiencing real growth per capita, it must be accumulating capital.[35] Accumulated capital is the tax base of the estate tax. Thus, real growth can lead to more individuals having real wealth above any given fixed *real* exempt amount.[36]

Indexing the exemption for inflation is equivalent to creating a fixed real exemption rather than a fixed nominal exemption. Had the $600,000 effective exemption created by the 1981 Act (effective for 1987) been indexed for inflation subsequent to 1987, its nominal value today would be approximately $838,000. Had the $175,625 effective exemption created by the 1976 Act (effective for 1982) been indexed for inflation subsequent to 1982, its nominal value today would be approximately $289,000.

Revenue from the estate, gift, and generation-skipping taxes

Table 25 provides data on estate, gift, and generation-skipping tax revenues for selected years from 1940 to 1996. Total estate and gift revenues include taxes paid for estate, gift, and generation-skipping taxes, as well as payments made as the result of IRS audits.

Table 25.—Revenue From the Estate, Gift, and Generation-Skipping Transfer Taxes, Selected Years 1940–1996

Year	Revenue ($ millions)	Percentage of total Federal receipts
1940	357	6.9
1945	638	1.4
1950	698	1.9
1955	924	1.4
1960	1,606	1.7
1965	2,716	2.3
1970	3,644	1.9
1975	4,611	1.7
1976	5,216	1.7
1977	7,327	2.1
1978	5,285	1.3

ing spouses becoming taxable after their decedent spouse had claimed the unlimited marital deduction.

[35] The following analysis assumes that the capital accumulated is physical or business intangible capital. Real per capita GNP could grow if individuals accumulated more knowledge and skills, or what economists call "human capital." Accumulation of human capital unaccompanied by the accumulation of physical or business intangible capital would not necessarily lead to increasing numbers of decedents becoming liable for estate tax.

[36] This analysis assumes that the capital accumulation is held broadly. If the growth in the capital stock were all due to a declining number of individuals doing the accumulating, then the distribution of wealth would be becoming less equal and real growth could be accompanied by a declining percentage of decedents being liable for estate tax.

Table 25.—Revenue From the Estate, Gift, and Generation-Skipping Transfer Taxes, Selected Years 1940–1996—Continued

Year	Revenue ($ millions)	Percentage of total Federal receipts
1979	5,411	1.2
1980	6,389	1.2
1981	6,787	1.1
1982	7,991	1.3
1983	6,053	1.0
1984	6,010	0.9
1985	6,422	0.9
1986	6,958	0.9
1987	7,493	0.9
1988	7,594	0.8
1989	8,745	0.9
1990	11,500	1.12
1991	11,138	1.06
1992	11,143	1.02
1993	12,577	1.09
1994	15,225	1.21
1995	15,087	1.12
1996	17,189	1.18

Sources: Joint Economic Committee, *The Federal Tax System: Facts and Problems,* 1964; Joseph A. Pechman, *Federal Tax Policy* (Washington: Brookings Institution), 1987; Internal Revenue Service, *Statistics of Income Bulletin,* Fall 1996, and U.S. Office of Management and Budget, *Budget of the United States Government Fiscal Year 1997,* and prior years.

III. DESCRIPTIONS OF TAX RESTRUCTURING ALTERNATIVES

The press release by the House Committee on Ways and Means announcing this set of tax restructuring hearings asked all witnesses to comment on the impact of certain basic tax reform proposals. These basic alternatives to replace the current tax system are: (1) a national retail sales tax; (2) a value-added tax; (3) a flat consumption-based tax; (4) a cash flow tax; and (5) a "pure" income tax.

This part of the pamphlet provides brief descriptions of these alternative tax systems. In some cases, the descriptions include summaries of introduced legislation; in other cases, the descriptions are based upon theoretical models of the tax systems. These descriptions provide a summary of the alternative systems and are not intended to provide detailed analyses of specific aspects of the proposed systems. Such analyses will be provided in pamphlets to be prepared for separate hearings.[37]

Other than the "pure" income tax, the alternative tax systems discussed in this section are consumption-based, rather than income-based, taxes. The major difference between a consumption-based tax and an income-based tax generally involves the treatment of savings. Under an income-based tax, returns to savings (e.g., dividends, interest, and capital gains) generally are subject to tax. Under a consumption-based tax, returns to savings generally are excluded from the tax base. Such exclusion may be achieved by taxing consumption directly (e.g., as under a retail sales tax), excluding investment income from the tax base (e.g., as under a value added tax), or providing a deduction for increased savings (e.g., as under a cash flow tax).[38]

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[37] See Joint Committee on Taxation, *Impact on Small Business of Replacing the Federal Income Tax* (JCS–3–96), April 23, 1996; Joint Committee on Taxation, *Impact on State and Local Governments and Tax-Exempt Organizations of Replacing the Federal Income Tax* (JCS–4–96), April 30, 1996; Joint Committee on Taxation, *Impact on International Competitiveness of Replacing the Federal Income Tax* (JCS–5–96), July 17, 1996; and Joint Committee on Taxation, *Impact on Manufacturing, Energy, and Natural Resources of Replacing the Federal Income Tax* (JCS–7–96), July 31, 1996. Additional analysis can be found in Joint Committee on Taxation, *Description and Analysis of Proposals to Replace the Federal Income Tax* (JCS–18–95), June 5, 1995, and Martin A. Sullivan, *Flat Taxes and Consumption Taxes: A Guide to the Debate*, American Institute of Certified Public Accountants, December 1995.

[38] For a further discussion of the distinctions between consumption-based taxes and income-based taxes and the equivalence among different types of consumption taxes, see Joint Committee on Taxation, *Description and Analysis of Proposals to Replace the Federal Income Tax*, and the citations contained therein.

A. National Retail Sales Tax

1. In general

As the name implies, a retail sales tax is a tax imposed on the retail sales price (i.e., sales to consumers, but not sales of inputs to businesses) of taxable goods or services.

The Federal government currently imposes excise taxes on various products and services.[39] However, these taxes generally apply to a narrowly defined class of goods and services, and generally are not imposed at the retail level. Rather, as described in Part II, the present-law Federal excise taxes generally are imposed upon manufacturers (as in the case of the alcohol and tobacco excise taxes) or some other intermediate (pre-retail) stage of the distribution of a product (as in the case of the highway motor fuels tax), or are imposed upon both the consumers and business users of a good or service (as in the case of the communications services tax ("telephone tax") or the air passenger ticket tax).

Most States and many local governments impose general sales taxes within their jurisdictions,[40] and all States impose some form of excise-type tax on specified goods or services. Although the typical State sales tax is familiar to most consumers and appears simple on its face, several issues may arise in the application of such a tax. State sales taxes generally are designed to apply to most tangible personal property and selected services purchased by consumers.[41] Certain sales to persons other than consumers (i.e., businesses) may be exempted from the tax in a variety of ways. Exemptions may be provided for goods acquired as "sales for resale," or for articles for use in manufacture, fabrication, or the processing of personal property for resale, if the articles become incorporated in such property. Thus, persons who are not consumers may be subject to the sales tax in certain instances. For example, a furniture maker may be exempt from tax on lumber acquired to manufacture chairs, but would not be exempt from tax on a truck purchased to deliver the chairs to customers. Controversies often arise as to whether articles or services (such as packaging or utility services) are incorporated into goods.[42] Most States also provide exemptions for acquisitions by the State and its political subdivisions, and charitable, religious, and educational organizations.[43] In order to address the regressivity of sales taxes, most States exempt food, but impose a tax on candy, soda and prepared meals, thus requiring subtle distinctions between taxable and tax-exempt items. Similarly, most States do not tax sales of intangible property, raising issues as to whether a particular item (e.g., computer software)

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[39] See Joint Committee on Taxation, *Schedule of Present Federal Excise Taxes (As of January 1, 1994)* (JCS–5–94), June 28, 1994, for a description the various Federal excise taxes.

[40] It has been reported that there are approximately 50,000 separate sales tax jurisdictions in the United States. *Wall Street Journal,* April 18, 1990, p. A1. Alaska, Delaware, Montana, New Hampshire, and Oregon currently do not have broad-based sales taxes. The District of Columbia has a sales tax.

[41] For a detailed discussion of State and local sales taxes, see Jerome R. Hellerstein and Walter Hellerstein, *State Taxation (Vol. II: Sales and Use, Personal Income, and Death and Gift Taxes)* (Warren, Gorham, Lamont: Boston, MA) 1992.

[42] See, for example, *Sta-Ru v. Mahin,* 64 Ill. 2d 330 (1976), and *Burger King v. State Tax Commission,* 51 N.Y. 614 (1980) (whether paper and plastic cups and similar items purchased by a fast-food restaurant were subject to State sales taxes.)

[43] See John Due and J. Mikesell, *Sales Taxation: State and Local Structure and Administration* (1983), pp.78–80.

represents taxable tangible or tax-exempt intangible property. Moreover, most States provide broad taxation of personal property, but only limited taxation of services, raising issues whenever a business provides both taxable goods and tax-exempt services to a customer. For example, an automotive repair shop typically provides both goods (replacement parts) and services (labor on installation of the parts) when it repairs an automobile. Further, a State's sales tax generally does not apply to goods shipped to out-of-State customers.[44] In such cases, the customer likely is subject to a complementary "use" tax in his or her State of residence. However, there are significant compliance problems with State use taxes.[45] Several States mail use tax forms to all State income taxpayers and rely upon voluntary reporting of taxable out-of-State purchases.

2. Description of the "National Retail Sales Tax Act of 1996" (H.R. 3039, 104th Cong.)

Recently, there has been interest in replacing the U.S. income tax system with a Federal retail sales tax.[46] On March 6, 1996, Messrs. Schaefer, Tauzin, Chrysler, Bono, Hefley, Linder, and Stump, introduced H.R. 3039, the "National Retail Sales Tax Act of 1996." Following is a discussion of the bill.

In general

The bill would impose a tax at a rate of 15 percent on gross payments for the use, consumption, or enjoyment in the United States of any taxable property or service, whether produced or rendered within or without the United States. In general, the tax would be imposed and remitted by the seller of the taxable item. "Taxable property or service" would mean (1) any property (including leaseholds of any term or rents with respect to such property other than intangible property), and (2) any service (including any financial intermediation services). The tax would be due when payment for the taxable item is received, even if received pursuant to an installment method. Alternatively, the seller may elect to adopt an accrual method of accounting.

Tax would not be imposed upon any property or service: (1) purchased for resale; (2) purchased to produce taxable property or services; or (3) exported from the United States for use, consumption, or enjoyment outside the United States. These exemption would not apply for purchases made by a trade or business if that trade or business is an activity not engaged in for profit. A trade or business would be deemed to be engaged in for-profit activity if

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[44] Thus, most State sales and use taxes are based on a "destination principle." The destination principle is discussed in detail in the following part of this pamphlet.

[45] The ability of one State to require an out-of-State retailer to collect that State's sales or use tax on sales into the State (generally through mail-order catalog sales) is restricted by the Commerce Clause of the U.S. Constitution where the retailer has no physical presence in the State. See *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1976), and *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

[46] Senator Richard Lugar had proposed that the current Federal taxes be repealed and replaced with a retail sales tax that would be collected by the States on behalf of the Federal Government. *Washington Post*, April 20, 1995. For a discussion of similar proposals, see Laurence J. Kotlikoff, "Economic Impact of Replacing Federal Income Taxes with a Sales Tax," published by the Cato Institute in December 1992, and Stephen Moore, "The Economic and Civil Liberties Case for a National Sales Tax," published for a Hoover Institution conference on May 11, 1995.

it has received gross payments that exceed the sum of (1) taxable property and services purchased, (2) wages paid, and (3) taxes paid in three or more of the most recent calendar years. Tuition for general primary, secondary, or university level education and job-related training courses would be treated as purchased to produce taxable property or services. Special rules would apply to property or services purchased for a dual use (i.e., both a taxable and tax-exempt purpose).

Specific rules for certain transactions

Specific rules would be provided for transactions involving casual or de minimis sales, governmental units and not-for-profit organizations, purchasers of principal residences, financial intermediation services, and international transactions.[47]

Casual sales.—The tax would not apply to amounts received by a person not engaged in a trade or business at any time during the year in connection with a casual or isolated sale if (1) the gross payments from each such sale during the year do not exceed $2,000 and (2) the aggregate gross payments from all such sales during the year do not exceed $5,000.

Governmental units.—Any Federal, State, or local governmental unit or political subdivision would not be exempt from the tax on any sale, purchase, use, consumption, or enjoyment of a taxable good or service by the unit. In addition, an excise tax of 15 percent would be imposed on the wages of Federal, State, and local government employees; the tax would be collected from the governmental employers.

Not-for-profit organizations.—Dues, contributions, and payments to a qualified not-for-profit organization generally would not be subject to tax. However, payments to a not-for-profit organization would be subject to the tax if the property or service provided in exchange for the payment is not substantially related to the exempt purpose of the organization or is commercially available. The provision of property or personal services by a not-for-profit organization in connection with contributions or dues to the organization would be treated as a taxable transaction in an amount equal to the fair market value of the property or service. Property or personal services acquired by a not-for-profit organization for resale or use in the production of taxable property or services would not be subject to tax. For this purpose, a "qualified not-for-profit organization" generally would be an organization organized and operated exclusively as an organization generally described in present-law sections 501(c)(3), (4), (5), (6), (8) and (10) of the Code, provided that no part of the net earnings of the organization inures to the benefit of any private shareholder or individual. In general, qualified not-for-profit organizations would apply for a qualification certificate from the appropriate State tax administrator.

[47] Principal residences and other durable goods and financial intermediation services present special issues under most consumption taxes. These issues will be examined in future pamphlets devoted to these topics. The treatment of governmental units and not-for-profit organizations and international transactions under tax restructuring proposals were discussed in Joint Committee on Taxation, *Impact on State and Local Governments and Tax-Exempt Organizations of Replacing the Federal Income Tax* (JCS–4–96), April 30, 1996; Joint Committee on Taxation, *Impact on International Competitiveness of Replacing the Federal Income Tax* (JCS–5–96), July 17, 1996, respectively.

Principal residences.—A purchaser may elect to pay the tax (plus simple interest computed at the rate imposed by present-law section 6621 of the Code) in equal installments over a 30-year period with respect to property purchased and used as a principal residence. If the property is sold or ceases to be used as a principal residence by the purchaser before the close of the 30-year period, the unpaid balance of the tax would become payable within two years of such sale or cessation.

Financial intermediation.—The tax would be imposed upon explicitly and implicitly charged financial intermediation services. Explicitly charged financial intermediation services would include brokerage fees; explicitly stated banking, loan origination processing, documentation, credit check and other similar fees; safe-deposit fees; insurance fees (to the extent not allocable to the investment account of the underlying insurance policy); trustee's fees; and other financial service fees, including mutual fund management, sales, and exit fees. Providers of these services would be subject to tax on the amount charged for the services. Implicitly charged financial intermediation services generally would be determined based upon the difference between the rate of interest earned on any underlying interest-bearing investment and the interest paid on any underlying interest-bearing debt.

International aspects of the tax.—The tax would be imposed on payments for the use, consumption, or enjoyment in the United States of any taxable property or service, whether produced or rendered within or without the United States. The tax normally would be collected from the seller of a taxable good or service; however, in the case of a taxable good or service purchased outside the United States for use, consumption or enjoyment in the United States, the tax would be collected from the purchaser. The tax would be imposed in addition to any import duties imposed by law and the Secretary of the Treasury would be instructed to issue regulations to coordinate the collection and administration of the tax and import duties.

A financial intermediation service would be deemed to be used, consumed, or enjoyed in the United States if the service provider or any related party has a permanent establishment in the United States and the person purchasing the service is a U.S. resident. In the case of transportation services where either the origin or the final destination of the trip is outside the United States, the service amount would be deemed to be 50 percent attributable to the United States origin or destination.

Credits and rebates

The bill would provide credits with respect to sales of used property, property converted to business use, taxes collected on exempt purchases, administrative costs, compliance equipment costs, and over-collected taxes. These credits may result in a tax refund if the taxpayer files two consecutive tax reports with a credit balance. The used property tax credit is designed to alleviate the cascading of tax when taxable goods are acquired by a consumer, sold to a used goods dealer, and then resold by the dealer to another consumer. The business use conversion credit would allow a credit when a consumer devotes a previously-taxed item to exclusive use

in the consumer's business. The administrative costs credit would be an amount equal to the greater of $100 or one-half of one percent of the tax remitted by the taxpayer. The administrative costs credit could not exceed 20 percent of the tax remitted, determined before the application of the credit. The compliance equipment costs credit would be an amount equal to 50 percent of the cost of equipment that a vendor must purchase to comply with the requirement (described below) that the amount of tax be stated and separately charged.

The bill would provide a family consumption rebate for each qualified family unit. The amount of the rebate would be 15 percent of the lesser of: (1) the poverty level of the family, or (2) the wage income of the family unit. The qualified family unit would be determined with respect to family members sharing a common residence. The poverty level of the family would be the quotient of (1) the level determined by the Department of Health and Human Services poverty guidelines for family units of a particular size, divided by (2) 85 percent. The size of the family unit would determined by including each spouse or head of household, child, grandchild, parent and grandparent. Family members would include certain students living away from home and exclude persons over the age of two without a bona fide Social Security number and unlawful residents of the United States. In no event may a person be considered to be part of more than one family unit. The residence of family members, marital status, and number of persons in a family unit would be determined on January 1 of the year in question.

The rebate would be provided by including a pay period rebate amount in each paycheck. The pay period rebate amount would be the 15 percent of the lesser of: (1) the wages paid during the pay period or (2) the quotient that is the poverty level for the family unit divided by the number of pay periods in a year. Social Security taxes to be withheld from the wages of employees would be adjusted to take into account the pay period rebate. The family member receiving the rebate would be required to provide his or her employer the names and Social Security numbers of all members of the family unit for which the rebate is claimed. Employers would provide this information to the Social Security Administration. A family unit with multiple working members would be allowed to divide the rebate between two family members.

Administration of the tax

The sales tax would be charged separate from the purchase price of each taxable sale. Vendors would be required to provide purchasers with a receipt that sets forth the tax-exclusive price of the taxable item, the amount of tax paid, the tax-inclusive price of the taxable item, the tax rate, the date the item was sold, and the vendor's name and registration number.

Any person liable to collect and remit the tax who is engaged in an active trade or business would register with the appropriate taxing authority. Taxpayers would be required to pay the tax on or before the 25th day following the month in which the tax was collected, and to file a report that sets forth the gross receipts on taxable items for the month, the tax collected in connection with these payments, and the amount and types of credits claimed. Interest

would apply to late receipts. Civil or criminal penalties would apply to late filings; failures to register; and failures to collect, remit, or pay the tax.

The tax would be administered, collected, and remitted to the Federal government by an administering State within which taxable items are used, consumed, or enjoyed. A State would be an administering State if it maintains a sales tax that significantly conforms to the Federal tax and enters into a cooperative agreement with the Secretary of the Treasury regarding the State's administration of the tax. Administering States would be allowed to retain one percent of the Federal tax as an administration fee. A conforming State may contract with another conforming State to administer its sales tax. The Secretary of the Treasury would administer the tax in jurisdictions that are not administering States, where the administering State has failed on a regular and sustained basis timely to remit the tax to the United States, where the administering State has been adjudicated to have breached the cooperative agreement, and with respect to certain multistate vendors. Special rules would determine the situs of the use, consumption or enjoyment of a taxable item based on a destination principle. The Secretary of the Treasury would be required to issue guidance with respect to the tax and to establish an Office of Revenue Allocation to arbitrate claims and disputes among administering States.

Appropriations to the Internal Revenue Service ("IRS") would not be authorized after fiscal year 2000. An Excise Tax Bureau would be established to administer and collect excise tax formerly collected by the IRS, and the Social Security Administration would administer and collect payroll taxes.

B. Value-Added Tax

1. In general

A value-added tax ("VAT") generally is a tax imposed and collected on the "value added" at every stage in the production and distribution process of a good or service. Although there are several ways to compute the taxable base for a VAT, the amount of value added generally can be thought of as the difference between the value of sales (outputs) and purchases (inputs) of an enterprise.[48]

The amount of value added may be determined under a VAT in a number of ways. The two most common methods are the credit-invoice method and the subtraction method.[49] The credit-invoice method is the system of choice in nearly all countries that have adopted a VAT,[50] while the subtraction method has been used in the States of Michigan and New Hampshire.[51] A subtraction-method VAT is also sometimes is referred to as a business transfer tax.

2. Credit-invoice method VAT

Under the credit-invoice method, a tax is imposed on the seller for all of its sales. The tax is calculated by applying the tax rate to the sales price of the good or service, and the amount of tax generally is disclosed on the sales invoice. A business credit is provided for all VAT paid on all purchases of taxable goods and services (i.e., "inputs") used in the seller's business. The ultimate consumer (i.e., a non-business purchaser), however, does not receive a credit with respect to his or her purchases. The VAT credit for inputs prevents

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[48] Previous publications by the staff of the Joint Committee on Taxation have discussed some of the broad tax policy and economic issues to be considered in deciding whether a VAT should be enacted and have described the mechanics of various VAT systems. Numerous other publications also address these issues. See, e.g., Joint Committee on Taxation, *Description and Analysis of Proposals to Replace the Federal Income Tax*; Joint Committee on Taxation, *Factors Affecting the International Competitiveness of the United States* (JCS–6–91), May 30, 1991 (Part Three: "Discussion of Value–Added Taxes"), pp. 269–341; Joint Committee on Taxation, *Description of Tax Bills ... S. 442* (Value Added Tax) ... (JCS–11–89), May 11, 1989 (Part III.C., "Analysis of Specific Issues"), pp. 9–31; Department of the Treasury, *Tax Reform for Fairness, Simplicity, and Economic Growth*, Vol. 3, "Value–Added Tax", (1984); Congressional Budget Office, *Effects of Adopting A Value–Added Tax*, February 1992; Government Accounting Office, *Value Added Tax: Administrative Costs Vary with Complexity and Number of Businesses*, GAO/GGD–93–78, May 1993; Alan Schenk, *Value Added Tax: A Model Statute and Commentary, American Bar Association Section on Taxation*, (1989); Martin A. Sullivan, *Flat Taxes and Consumption Taxes*, American Institute of Certified Public Accountants, December 1995; Lorence L. Bravenec, *Design Issues in a Credit Invoice Method Value–Added Tax for the United States*, American Institute of Certified Public Accountants, (1990); Tax Executives Institute, Value–Added Taxes: A Comparative Analysis, (1992); Congressional Research Service, *Value–Added Tax: Tax Bases and Revenue Yields* (CRS Report 92–176E), November 23, 1992 (and publications cited therein); Charles E. McLure, Jr., *The Value–Added Tax: Key to Deficit Reduction?*, American Enterprise Institute for Public Policy Research, Washington, D.C. (1987); and Alan A. Tait, *Value Added Tax, International Practice and Problems*, International Monetary Fund, Washington, D.C. (1988).

[49] An addition method may also be used to compute value added. An addition method measures value added as the sum of wages, interest expense, and cash-flow profits of an entity (i.e., the returns to labor and financial capital of a business). The addition method is disfavored by some VAT commentators generally because of the difficulty in measuring cash-flow profits, but may have utility in certain instances (e.g., for measuring the value added of a not-for-profit organization).

[50] It is reported that Japan imposes a version of an "accounts-based" subtraction method VAT. The Japanese VAT also has elements of the credit-invoice method. See Tax Executives Institute, *Value–Added Taxes: A Comparative Analysis* (1992), p. 80.

[51] The subtraction method also has been proposed in several recent U.S. legislative proposals. See, e.g., the business tax components of the flat taxes proposed in H.R. 1040 and S. 1050 as introduced by Mr. Armey and Senator Specter on March 12, 1997 (described below); H.R. 4050 (104th Cong.) as introduced by Mr. Gibbons on September 11, 1996; the "Business Transfer Tax" of S. 2160 (103rd Cong.) proposed by Senators Boren and Danforth on May 26, 1994; and the business tax component of the "USA Tax" proposed in S. 722 (104th Cong.) as introduced by Senators Domenici and Nunn on April 25, 1995 (described below).

the imposition of multiple layers of tax with respect to the total final purchase price (i.e., "cascading" of the VAT). As a result, the net tax paid at a particular stage of production or distribution is based on the value added by that taxpayer at that stage of production or distribution. In theory, the total amount of tax paid with respect to a good or service from all levels of production and distribution should equal the sales price of the good or service to the ultimate consumer multiplied by the VAT rate.

In order to receive an input credit with respect to any purchase, a business purchaser generally is required to possess an invoice from a seller that contains the name of the purchaser and indicates the amount of tax collected by the seller on the sale of the input to the purchaser. At the end of a reporting period, a taxpayer may calculate its tax liability by subtracting the cumulative amount of tax stated on its purchase invoices from the cumulative amount of tax stated on its sales invoices.

Example 1. Simple credit-invoice method VAT.—Assume a landowner sells felled trees to a paper mill for $1,000. The landowner had not been subject to tax with respect to anything used in the production of the trees. The paper mill processes the trees into rolls of paper and sells the rolls to a distributor for $1,300. The distributor cuts the rolls into sheets, packages the sheets, and sells the packages to a retail stationery store for $1,500. The retail stationery store sells the entire lot of packages to nonbusiness consumers for $2,000. The jurisdiction in question levies a broad-based VAT at a rate of 10 percent. The tax would be determined as follows:

Production stage	Sales		VAT on sales		VAT on purchases		Net VAT
Landowner	$1,000 x .1	=	$100	-	(0)	=	$100
Paper mill	1,300 x .1	=	130	-	(100)	=	30
Distributor	1,500 x .1	=	150	-	(130)	=	20
Retail store	2,000 x .1	=	200	-	(150)	=	50
Total			580	-	(380)	=	200

Thus, a total of $200 of VAT is assessed and collected in various amounts from the four stages of production. If, instead of a VAT, the jurisdiction in question levied a retail sales tax at a rate of 10 percent, the total amount of tax also would be $200 ($2,000 sales price times 10 percent), all collected by the stationery store at the retail level.

3. Subtraction-method VAT

Under the subtraction method, value added is measured as the difference between an enterprise's taxable sales and its purchases of taxable goods and services from other enterprises. At the end of the reporting period, a rate of tax is applied to this difference in order to determine the tax liability. The subtraction method is similar to the credit-invoice method in that both methods measure value added by comparing outputs (sales) to inputs (purchases)

that have borne the tax. The subtraction method differs from the credit-invoice method principally in that the tax rate is applied to a net amount of value added (sales less purchases) rather than to gross sales with credits for tax on gross purchases (as under the credit-invoice method). The determination of the tax liability of an enterprise under the credit-invoice method relies upon the enterprise's sales records and purchase invoices, while the subtraction method may rely upon records that the taxpayer maintains for income tax or financial accounting purposes.

Example 2. Simple subtraction method VAT.—Assume the same facts as in Example 1 above. The subtraction method VAT would operate as follows:

Production stage	Sales	-	Purchases	=	Value added	x rate	=	VAT
Landowner	$1,000	-	(0)	=	$1,000	x .1	=	$100
Paper mill	1,300	-	(1,000)	=	300	x .1	=	30
Distributor	1,500	-	(1,300)	=	200	x .1	=	20
Retail store	2,000	-	(1,500)	=	500	x .1	=	50
Totals ...					2,000	x .1	=	200

Comparing Examples 1 and 2, the credit-invoice and subtraction methods yield the same amounts of tax at the same levels of production.

4. Exclusions under a VAT

Most VATs provide exclusions for various goods and services, or classes of taxpayers, for economic, social, or political reasons. Certain goods and services are excluded from the VAT due to difficulties in measuring either the amount of the value added or the element of consumption (as opposed to the investment element) with respect to the good or service. Many VATs adopted to date provide exclusions or different rates of tax for certain staples (e.g., food, medicine, certain clothing) in order to address the perceived regressivity of the tax.[52] In addition, as described in detail below, most VATs adopted to date provide special treatment for imported and exported goods and services.[53]

Goods, services, or classes of taxpayers may be excluded from a VAT either by providing a "zero rating" or through an exemption. There may be significant differences between these two alternatives, particularly under the credit-invoice method. If a sale is zero-rated, the sale is considered a taxable transaction, but the rate of tax is zero percent. Sellers of zero-rated goods or services do not collect or remit any VAT on their sales of those items, but are required to register as taxpayers. Sellers of zero-rated items are allowed to claim credits (and perhaps a refund to the extent the taxpayer does not have taxable sales) for the VAT they paid with respect to purchased goods and services.

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[52] Alternatively, or in addition, some VATs adopted to date provide an increased VAT rate on perceived luxury goods.

[53] See the following discussion for the general treatment of imported and exported goods and services under consumption-based taxes.

Similarly, a seller of goods or services that is exempt is not required to collect any VAT on its sales. However, because such sellers are not considered taxpayers under the VAT system, they may not claim any refunds of the VAT that they may have paid on their purchases. In addition, under the credit-invoice method, purchasers of exempt goods or services generally are not allowed a credit for any VAT borne with respect to such goods or services prior to the exempt sale. Consequently, a VAT exemption, as opposed to a zero rating, in a credit-invoice system breaks the chain between inputs and outputs along the various stages of production and distribution and may result in a cascading of the tax (i.e., total tax collected from all stages of production would be greater than the retail sales price of the good times the VAT rate). For this reason, most VAT commentators, while recognizing that exemptions may be useful in easing the administrative and recordkeeping burdens of certain targeted taxpayers or transactions (such as small businesses or casual sales), prefer zero rating as the means of providing VAT relief under the credit-invoice method.

There is little practical experience available to assess how exclusions would operate under a subtraction-method VAT. It is, however, theoretically possible to design exclusions under a subtraction method that replicate the effects of either zero rating or exemptions under a credit-invoice VAT. Moreover, exemptions under the subtraction method may relieve the tax on the value added by the exempted activity, but do not result in the cascading that occurs with exemptions under the credit-invoice method.

5. Border adjustments

VATs generally are imposed based upon either an "origin principle" or a "destination principle." A VAT based on the origin principle imposes tax on goods or services produced in the jurisdiction that imposes the tax. Under the origin principle, exports are subject to tax while imports are not. Conversely, a VAT based on the destination principle imposes tax on goods or services consumed in the jurisdiction that imposes the tax. Under the destination principle, imports are subject to tax and the tax on exports is rebated. These import charges and export rebates are commonly referred to as "border adjustments" and are a part of nearly all VAT systems currently in place.[54]

Under the border adjustments, exported goods would not be subject to the credit-invoice VAT through zero-rating the sale of exported goods (i.e., by applying a VAT rate of zero to exports, thus allowing the exporter to claim refundable credits for VAT paid with respect to the purchased inputs). On the other hand, importers would be subject to tax on the full value of imported goods (because inputs with respect to such products previously had not been subject to the U.S. VAT). Similar treatment would be provided for imported and exported services. Under a subtraction-method VAT, border adjustments could be provided by not including export sales as taxable transactions and by treating the value of imported items as a taxable sale.

[54] A more complete discussion of border adjustments under a VAT can be found in Joint Committee on Taxation, *Impact on International Competitiveness of Replacing the Federal Income Tax* (JCS–5–96), July 17, 1996.

Border adjustments are fully consistent with the General Agreement on Tariffs and Trade (GATT), as long as they do not discriminate against imports or provide over-rebates on exports. Relief from "indirect" taxes on exports does not constitute an illegal export subsidy, while relief from "direct" taxes (such as income taxes) is illegal. "Indirect" taxes are defined to include value-added taxes, and credit-invoice VATs have been accepted as border-adjustable under GATT. Although a subtraction-method VAT has the same base as a credit-invoice VAT, it is not clear whether a subtraction-method VAT is an indirect tax and whether border adjustments under the subtraction-method are GATT-legal.[55] Further, because there are no pure subtraction-method VATs currently in existence, there have been no GATT challenges or test cases with respect to the legality of subtraction-method border adjustments.

[55] See George N. Carlson and Richard A. Gordon, "VAT or Business Transfer Tax: A Tax on Consumers or on Business?" *Tax Notes*, October 17, 1988, p. 329.

C. Consumption-Based "Flat" Tax

1. In general

A "flat tax" generally is any tax system with only one marginal tax rate.[56] 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 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.

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. As discussed above, there are two main approaches: a consumption base and an income base. The gross income of a taxpayer in any year can be thought of as the sum of the taxpayer's consumption and gross saving. The difference between these two approaches 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 have been several consumption-based flat taxes introduced in recent Congresses.[57] On March 2, 1995, Senator Specter introduced S. 488 (104th Cong.).[58] On January 4, 1995, Mr. Crane introduced H.R. 214 (104th Cong.), "The Tithe Tax." In the 103rd Congress, on January 26, 1993, Senator Helms introduced S. 188, "The Tithe Tax;" and on June 16, 1994, Mr. Armey introduced H.R. 4585, "The Freedom and Fairness Restoration Act of 1994." House Majority Leader Armey modified his flat tax proposal and introduced H.R. 2060 (104th Cong.) on July 19, 1995. Senator Shelby introduced a companion bill, S. 1050 (104th Cong.), in the Senate on the same date. Mr. Armey's bill was reintroduced in the 105th Congress as H.R. 1040 on March 12, 1997, with slight modifications.[59] The subsequent discussion provides a description of H.R. 1040.

2. Description of H.R. 1040 (105th Cong.)

Overview

H.R. 1040 is based on a flat tax developed by Professors Robert Hall and Alvin Rabushka of Stanford University.[60] In general, the tax described in the bill is a consumption-based flat tax that is im-

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[56] A bracket with a marginal rate of zero also could 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 would commonly be referred to as a "flat tax."

[57] The bills describe flat taxes because the taxes would be imposed at a single rate on taxable income. These flat taxes generally 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.

[58] S. 488 was similar to the consumption-base flat tax of H.R. 1040 (as described in detail in this section), but would have allowed individuals limited deductions for mortgage interest expense and charitable contributions.

[59] A companion Senate bill has not yet been introduced in the 105th Congress as of the date of publication of this pamphlet.

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

posed at single rate upon individuals and businesses. An individual is taxed on the amount by which the individual's wages and distributions from qualified plans exceed the individual's standard deduction. The business activities tax is a subtraction-method VAT, with deductions for wages and contributions to retirement plans. The business activities tax proposed by the bill resembles a subtraction-method VAT, as described above. The difference between the bill's business activities tax and a subtraction-method VAT is that the bill would allow businesses to deduct compensation expenses, while VATs generally do not allow compensation deductions. However, under the bill, the receipt of such compensation is subject to tax at the individual level at the same flat rate applicable to businesses. Thus, the combination of the business activities tax and the individual tax is roughly equivalent to a VAT. The combination of the individual and business taxes under H.R. 1040 is not exactly equivalent to a VAT because of the allowance for standard deductions under the individual-level tax. Alternatively, the bill could be viewed as a VAT that provides individuals with built-in exemptions for a minimum amount of consumption.[61] Following is a more detailed description of H.R 1040.

Taxation of individuals

The bill would impose a tax equal to 20 percent (the tax rate is reduced to 17 percent for taxable years beginning after December 31, 1998) of the excess (if any) of: (1) certain earned income received during the taxable year over (2) the standard deduction for the year. For this purpose, earned income subject to tax would be wages paid in cash for services provided in the United States, distributions from retirement plans, and unemployment compensation.

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 26 below. (For the sake of comparison, the amounts of standard deductions allowable under present law also are provided in the table.)

[61] As described by Robert E. Hall and Alvin Rabushka in "The Flat Tax: A Simple Progressive Consumption Tax," a paper prepared for a Hoover Institution conference of May 11, 1995, the exemption amounts of their proposed flat tax are intended to provide relief for lower income individuals under their consumption-based tax.

Table 26.—Comparisons of "Standard Deductions" Under H.R. 1040 and Present Law

Filing status[1]	H.R. 1040 basic standard deduction	Present-law standard deduction[2]
Joint return	$22,000	$6,900
Surviving spouse	22,000	6,900
Head of household	14,400	6,050
Married filing separately	11,000	3,450
Single	11,000	4,150

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

[2] The amounts shown for the standard deductions apply for calendar year 1997. These amounts are indexed annually for changes in the Consumer Price Index. In addition, individuals who 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 $5,000 multiplied by the number of dependents of the taxpayer. (Under present law, a $2,650 exemption amount is allowed for calendar year 1997 for the taxpayer, his or her spouse, and each dependent of the taxpayer. The exemption amounts are indexed annually for changes in the Consumer Price Index.) The basic standard deduction and the additional standard deduction amounts under the bill would be similarly indexed.

Taxable income of an individual would include the otherwise taxable income of his or her dependent children under the age of 14.

Taxation of business activities

In general.—The bill would impose a tax equal to 20 percent (the tax rate is reduced to 17 percent for taxable years beginning after December 31, 1998) 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, "business taxable income" would mean gross active income reduced by specified deductions. "Gross active income" would mean gross receipts from (1) the sale or exchange of property or services in the United States by any person in connection with a business activity and (2) the export of property or services from the United States in connection with a business activity.

The bill would allow deductions for (1) the cost of business inputs for the business activity, (2) wages paid in cash to employees for the performance of services in the United States, and (3) contributions to qualified retirement plans or arrangements. For this purpose, "the cost of business inputs" would mean (1) the amount paid for property sold or used in connection with a business activity, (2) the amount paid for services (other than for services of employees, including fringe benefits), and (3) any excise tax, sales tax, customs duty or other separately stated levy imposed by a Federal, State, or local government on the purchase of property or services used in connection with a business activity (other than the flat tax).

If a taxpayer's aggregate deductions for any taxable year exceed its gross active income for the year, the taxpayer would be allowed a credit in succeeding years for the credit-equivalent 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.

International transactions.—The bill would impose the business tax based on the origin principle.[62] That is, proceeds from the sale or exchange of property or services produced in the United States would be subject to tax, even if such property or service are exported outside the United States. There would be no separate tax on imported goods or services. Deductions would be allowed with respect to inputs for business activity conducted within the United States, whether such inputs are acquired from U.S. or foreign sources.[63]

Special rules.—The bill would provide special rules for financial intermediation service activities and noncash compensation provided by employers not engaged in a business activity. The taxable income from the business activity of providing financial intermediation services would be the value of such services.

Governmental entities and other tax-exempt organizations would not be subject to the business activities tax. However, these entities would be subject to a tax equal to 20 percent (the tax rate is reduced to 17 percent for taxable years beginning after December 31, 1998), on the amount of remuneration for services performed by an employee other than (1) wages, (2) remuneration for services performed outside the United States, or (3) retirement contributions to qualified plans or arrangements (i.e., fringe benefits would be subject to the tax).

Treatment of qualified retirement plans

The bill would make several changes to the present-law treatment of qualified retirement plans. Specifically, the bill would expand the availability of qualified retirement plans by repealing nondiscrimination rules, contribution limits, and excise taxes on premature distributions, and by removing restrictions relating to self-employed individuals and tax-exempt organizations and governments. The bill also would provide rules regarding the transfer of excess pension assets.

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[62] Because the flat taxes of H.R. 1040 and S. 1050 allow businesses deductions for wages, some commentators have suggested that the taxes would be classified as a "direct" tax and thus could not be designed as a destination-principle tax that is in compliance with GATT rules. See, e.g., Reuven S. Avi-Yonah, "The International Implications of Tax Reform", *Tax Notes*, November, 13, 1995, p. 916.

[63] These rules are consistent with the flat tax as originally designed by Professors Hall and Rabushka. See Robert E. Hall and Alvin Rabushka, *Low Tax, Simple Tax, Flat Tax* (New York: McGraw-Hill), 1983, pp. 51–2.

D. Cash Flow Tax

1. In general

A cash flow tax is a personal consumption tax imposed on the net cash flow of an individual taxpayer. The base of the tax is determined by subtracting a deduction for net increases in savings from the gross income of the taxpayer. Under a pure cash flow tax, withdrawals from savings and net borrowings would be treated as gross income. The cash flow tax is considered a consumption tax because, ignoring gifts and bequests, the amount an individual is considered to have consumed during the year should be the difference between (1) the amount the individual earned and borrowed and (2) the amount the individual saved and repaid borrowings. A cash flow tax differs from other consumption taxes, such as a retail sales tax, in that the cash flow tax can be levied and collected from individual taxpayers rather than businesses. This personalization of the tax can measure the consumption of any individual taxpayer and allows the application of a progressive rate structure.

2. Description of the "USA Tax Act of 1995" (S.722, 104th Cong.)

Overview

On April 25, 1995, Senators Sam Nunn and Pete Domenici introduced a form of a cash flow tax in S. 722 (104th Cong.), (the "USA Tax Act of 1995"). In general, S. 722 would replace the current individual income tax with a "savings-exempt income tax"—a broader-based individual income tax with an unlimited deduction for net new saving. The tax would be imposed using a three-tier graduated rate schedule. In addition, S. 722 would replace the current corporate income tax with a subtraction-method VAT imposed on all businesses at a rate of 11 percent. Thus, in general, the bill would apply two different consumption-based taxes—a cash flow tax on individuals and a VAT on businesses. The bill also would provide individuals with a refundable credit against the individual tax for employee payroll taxes paid by them, and businesses with a credit against the business tax for employer payroll taxes paid by them. Following is a more detailed description of the bill.

Treatment of individuals under the "savings exempt income tax"

The individual tax, or "savings exempt income tax," would be a broad-based income tax with an unlimited deduction for new savings. In other words, it is a modified version of a personal consumption tax with one principal distinction. As discussed in more detail below, borrowing would not be included in income, but rather would only reduce (but not below zero) the net saving deduction. Thus, unlike a personal consumption tax, a net borrower would not pay tax on an amount greater than his income in a given year, even though the net borrowing reflects additional consumption. This additional consumption generally would be taxed as the loan is repaid.

The individual tax would have a three-tier graduated tax rate structure. As under present law, separate rate schedules would

apply based on an individual's filing status. The rate structure would be phased in from 1996 to 1999. After 1999, the individual income tax rate schedules would be as follows:

Table 27.—Individuals Income Tax Rates Under S. 722 [1]

If taxable income is	Then income tax equals
	Single individuals
$0–$3,200	8 percent of taxable income.
$3,200–$14,400	$320, plus 19% of the amount over $3,200.
Over $14,400	$2,560, plus 40% of the amount over $14,400.
	Heads of households
$0–$4,750	8 percent of taxable income.
$4,750–$21,100	$380, plus 19% of the amount over $4,750.
Over $21,100	$3,486.50, plus 40% of the amount over $21,100.
	Married individuals filing joint returns
0–$5,400	8 percent of taxable income.
$5,400–$24,000	$432, plus 19% of the amount over $5,400.
$Over $24,000	$3,966, plus 40% of the amount over $24,000.
	Married individuals filing separate returns
$0–$2,700	8 percent of taxable income.
$2,700–$12,000	$216, plus 19% of the amount over $2,700.
$Over $12,000	$1,983, plus 40% of the amount over $12,000.

[1] The rate schedules are expressed in 1996 dollars and would be indexed for changes in the Consumer Price Index beginning in 1997.

Gross income would be defined broadly to include compensation for services (including salaries, wages, commissions, tips, and distributions from business entities); most fringe benefits;[64] alimony, separate maintenance, and child support payments; distributions from business entities (including returns of capital); rents; royalties; interest (other than tax-exempt interest); includible social security benefits; pensions and other retirement plan payments; proceeds from the sale of assets (other than savings assets); income from the discharge of indebtedness; and amounts stolen or embezzled. Exclusions from gross income would be limited to tax-exempt bond interest,[65] gifts and bequests, certain government transfer

[64] Fringe benefits subject to tax would include (but would not be limited) to: (1) the cost of health, disability, or other similar insurance paid by the employer for the direct or indirect benefit of the employee; (2) employer-provided parking (unless used regularly for car used in company business); (3) employer-paid educational benefits; (4) employer-paid housing (unless for the convenience of the employer); (5) employer-paid meals (unless for the convenience of the employer or as a reimbursement for meals incurred on overnight travel); (6) group-legal services; and (7) dependent care assistance. The following fringe benefits would not be includible in income: (1) no additional-cost services (subject to anti-discrimination rules), (2) qualified employee discounts, (3) items that would be deductible by the employee if the employee were treated as engaged in a business, (4) de minimis fringe benefits, (5) transportation in a commuter highway vehicle, and (6) moving expenses (to the extent deductible under present law).

[65] This exemption may be worth less than under present law, because the "tax" on taxable interest may be deferred under the savings deduction.

and similar payments,[66] certain accident and health care payments and reimbursements, amounts received as compensation for personal injury or sickness, Medicare and Medicaid payments, income earned abroad (that would be excludible under section 911 of present law), certain military pay and veteran's benefits, parsonage allowances, and a portion of social security payments (generally as under present law).

An individual would be allowed a deduction for any increase in his or her "net savings" during the year. "Net savings" would be the taxpayer's additions to qualified savings assets during the year over taxable withdrawals from qualified savings assets during the year. An annual decrease in net savings would constitute taxable income. Borrowing would not be treated as a withdrawal from saving, but generally would reduce (but not below zero) the amount of "net savings" that could be deducted in a taxable year.[67] In addition, "net savings" would be reduced by interest income on tax-exempt bonds.

Qualified savings assets would include stocks, bonds, securities, certificates of deposits, interests in proprietorships and partnerships, mutual fund shares, life insurance policies, annuities, retirement accounts, and bank, money market, brokerage and other similar money accounts. Qualified savings assets would not include investments in land, collectibles, or cash on hand.

Under the bill, in addition to certain itemized deductions (discussed below) each taxpayer would be entitled to two types of standard deductions: (1) a family living allowance, and (2) a personal and dependency deduction. The family living allowance and the personal and dependency deductions under the bill are comparable to the standard deductions and personal exemptions of present law, respectively.

The bill would continue to allow deductions for qualified home mortgage interest[68] and charitable contributions. In contrast to current law, these itemized deductions would be allowed in addition to the standard deduction, rather than in lieu of the standard deduction. Other deductions allowable under present law generally would be eliminated, such as itemized deductions for state and local taxes and medical expenses.

The bill would allow a new deduction for certain qualified higher educational expenses. This deduction generally would be limited to $2,000 per eligible student per year, and to $8,000 in total per year. These amounts would be adjusted for inflation. Qualified higher educational expenses would include tuition and fees required for the enrollment of an eligible student at an eligible education institution, but would not include any expenses with respect to any course or other education involving sports, games, or hobbies other than as part of a degree program. An eligible education institution means (1) an institution described in section 1201(a) or sec-

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[66] Excludible government assistance would include supplemental security income, aid to families with dependent children, Section 8 Low Income Rental Assistance, low-income home energy assistance, or similar Federal or State benefits.

[67] Certain types of debt would not reduce deductible "net savings" in a taxable year, including mortgage debt on a principal residence, debt (of $25,000 or less) to purchase consumer durables, credit card and similar debts, and $10,000 of other debts.

[68] The home mortgage deduction generally would be the same as under present law, except that no deduction would be allowed for "home equity indebtedness." See Code section 163(h)(3).

tion 481(a)(1(C) or (D) of the Higher Education Act of 1965 (as in effect on October 21, 1988); (2) an are vocational education school as defined in section 521(3)(C) or (D) of the Carl D. Vocational Educational Act; or (3) in the case of a student age 18 or older who is not a high school graduate, an accredited school providing remedial education. An eligible student would include (1) the taxpayer, so long as the taxpayer is not claimed as dependent by another; (2) the taxpayer's spouse; or (3) any dependent of the taxpayer.

The bill would allow certain credits against the amount of tax due. First, a foreign tax credit would be allowed in a manner similar to present law. Second, a credit generally would be allowed for the employee share of payroll taxes paid by the taxpayer. Third, for low-income individuals, an earned income credit similar to present law would be allowed.

The bill would provide certain transition rules (e.g., recovery of pre-transition basis) for purposes of the individual tax. A discussion of these rules is beyond the scope of this pamphlet.

Business tax

In general.—The bill would impose a subtraction-method VAT on any business that sells or leases property or sells services in the United States. The tax would equal 11 percent of the "gross profits" of the business for the taxable year. "Gross profits" generally is the amount by which the taxpayer's taxable receipts exceed the taxpayer's business purchases for the taxable year. If the taxpayer's business purchases exceed its taxable receipts for the taxable year, the taxpayer generally would be entitled to a loss carryover to future taxable years. Employer payroll taxes paid by the business may be credited against the business tax.

"Taxable receipts" generally would mean all receipts from the sale or lease of property and the performance of services in the United States. The amount treated as taxable receipts from the exchange of property or services is the fair market value of the property or services received, plus any cash received. Taxable receipts do not include: (1) any excise tax, sales tax, customs duty, or other separately stated levy imposed by the Federal, a State, or a local government on property or services, or (2) financial receipts, such as interest, dividends, or proceeds from the sale of stock or other ownership interests.

"Business purchases" generally would mean any amount paid or incurred to purchase property, the use of property, or services for use in a business activity in the United States other than: (1) compensation paid to employees; (2) payments for use of money or capital, such as dividends or interest, (3) life insurance premiums; (4) amounts paid for the acquisition of savings assets or financial instruments; and (5) amounts paid for property purchased or services performed outside the United States (unless treated as an import). The cost of a business purchase does not include any taxes other than any excise tax, sales tax, customs duty, or other separately stated levy imposed by the Federal, a State, or a local government with respect to the property or services purchased for use in a business activity. "Business activity" means the sale of property or services, the leasing of property, and the development of property or services for subsequent sale or use in producing property or

services for subsequent sale. A business activity would not include casual or occasional sales of property.

International aspects.—The business tax generally is based on the destination principle. Goods and services sold in the United States are subject to tax; export sales are not subject to tax. Deductions are allowed only for expenditures relating to the conduct of a business activity in the United States. For purposes of the business tax, the term "United States" would not include the U.S. possessions. A separate tax, imposed at a rate of 11 percent, would apply to the customs value of any property entering the United States (other than property that may be entered duty free under Chapters I through VII of chapter 98 of the Tariff Schedules of the United States). Similarly, recipients of imported services would be subject to an 11-percent tax on the cost of such services. Deductions would be allowed for imported property or services used in a business activity in the United States. The amount of such deductions would be based on the amount upon which the separate import taxes are based; deductions would not be allowed for the amount of the import tax.

Services would be treated as imported or exported based upon where the benefit of the service is realized. If a business entity acquires services from a service provider that provides services both inside and outside the United States, the business entity and the service provider would treat the services as provided as indicated on the invoice provided by the service provider. In the absence of an invoice, the business entity would treat the services as provided in the location to which payment is sent and the service provider would treat any payments received as taxable receipts. Special rules and regulations would apply to international transportation services, international communication services, insurance services, and banking and other financial intermediation services.

Accounting methods.—In computing its gross profits, a taxpayer generally would be required to use an accrual method of accounting. For this purpose, an amount would not be treated as incurred earlier than when "economic performance" with respect to the item has occurred (Code sec. 461(h).) Businesses presently using the cash receipts and disbursements method, however, generally could continue to use that method. The Secretary of Treasury also could allow certain new businesses to use the cash method. The taxpayer's method of accounting could be changed only with the permission of the Secretary. Special accounting rules would apply with respect to property produced pursuant to long-term contracts.

Financial intermediation services.—The bill would impose the business tax on the provision of financial intermediation services. Special rules would apply to determine the taxable amount derived from financial intermediation services. In addition, the bill would permit the business user of financial intermediation services to deduct as business purchases any stated fees for such services and any implicit fees allocated and reported to it by the financial intermediary. The bill would provide a method (and reporting mechanism) for allocating the value of financial intermediation services among users of the services.

Government and non-profit entities.—Government entities would not be subject to the business tax with respect to the following ac-

tivities: (1) public utility services; (2) mass transit services; and (3) any other activity involving an "essential governmental function." Any other government activity of a type "frequently provided by business entities" would be subject to tax. The governments of possessions of the United States would not be subject to the business tax.

The bill generally would exempt the following types of entities from the business tax: (1) instrumentalities of the United States, (2) organizations described in present-law Code section 501(c)(3),[69] (3) certain qualified benefit plans and trusts, (4) religious and apostolic organizations, (5) cemetery companies, (6) certain title and real property holding companies, (7) cooperative hospital service organizations, and (8) cooperative educational service organizations. These entities would be subject to the business tax only with respect to their business activities that would be subject to the unrelated business income tax ("UBIT") under present law. The taxable amount for a "UBIT activity" would be determined in the same manner as the taxable amount for any other business activity subject to the business tax.

Entities (other than those listed above) that are tax-exempt under present law would be fully subject to the business tax on transfers of property or furnishing of services, even if such activities are substantially related to what historically has been considered to be the exempt purposes of these organizations.

Transition rules.[70]—The bill would provide certain transition rules (e.g., recovery of pre-transition basis) for purposes of the business tax. Generally, these rules would sort property held by the taxpayer on January 1, 1996, (the effective date of the bill) into four categories and would allow amortization deductions for the remaining basis of such property under the business tax. Category I assets would be those assets with a remaining recovery period of less than 15 years, and the unrecovered bases of such property would be amortized over 10 years. Category II assets would be those assets with a remaining recovery period of 15 or more years, and the unrecovered bases of such property would be amortized over 30 years. Category III assets generally would be those assets which were not amortizable under the income tax, and the unrecovered bases of such property would be amortized over 30 years. The final category of assets would be unrecovered inventory costs, and the unrecovered bases of such property would be amortized over 3 years. No carryovers would be allowed for pre-effective date net operating losses, net capital losses, or any other loss.

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[69] The bill, however, would not exempt organizations that test for public safety or foster amateur sports competition.

[70] A more detailed discussion of these rules is beyond the scope of this pamphlet and will be addressed in a future hearing pamphlet.

E. A "Pure" Income Tax

1. In general

Under a "pure" income tax, all income would be subject to tax and deductions would be allowed only for expenses that are incurred in the production of income. Income would be recognized when earned and deductions generally would be matched with the accounting period in which the related income is recognized.

A significant portion of the current U.S. tax system generally is considered to be an "income tax."[71] Code section 61 subjects to tax "income from whatever source derived," except for certain items explicitly exempted or excluded by statute. However, the current Federal "income" tax has features that are consumption-based. For example, present law excludes from income contributions to, and earnings of, qualified retirement plans. These exclusions are features of a consumption-based tax because of their treatment of savings.

The current Federal income tax allows certain deductions in a manner similar to the way such deductions are allowed under a consumption-based tax. For example, under a value-added tax or consumption-based flat tax, businesses are allowed to expense the cost of property used in the business (such as machinery, equipment, real property, and inventory) in the year such costs are paid or incurred. Expensing is equivalent to excluding from tax the expected return from the property because the cost of such property is equal to the present value of the expected stream of income from the property. Under a "pure" income tax, costs of property that benefit future accounting periods are capitalized and recovered over such periods. Under present law, certain costs are expensed in the period they are incurred even though such costs may benefit future periods and would be capitalized under a "pure" income tax. Examples of such expenditures include up to $18,000 (in 1997) of the cost of tangible personal property of small business, the cost of clean-fuel vehicles and refueling property, intangible drilling costs, research and experimental expenditures, expenditures to increase the circulation of newspapers, magazines and periodicals, certain timber expenditures, certain expenditures of farmers, costs of removing architectural and transportation barriers to the handicapped and elderly, certain mining expenditures, and certain costs incurred by free lance authors, photographers, and artists. In addition, present law allows certain capitalized costs to be recovered more rapidly than would be allowed under a "pure" income tax. For example, present law allows the cost of tangible personal property to be depreciated using accelerated methods over periods that may be shorter than the useful lives of the property. Expensing or accelerated cost recovery is provided under present law for certain expenditures in order to simplify the tax accounting for such costs or to provide a tax benefit or incentive for particular activities or types of taxpayers.

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[71] In 1994, 54.34 percent of Federal receipts came from individual and corporate income taxes, 36.69 percent came from payroll taxes, 4.39 percent came from excise taxes, and 4.58 percent came from other sources. Joint Committee on Taxation, *Selected Materials Relating to the Federal Tax System Under Present Law and Various Alternative Tax Systems* (JCS–1–96), March 14, 1996, pp. 5–8.

Certain exemptions, exclusions, deductions, special rates, and credits are provided in the current Federal income tax largely to promote social, economic, or intragovernmental policies, rather than to contribute to a more accurate measure of economic income. Examples of such items include itemized deductions for medical expenses, home mortgage interest, charitable contributions,[72] State and local income taxes,[73] and property taxes; percentage depletion in excess of cost for natural resources; the exclusion from income for employer-provided health insurance; the exclusion of interest on State and local bonds; special rules applicable to military personnel; parsonage allowances for clergy; the special rate of tax on long-term capital gains; and most tax credits. Similarly, present law denies tax deductions for certain trade or business expenses for social policy reasons. Examples include the denial of deductions for penalties, fines, bribes, lobbying activities, and compensation in excess of $1 million for certain executives.

Several adjustments could be made to the present-law tax system to arrive at a more "pure" income tax. The base of the income tax could be expanded to be more comprehensive. A comprehensive income base would include income from all sources, whether labor income or returns to saving. Sources of income currently excluded from tax (such as employer-provided health insurance, and interest from State and local bonds) would be included in the base. Items currently given consumption-base treatment in the individual income tax would be put on an income base. For example, contributions by an employer on behalf of an employee to a qualified retirement plan would be taxed to the employee when the amount of the contribution is earned. Long-term capital gains would be treated the same as ordinary income. Present-law conventions that result in the deferral of income could be repealed in order to result in a more accurate measure of economic income.

Under a more comprehensive income tax, deductions would be allowed only for expenditures that are incurred for the production of income. Expenditures that benefit future accounting periods would be capitalized and recovered in the appropriate period. In general, the tax base for business income would more closely resemble the present-law corporate alternative minimum tax base. The tax base for individual taxpayers would resemble present law, but without the exclusions, deferrals, and non-income producing itemized deductions described in Part II of this pamphlet.

The present-law "income" tax is known as a two-tier income tax in that the income of a "C corporation"[74] is subject to a separate corporate tax as the income is earned and the individual income tax when the income is distributed to the individual shareholders of the corporation (or when the shareholders sell their interests in the corporation). Unlike the two-tier tax treatment of investments in corporate equity, investments in certain "flow-through" entities

[72] Under one view, deductions for charitable contributions are allowable in order to measure more properly the disposable income of the donor.

[73] Deductions also may be allowed for State and local income tax for income measurement purposes.

[74] A "C corporation" is a corporation described in subchapter C of the Code. Subchapter C provides rules governing the treatment of taxable corporations and their shareholders.

(e.g., partnerships and S corporations[75]) are subject to tax only at one level (generally, the investor level). Similarly, investment in a security that is issued by any type of entity that is treated as debt for Federal income tax purposes is subject to only one level of tax because interest on debt is deductible by the issuer and includible by the investor. Thus, present law contains certain discontinuities with respect to the tax treatment of different investments and influences the choice of entity through which to conduct business and how to capitalize the business. How these discontinuities would be addressed under a "pure" income tax is unclear.[76] On the one hand, the two-level taxation of business earnings could be preserved. Conversely, the corporate and individual income taxes could be "integrated" to provide one level of taxation.[77]

2. Description of the "Ten Percent Tax Plan"

The Treasury Department described a more comprehensive income tax base in its study of tax reform in 1984.[78] Portions of this were enacted as part of the Tax Reform Act of 1986, which broadened the tax base while lowering ordinary income tax rates. More recently, the House Minority Leader (Mr. Gephardt) has proposed an individual income tax (the "Ten Percent Tax Plan") with a more comprehensive base.[79] Under the proposal, interest income on State and local bonds, employer-provided fringe benefits (primarily health insurance), and employer pension contributions would be subject to tax. The foreign earned income exclusion (section 911 of the Code), deductions for IRA and Keogh contributions, and the deduction for self-employed health insurance would be eliminated. The only itemized deduction allowed under the plan would be the mortgage interest deduction. Deductions for investment interest and job-related expenses would be retained. The individual tax rates that would be applied to this expanded income base would be reduced from a range of 15 to 39.6 percent to a range of 10 to 34 percent. The special capital gains rate would be repealed. The proposal would repeal the child care and elderly tax credits, while retaining the earned income and foreign tax credits.

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[75] An "S corporation" is a corporation described in subchapter S of the Code. Subchapter S provides an election for a small business corporation to be exempt from the corporate-level tax applicable to C corporations and provides rules governing the treatment of electing corporations and their shareholders. For a more detailed discussion of the treatment of S corporations, see Joint Committee on Taxation, *Present Law and Proposals Relating to Subchapter S Corporations and Home Office Deductions* (JCS–16–95) May 24, 1995.

[76] Charts 1 and 3 included at the end of this Part of the pamphlet assume that the two-tier taxation of corporate earnings would continue under the "pure" income tax depicted therein.

[77] Several of the U.S. trading parties (e.g., Australia, Canada, France, Germany, New Zealand, and the United Kingdom) have integrated their corporate and individual income tax systems to some extent. In addition, the consumption-based taxes described above in this part of the pamphlet provide forms of tax integration by taxing business activity no more than once. For a further discussion of this issue, see Department of the Treasury, *Integration of the Individual and Corporate Tax Systems—Taxing Business Income Once*, January 1992, and American Law Institute, Federal Income Tax Project, *Integration of the Individual and Corporate Income Taxes, Reporter's Study of Corporate Tax Integration*, by Alvin C. Warren, March 31, 1993.

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

[79] See press release dated January 17, 1996. The press release also provides that the "Ten Percent Tax cuts corporate welfare by more than $50 billion and uses that money to cut taxes for small businesses." Specific details with respect to changes in business taxation are not provided. In addition, the "Ten Percent Tax Plan" has not been introduced as a bill, nor has statutory language for the plan been released.

F. Summary of Treatment of Various Items Under Alternative Tax Systems

The following charts generally compare the treatment of certain common items of income and expense under various alternative tax systems. The charts describe how taxpayers would treat these items on their own tax returns. The treatment of items under "national retail sales tax" is based upon H.R. 3039 (104th Cong.). The "value-added tax" is based upon the Business Activities Tax of S. 2160 (103th Cong.). The "consumption-based flat tax" is based upon H.R. 1040 (105th Cong.) and S. 1050 (104th Cong.). The "USA Tax" is based upon S. 722 (104th Cong.). The description of the "pure" income tax is based upon a theoretical model for such a system.

Chart 1.--Treatment of Income of Individuals Under Various Tax Systems

	National Retail Sales Tax	Value-Added Tax (VAT)	Consumption-based Flat Tax (Armey/Shelby)	USA Tax (Nunn-Domenici)	Present Law Inc. Tax	"Pure" Income Tax
INCOME:						
Wages\Salaries	N/A	N/A	Includible	Includible	Includible	Includible
Retirement Benefits (incl. inside build-up)	N/A	N/A	Includible when Received	Includible when Received	Includible when Received	Includible when Earned
Social Security Benefits	N/A	N/A	Not Includible	Partially Includible	Partially Includible	Includible
Unemployment Compensation	N/A	N/A	Includible	Includible	Includible	Includible
Employer-paid Health Care	N/A	N/A	Not Includible	Includible	Not Includible	Includible
Dividends	N/A	N/A	Not Includible	Includible	Includible	Includible
Interest	N/A	N/A	Not Includible	Includible	Includible	Includible
Municipal Interest	N/A	N/A	Not Includible	Not Includible	Not Includible	Includible
Capital Gains	N/A	N/A	Not Includible	Includible	Includible	Includible
Business, Farm, Partnership, & Sub S Income	N/A	N/A	Subject to Business Tax	Includible	Includible	Includible
Rental & Royalty Income	N/A	N/A	May be subject to Business Tax	Includible	Includible	Includible
Alimony	N/A	N/A	Not Includible	Includible	Includible	Includible
Child Support	N/A	N/A	Not Includible	Includible	Not Includible	Includible

Chart 2.--Treatment of Deductions of Individuals Under Various Tax Systems

	National Retail Sales Tax	Value-Added Tax (VAT)	Consumption-based Flat Tax	USA Tax (Nunn-Domenici)	Present Law Inc. Tax	"Pure" Income Tax
DEDUCTIONS:						
IRA & Savings Contributions	N/A	N/A	Not Deductible	Unlimited Ded. for Savings	Ded. within limits	Not Deductible
Alimony	N/A	N/A	Not Deductible	Deductible	Deductible	Deductible
Child Support	N/A	N/A	Not Deductible	Deductible	Not Ded.	Deductible
Moving Expense	N/A	N/A	Not Deductible	Not Deductible	Ded. within limits	Not Deductible
Medical	N/A	N/A	Not Deductible	Not Deductible	Ded. within limits	Not Deductible
State/Local Taxes	N/A	N/A	Not Deductible	Not Ded.	Deductible	Not Ded.
Real Estate Taxes	N/A	N/A	Not Deductible	Not Ded.	Deductible	Not Ded.
Mortgage Int.	N/A	N/A	Not Deductible	Deductible	Deductible	Not Ded.
Investment Int.	N/A	N/A	Not Deductible	Not Deductible	Ded. within limits	Not Deductible
Charitable Contributions	N/A	N/A	Not Deductible	Ded. within limits	Ded. within limits	Not Deductible
Casualty Losses	N/A	N/A	Not Deductible	Not Deductible	Ded. within limits	Not Deductible
Employee Business Exp.	N/A	N/A	Not Deductible	Not Deductible	Ded. within limits	Not Deductible
Investment Exp.	N/A	N/A	Not Deductible	Not Deductible	Ded. within limits	Not Deductible
Education Exp.	N/A	N/A	Not Deductible	Deductible w/in limits	Generally not ded.	Not Deductible

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Chart 3.--Treatment of Businesses Under Various Tax Systems

	National Retail Sales Tax	Value-Added Tax (VAT)	Consumption-based Flat Tax	USA Tax (Nunn-Domenici)	Present Law Inc. Tax	"Pure" Income Tax
INCOME:						
Gross Receipts from Sales of Goods/Services	Retail Sales Only	Includible	Includible	Includible	Includible	Includible
Interest	Not Incl.	Not Incl.	Not Incl.	Not Incl.	Includible	Includible
Dividends	Not Incl.	Not Incl.	Not Incl.	Not Incl.	Partially Includible	Includible
Capital Gains	Not Incl.	Not Incl.	Not Incl.	Not Incl.	Includible	Includible
Proceeds from Sales of Business Assets	Not Incl.	Includible	Includible	Includible	Includible	Includible
Rental & Royalty Income	Not Incl.	Incl. if trade or business	Incl. if trade or business	Incl. if trade or business	Includible	Includible

DEDUCTIONS:						
Inventory	Not Ded.	Ded. when acquired	Ded. when acquired	Ded. when acquired	Ded. when sold	Ded. when sold
Cost Recovery of Property	Not Ded.	Expensed when acquired	Expensed when acquired	Expensed when acquired	Deprec. over time	Depreciate over time
Payments to Indep. K'ors	Not Ded.	Deductible	Deductible	Deductible	Deductible	Deductible
Salaries/Wages	Not Ded.	Not Ded.	Deductible	Not Ded.	Deductible	Deductible
Retire. Benefits	Not Ded.	Not Ded.	Deductible	Not Ded.	Deductible	Deductible
Employee Health	Not Ded.	Not Ded.	Not Ded.	Not Ded.	Deductible	Deductible
Taxes	Not Ded.	Not Ded.	Not Ded.	Not Ded.	Deductible	Deductible
Interest	Not Ded.	Not Ded.	Not Ded.	Not Ded.	Deductible	Deductible
Charitable Contributions	Not Ded.	Not Ded.	Not Ded.	Not Ded.	Ded. with limits	Deductible
Advertising	Not Ded.	Deductible	Deductible	Deductible	Deductible	Deductible

IV. ANALYSIS OF ISSUES RELATING TO TAX RESTRUCTURING AND THE TAXATION OF THE INDIVIDUAL AND FAMILIES

A. Background on Alternative Tax Systems

1. Equivalence of different types of consumption taxes

To understand the economic effects of a tax, one should first look at the base of the tax, that is, what goods, services, or activities are subject to the tax. Looking at most of the proposed replacements for the current income tax that were described in Part III, one sees that their tax bases are consumption, rather than income.[80] The similarity of the tax base of these proposals may not be apparent at first glance, because they take different routes to tax that base. This Part discusses how outwardly different forms of taxation such as subtraction method VATs, credit-invoice VATs, retail sales taxes, the consumption-based flat tax of H.R. 1040, and consumed income taxes can all be seen as variants of a tax on consumption. This assertion does not deny that particular proposals in Part III may grant certain exemptions from the tax base or may have special provisions that make them slightly different from competing proposals. Rather, it stresses that any differences lie in the details; all the proposals fundamentally aim at taxing the same base—consumption.

Relationship between income and consumption bases

While the term "income" may suggest funds coming in to an individual (the "factor payments" view of income[81]), the theoretical underpinning for the income tax relies on a "uses" definition of income. The Haig–Simons definition of income,[82] commonly used by economists, defines income for a period as the "total value of rights exercised in the market, together with the accumulation of wealth in that period," that is, the value of consumption plus the change in net wealth for the period. Because the change in net wealth for an individual is the amount of saving (or dissaving, if net wealth decreases) for the period, an equivalent way to restate an income base is that it is consumption plus net saving. The difference between income and consumption as the base of a tax is that a consumption base does not include changes in wealth (savings).

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[80] The last alternative replacement tax discussed in Part III, the "pure" income tax, broadens the measured income base of the present-law income tax.

[81] David F. Bradford, *Untangling the Income Tax*, (Cambridge, Mass.: Harvard University Press), p. 15.

[82] Robert M. Haig, "The Concept of Income: Economic and Legal Aspects" in Robert M. Haig, (ed.), *The Federal Income Tax*, (New York: Columbia University Press), 1921, and Simons, *Personal Income Taxation*, (Chicago: University of Chicago Press), 1938.

Point-of-sale consumption taxes

The retail sales tax is perhaps the easiest to see as a tax on a consumption base. If all final consumption (goods and services purchased for final use by households) is subject to the tax and no intermediate goods and services (those purchased by businesses and used to produce other goods and services) are subject to the tax, then a retail sales tax is tautologically a consumption tax. In practice, existing State sales taxes stray from this comprehensive consumption base by exempting certain goods and failing to tax many services provided to households.[83]

A broad-based, VAT, using either the credit-invoice or subtraction method, achieves the same end as a retail sales tax even though it appears to be collecting tax at many stages of production rather than only at the time of final sale to a household.[84] From a prospective of the tax system as a whole, any time a sale is made from one business to another, the inclusion of the sale proceeds into the seller's tax base is offset by a deduction from the purchaser's base for the cost of the input. For a business-to-business sale, there is no net tax collected (although there may be payments going between businesses and the government). It is only at the time a sale is made to a non-business purchaser (i.e., a household) that a net tax is collected, because the inclusion of the sale proceeds is not offset by another business's deduction. But that result is identical to the retail sales tax: tax is collected only at the time of a final sale to a household. Thus, it is the "expensing" of business purchases in a VAT that creates a consumption-based tax.

Just as a VAT can be shown to be economically equivalent to a retail sales tax (assuming equivalent tax rates and levels of compliance), the consumption-based flat tax described in H.R. 1040 can be shown to be equivalent to a VAT or retail sales tax, with a built-in exemption for a minimum amount of consumption. The consumption-based flat tax of H.R. 1040 is imposed at single rate upon individuals and businesses. The business activities tax of H.R. 1040 is a subtraction-method VAT, but with deductions for wages and contributions to retirement plans. However, the receipt of such compensation is subject to tax at the individual level at the same flat rate applicable to businesses. Thus, the combination of the business activities tax and the individual tax is roughly equivalent to a VAT. The combination of the individual and business taxes under H.R. 1040 is not exactly equivalent to a VAT because of the allowance for standard deductions under the individual-level tax. Alternatively, the bill could be viewed as a VAT or retail sales tax that provides individuals with built-in exemptions or rebates of tax for a minimum amount of consumption.

Individual consumption taxes

Instead of measuring consumption by households at the point of sale, one could impose a consumption tax through annual returns

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[83] As discussed in Part III.A.1. of this pamphlet, a more subtle divergence is that business purchases of intermediate goods, especially by small businesses, may be subjected to the retail sales tax. This point is noted in Charles E. McLure, Jr., "Economic, Administrative, and Political Factors in Choosing a General Consumption Tax," *National Tax Journal*, 46(3), September 1993, pp. 345–358.

[84] See Part III, B.2, for a more detailed discussion of the operation of a credit-invoice method VAT, the subtraction method VAT, and the equivalency of the two methods.

of individuals' finances. This individualized approach may be useful if one were attempting to increase the progressivity of the consumption tax through the provision of standard deductions and personal exemptions or graduated rates.[85]

Cash-flow approach

A way to measure consumption that would operate on annual returns would calculate a cash-flow base based on the fact that consumption equals income minus saving. A cash-flow base includes income from all sources and allows deductions for saving, resulting in only consumption being subject to tax. This cash-flow treatment is used in the individual portion of the Nunn–Domenici proposal.[86] Such an approach is similar to the treatment of deductible IRAs under present law. Taxpayers deduct contributions to qualified accounts in the year they make contributions, and earnings within the account are not subject to tax. However, upon withdrawal individuals include in income the entire amount withdrawn, including earnings on the amounts contributed. A cash-flow consumption tax treats all saving as if it were done in a qualified account. Under a pure cash-flow tax, loan proceeds are included in the tax base and a deduction is allowed for payments of both interest and loan principal.

The effect of cash-flow treatment is that the taxpayer receives a tax-free return on his savings, assuming the tax rate is the same at the time of deduction and withdrawal. The following example illustrates how the cash-flow approach (initial deduction plus 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 were 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.[87]

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[85] See Part IV.B.3., below, for a discussion of some of these issues.

[86] The Nunn–Domenici proposal also contains a subtraction-method VAT collected from businesses. Thus, it consists of two consumption-based taxes.

[87] An alternative way to think about conclusion is as follows. The cash-flow approach makes the government a partner in any saving done by the individual. The government forgoes the $200 of tax at the time the saving is done and collects a tax of $210 (equal to $200 plus five-percent interest) at the time the proceeds of saving are withdrawn. The $200 deduction for saving could be viewed as the government making a contribution to the purchase of the asset that is the vehicle for the individual's saving. The size of the government share is equal to the marginal tax rate, in this example, 20 percent.

Tax prepayment approach

Another way to implement a consumption tax is to include in the base only earned income. This "tax prepayment" approach[88] treats all savings as coming from after-tax dollars. 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 consumption-posed in the tax base. This tax prepayment approach is generally used in the individual portion of the flat tax proposal of H.R. 1040, in which the individual portion of the tax includes only wage and salary income plus pensions[89] in the tax base.

Lifetime correspondence of consumption taxes and wage taxes

The equivalence of the cash-flow and prepayment approaches suggests a more general relationship between consumption taxes and taxes on labor income ("wage taxes"). Although wage taxes are not consumption taxes *per se*, they are often discussed in the context of consumption taxes because under certain conditions the two taxes are economically equivalent. Because economists stress the equivalence of these two taxes, it is important to understand the conditions under which equivalence holds.

Under a consumption tax (of either the point-of-sale type or the cash-flow individual type), all income is subject to tax except amounts equal to increases in net wealth (i.e., saving). Under a wage tax (which is similar to the tax prepayment approach to a consumption tax), labor income (but not capital income) is subject to tax. It is also true that under a wage tax increases in net saving are exempt from tax. The key to the equivalence of the two taxes is the equivalent treatment of increases in net wealth.N

Increases in net wealth (except for gifts and inheritances) can arise only from either of two sources: savings out of capital income (sometimes known as "inside build-up") or savings out of labor income. The first type of increase in net wealth is exempt both under a consumption tax, because it is not consumed, and under a wage tax, because it is not earned by the performance of labor services. The second type of increase in net wealth, savings from wages, is taxed under a wage tax at the time of the act of saving (because the savings are made from after-tax wages), but it is exempt from tax when it is withdrawn to pay for consumption. Under a consumption tax, savings from wages is not taxed at the time of the act of saving (because those amounts are not devoted to current consumption, but to savings), but it is taxed when it is withdrawn to pay for consumption. With a tax rate that is constant over the

[88] It is sometimes described as a "yield exemption" approach.

[89] The treatment of pensions in these proposals differs from the tax prepayment approach. Pensions follow the principles of the cash-flow 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.

individual's lifetime, the tax treatment of saving from capital income is exactly the same under consumption and wage taxation, and the tax treatment of saving from labor income is equal in present value under consumption and wage taxation. Therefore, from a lifetime perspective, a young person who neither receives nor grants bequests and who has yet to undertake any savings would be subject to the same economic burden under either a consumption or a wage tax.

For an example of this equivalence, suppose that all individuals live for two periods, earning wages of $10,000 in the first period and $11,000 in the second period.[90] Assume that the real interest rate is 10 percent and that the individuals may borrow or lend at this rate. This interest rate reflects the market price of deferring consumption from the first period to the second. That is, someone who chooses to give up $100 worth of consumption in the first period would be compensated by receiving $110 worth of consumption in the second period. The present value of the lifetime resources of an individual is $20,000. No individual can consume more than $20,000 (in present-value terms) over the two periods. If a 20-percent wage tax is levied, the individuals' net after-tax wages fall to $8,000 and $8,800 in the two periods, for a present value of $16,000.[91] The wage tax is equivalent to a 20-percent reduction ((20,000–16,000)/20,000) in the lifetime resources available to the individual.

A proportional tax on consumption at a rate of 25 percent would be equivalent to the 20-percent wage tax.[92] To understand why, note that a 25-percent consumption tax means that for each $100 that the individual is willing to spend on consumption goods, only $80 worth of consumption goods can be purchased. The other $20 (25 percent of $80) is needed to pay the consumption tax. Thus a present value of lifetime resources equal to $20,000 will only be able to purchase a present value of $16,000 worth of consumption goods. But this is the same amount that could be purchased under the 20-percent wage tax. Therefore, the wage tax and the consumption tax are equivalent: they result in the same reduction in the present value of resources available for consumption.

With either tax, the price of shifting consumption between the two periods remains the same, so the individuals' choices about consumption and saving in the two periods are unchanged. Under the wage tax, if an individual saves an additional $100 in period 1, his tax liability is unchanged, and the proceeds of his saving will yield $110 from which to consume in period 2. Under the consumption tax, if an individual saves an additional $100 in period 1, his tax liability in that period falls by $25, so he can invest $125, yielding him a return of $137.50, which is just enough to purchase $110 of consumption and pay the tax thereon in period 2.

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[90] These amounts are expressed in real dollars (i.e., adjusted for inflation).

[91] The interest rate remains at 10 percent, as interest is untaxed under a wage tax.

[92] The distinction between these two tax rates is that the 25-percent consumption tax is stated on a tax-exclusive basis. That is, the tax is stated as a percentage of after-tax consumption. The rates of retail sales taxes are generally stated on a tax-exclusive basis. The 20-percent wage tax is stated on a "tax-inclusive basis." If the consumption tax were stated on a tax-inclusive basis, it would also be 20 percent; that is, the tax would be 20 percent of the amount spend on consumption *inclusive of the tax*. The tax rates of VATs are often stated on a tax-inclusive basis. The tax-exclusive rate = (tax-inclusive rate)/(1—tax-inclusive rate) for two equivalent taxes.

It is important in the above example that the rate of the consumption tax remains the same across the two periods. For example, taxing consumption in future years at a higher rate would reduce the return to savings. Taxing future consumption at a lower rate would subsidize savings.

The equivalence example given above looked at the consumption tax and wage tax in a steady state, with no sources of wealth in existence that preceded the introduction of either tax. In the transition period from a wage tax to a consumption tax, however, there is a substantial difference between wage taxation and consumption taxation for those with existing savings.[93] Because of the eventual taxation of these savings under a consumption tax as compared to their non-taxation under a wage tax, a consumption tax potentially would be more progressive than a wage tax. Although consumption taxes and wage taxes are considered to be economically equivalent in the long run, differences in their incidence—especially their intergenerational incidence—can be substantial. Consumption taxes can impose a burden on existing wealth, while wage taxes do not.

Another way to express a consumption tax's implicit levy on existing wealth is that a broad-based consumption tax is equivalent to a tax on wages plus a tax on income from existing capital (but exempting income from new investment). Since, in competitive markets, the real purchasing power of existing capital assets is equal to their (expected) future stream of income, taxing the existing capital is equivalent to taxing the income generated from that capital. This establishes the equivalence between a broad-based consumption tax and a tax on wages and the income generated by "old capital" (i.e., any capital existing at the time of the introduction of the tax). Notice that under the tax on wages and income from existing capital, the returns to new investment are not taxed. Similarly, by taxing consumption at different times uniformly, a broad-based consumption tax effectively exempts the returns to savings from the tax base. In a closed economy, savings and investment are equal, confirming the equivalence of the taxes.[94]

2. Integration of business and individual taxes

It would be possible to enact an individual consumption tax of the cash-flow or tax prepayment type as a stand-alone tax without making changes to the taxation of businesses.[95] But many of the consumption tax proposals described in Part III, including the consumption-based flat tax, do more than just change the rates and the base of the individual income tax. These proposals also inte-

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[93] One aspect of this taxation of existing savings is discussed in Part IV.D.3, under Transition Issues.

[94] In an open economy, foreign holders of United States assets will be hurt by a tax on existing capital, but not by a consumption tax that increases the general domestic price level.

[95] Businesses would be treated as savings vehicles from the individual's standpoint. Amounts invested in a business would be deductible under a cash-flow approach and not deductible under a tax prepayment approach. Returns paid from the business to the individual would be included in a cash-flow base and exempt from a tax prepayment base. Sole proprietorships might be difficult to handle in this manner, however, since the lines between the individual and the business may be blurry. For example, the individual consumption tax discussed by the Treasury Department in *Blueprints for Basic Tax Reform* contemplated integrating sole proprietorships into the individual consumption tax using a cash-flow approach. No integration of corporate businesses was contemplated. Department of the Treasury, *Blueprints for Basic Tax Reform*, 1977, pp. 119–22, 130–34.

grate 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.[96] 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 of the Internal Revenue Code, however, a separate, generally income-based, tax applies in addition to taxation at the individual level of the returns from the business.

What makes a given business tax a consumption tax is its definition of the tax base according to what economists call cash-flow accounting principles. Under cash-flow accounting, businesses take immediate deductions for all business purchases, including capital assets and additions to inventory. By contrast, income taxes use accrual accounting principles to measure the base.[97] Cash-flow accounting principles treat business activity similar to the cash-flow approach to an individual consumption-based tax: savings is deducted from the base and returns to savings are included upon withdrawal.[98] In the business context, expenses in the current period that yield revenues in future periods are savings; those future revenues are the return to savings.

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 pencil manufacturer produces pencils in a particular year that it does not sell in that year, under an income base the cost of producing the unsold pencils is capitalized and a deduction for the capitalized cost is not allowed until the pencils are sold. Under cash-flow accounting, the production costs of unsold pencils 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 for it from the base of a cash-flow, consumption-based tax.

Similarly, if the pencil manufacturer purchases a new machine to attach erasers that has a useful life longer than one year, under an income base only the value of the machine that is used up during that year is subtracted from the value of the pencil manufacturer's output. The remainder of the value of the machine is deducted in future years.[99] Under accrual accounting, the net income during each year of the machine's useful life is the value of the output it produces minus the decline in the value of the machine minus the value of other inputs used to produce the pencils. Under cash-flow accounting, by contrast, the taxpayer deducts the entire purchase price of the machine from the annual output of the business in the year the machine is purchased. The purchase of a durable good is a form of savings and a full deduction is allowed for it

[96] S.722 (104th Cong.) also changes business taxation, but it can be described as a combination of two different consumption taxes: an individual cash-flow consumption tax at graduated rates plus a single-rate, subtraction-method VAT.

[97] 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.

[98] The business tax analogue of the tax prepayment approach to an individual consumption-based tax would result in no business-level tax.

[99] The amount of the machine that is used up in a given year is the decline in the value of the machine over the course of that year. Depreciation rules are generally used as a means to reflect this decline in value over the life of an asset.

from the base of a cash-flow, consumption-based tax. Expensing is equivalent to exempting the expected return from the machine because the cost of the machine is equal to the present value of the income stream the machine is expected to produce.

In general, consumption-based taxes allow the immediate deduction ("expensing") of the cost of capital purchases. Under an income base, however, 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.[100]

To this point, the description of the cash-flow business tax has not specified what cash flows are considered. There are two alternatives, sometimes labeled as "R" and "R+F".[101] The R alternative accounts only for cash flows based on real (non-financial) activity. Sales of goods and services are included in the base and purchases of inputs are subtracted from the base. Proceeds from a bank loan or a sale of stock 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 R+F alternative accounts for cash flows based on both real activity and financial activity (except for transactions with the equity holders). In addition to sales of goods and services, loan proceeds are included in the base. Purchases of inputs plus loan repayments and payments of interest are subtracted from the base. Stock sale proceeds and dividends are ignored.

The consumption-based flat tax use an R approach to defining the cash-flow base for businesses, which leads to a second distinction between it and the current income-based business tax.[102] That is the treatment of interest expense, which is deductible under the current income-based tax as a cost of producing income, but would not be deductible under an R base. By contrast, under an R+F base, interest would continue to be deductible and principal repayments would become deductible, while loan proceeds would become includible in 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 additional units of capital. In a competitive market, the price of each additional capital good would be the expected present value of the output produced over the lifetime of the capital good. The business deducts that price in the year of purchase. If we as-

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[100] Under Code section 179, in 1997 taxpayers other than estates, trusts or certain noncorporate lessors may elect to expense up to $18,000 ($9,000 for married individuals filing separate returns) of qualifying capital property. The $18,000 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. The expensing limitation under sec. 179 will increase annually until it reaches $25,000 for 2003 and thereafter. In addition, the depreciation allowance provided by Code section 168 generally exceed economic depreciation.

[101] This nomenclature was introduced by the Meade Committee in the study published by the Institute for Fiscal Studies, *The Structure and Reform of Direct Taxation* (London: George Allen and Unwin), 1978. "R" stands for "real," while "F" stands for "financial."

[102] The deductibility of interest is not required in an income-based business tax. The Comprehensive Business Income Tax proposed by the Treasury Department was an income-based tax that would have denied businesses a deduction for interest. Department of the Treasury, *Integration of the Individual and Corporate Tax Systems*, January 1992.

sume that 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 each additional 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 (in present value terms) of the cash-flow tax arise from returns in excess of those expected at the time of the purchase of an additional capital good or from inframarginal units of capital.[103]

3. Criteria for analysis of tax systems

Analysts generally judge tax systems in terms of how well the tax system answers four different questions:

(1) Does the tax system promote or hinder economic efficiency. That is, to what extent does the tax system distort taxpayer behavior? Does the tax system create a bias against the domestic production of goods and services? To what extent does it promote economic growth?

(2) Is the tax system fair? Does the tax system treat similarly situated individuals similarly? Does the tax system account for individuals' different capacities to bear the burden of taxation?

(3) Is the tax system simple? Is it costly for taxpayers to determine their tax liability and file their taxes?

(4) Can the tax system be easily administered by the government and can it induce compliance by all individuals? Is enforcement costly? Can some individuals successfully avoid their legal liabilities?

The design of a tax system involves tradeoffs between these different goals. Measures designed to ensure compliance may increase the complexity of taxation for individual filers. Measures designed to promote simplicity may create distortions in individual choice of investments. Measures designed to promote growth may alter the distribution of the tax burden. The discussion of the next section explores how present law and various tax reform proposals may affect the family in terms of efficiency, equity, and simplicity.

B. Taxation of the Family

1. Choice of tax filing unit

In general

Regardless of whether income or consumption is chosen as the tax base, an important question to be addressed in the design of a tax system is *who* should be taxed on income or consumption. Should each person be taxed separately on his or her own income or consumption or should individuals be grouped together and taxed as a family unit on the family's total income or consumption?

[103] 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 positive present value of tax collected on those returns.

The answer to this question is important to assessing both the efficiency and equity of a tax if tax rates vary with the amount of income or consumption either by having a multiple tax rate structure or by having an exempt amount of income or consumption. When tax rates vary by total income or consumption, the total tax burden on the family will vary depending upon whether the tax is assessed on each individual or on the family unit. However, when taxes are imposed at a uniform rate on all consumption or income, the total tax burden on the family is the same regardless of whether the tax is assessed on each individual or on the family unit.

The present-law income tax generally uses a family unit approach. Married individuals may file jointly, combining their incomes and computing their tax liability as one. In addition, certain income of minor children may be added to the income of the parents for income tax purposes. Different tax reform proposals adopt different approaches. The subtraction method VAT, the credit-invoice VAT, and the national retail sales tax are taxes imposed at the business level. Therefore, they generally impose tax on the consumption of each person, on [104] an individual rather than on a family unit. The national retail sales tax as proposed in H.R. 3039 (104th Cong.) would provide a family-based rebate amount, effectively making what would otherwise be an individual-based tax, a family-based tax. Both the consumption-based flat tax of H.R. 1040 and the individual component of the USA Tax (S. 722, 104th Cong.) tax family units and provide family-based exemptions. The USA Tax also provides marginal tax rates that vary with total family consumption.

When the total tax burden varies depending upon whether two individuals choose to remain unmarried and pay taxes as single persons or choose to marry and pay taxes as a married couple, a marriage penalty or marriage bonus is said to exist. A marriage penalty exists when the sum of the tax liabilities of two unmarried individuals filing their own tax returns (either single or head of household returns) is less than their tax liability under a joint return (if the two individuals were to marry). A marriage bonus exists when the sum of the tax liabilities of the individuals is greater than their combined tax liability under a joint return.

While the size of any marriage penalty or bonus under present law depends upon the individuals' incomes, number of dependents, and itemized deductions, as a general rule married couples whose earnings are split more evenly than 70–30 suffer a marriage penalty. Married couples whose earnings are largely attributable to one spouse generally receive a marriage bonus.[105]

Prior to 1993 (and continuing under present law for the 15-, 28- and 31-percent brackets), the bracket breakpoints [106] and the standard deduction for single filers were roughly 60 percent of those for joint filers and those for head of household filers were about 83 percent of those for joint filers. The rate changes in the Omnibus Budget Reconciliation Act of 1993 ("OBRA 1993") exacer-

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[104] See the discussion of who bears the burden of such taxes in Part IV.B.3., below.

[105] Appendix A provides a brief history of the marriage penalty of the present-law income tax and shows how the marriage penalty or bonus depends upon the pattern of income earned by two individuals.

[106] A bracket breakpoint is the dividing point between two marginal rate brackets.

bated the existing marriage penalty because the new bracket breakpoints did not provide the customary ratios across filing statuses.[107] For the new 36-percent bracket, the breakpoint for single filers and for head of household filers are 82 percent and 91 percent, respectively, of the breakpoint for joint filers. For the 39.6-percent bracket that results from the "surtax," the bracket breakpoint in 1977 is $271,050 regardless of filing status. Thus, it could be said that, under present law, higher income taxpayers face potential greater marriage penalties than do middle income taxpayers. In addition, as discussed in Part II.A.4.b, above lower income taxpayers may also experience significent marriage penalties due to the mechanics of the earned income credit and standard deduction.

Marriage neutrality versus equal taxation of married couples with equal incomes

Any system of taxing married couples requires making a choice among three different ideas of tax equity. One principle is that the tax system should be "marriage neutral"; that is, the tax burden of a married couple should be exactly equal to the combined tax burden of two single persons where one has the same income as the husband and the other has the same income as the wife. A second principle of equity is that, because married couples frequently consume as a unit, couples with the same income should pay the same amount of tax regardless of how the income is divided between them. (This second concept of equity could apply equally well to other tax units that may consume jointly, such as the extended family or the household, defined as all people living together under one roof.) A third concept of equity is that the tax should be progressive; that is, as income rises, the tax burden should rise as a percentage of income.

These three concepts of equity are mutually inconsistent. A tax system can generally satisfy any two of them, but not all three.[108] The current tax system is progressive: as a taxpayer's income rises, the tax burden increases as a percentage of income. It also taxes

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[107] Taxpayers who were not subject to the new rate brackets generally faced no change in their marriage penalty or bonus. Some taxpayers receiving the earned income credit (EIC) may have faced slightly larger or smaller marriage penalties or bonuses because of the OBRA 1993 changes in the EIC, but the magnitude of these changes was generally small relative to the previously existing marriage penalties or bonuses for these taxpayers.

[108] The inconsistency of progressivity, equal taxation of couples with equal income and marriage neutrality can be shown mathematically as follows: Consider four individuals, A, B, C and D. Assume that A and B have equal incomes, C has an income equal to the combined incomes of A and B, and D has no income. Let T(A), T(B), and T(C) be the tax burdens of the three individuals with income. If the tax system is not proportional,

$$T(C) \neq T(A) + T(B) \qquad (1)$$

Now assume A and B marry each other, as do C and D, and let T(AB) and T(CD) be the tax burdens of the married couples. The principle that families with the same income should pay the same tax requires that

$$T(AB) = T(CD) \qquad (2)$$

and marriage neutrality requires both that

$$T(A) + T(B) = T(AB) \qquad (3)$$

and that

$$T(CD) = T(C). \qquad (4)$$

Substituting (3) and (4) into (2) yields

$$T(A) + T(B) = T(C) \qquad (5)$$

This, however, contradicts equation (1), indicating that equations (2) and (3) can only both be true in a proportional tax system.

married couples with equal income equally: it specifies the married couple as the tax unit so that married couples with the same income pay the same tax. But it is not marriage neutral.[109] A system of mandatory separate filing for married couples would sacrifice the principle of equal taxation of married couples with equal incomes for the principle of marriage neutrality unless it were to forgo progressivity. It should be noted, however, that there is an exception to this rule if refundable credits are permissible. A system with a flat tax rate and a per-taxpayer refundable credit would have marriage neutrality, equal taxation of couples with equal incomes, and progressivity.[110]

There is disagreement among commentators as to whether equal taxation of couples with equal incomes is a better principle than marriage neutrality. (This discussion assumes that the dilemma cannot be resolved by moving to a proportional tax system.) Those who hold marriage neutrality to be more important argue that tax policy discourages marriage and encourages unmarried individuals to cohabit without getting married, thereby lowering society's standard of morality. Also, they argue that it is simply unfair to impose a marriage penalty even if the penalty does not actually deter anyone from marrying.

Those who favor the principle of equal taxation of married couples with equal incomes argue that as long as most couples pool their income and consume as a unit, two married couples with $20,000 of income are equally well off regardless of whether their income is divided $10,000–$10,000 or $15,000–$5,000. Thus, it is argued, those two married couples should pay the same tax, as they do under present law. By contrast, a marriage-neutral system with progressive rates would involve a larger combined tax on the married couple with the unequal income division. The attractiveness of the principle of equal taxation of couples with equal incomes may depend on the extent to which married couples actually pool their incomes.[111]

An advocate of marriage neutrality could respond that the relevant comparison is not between a two-earner married couple where the spouses have equal incomes and a two-earner married couple with an unequal income division, but rather between a two-earner married couple and a one-earner married couple with the same total income. Here, the case for equal taxation of the two couples may be weaker, because the non-earner in the one-earner mar-

[109] Even if the bracket breakpoints and the standard deduction amounts for unmarried taxpayers (and for married taxpayers filing separate returns) were half of those for married couples filing a joint return, the current tax system would not be marriage neutral. Some married couples would still have marriage bonuses. As described below, the joint return allows married couples to pay twice the tax of a single taxpayer having one-half the couple's taxable income. With progressive rates, this income splitting may result in reduced tax liabilities for some couples filing joint returns. For example, consider a married couple where one spouse has $60,000 of income and the other has none. By filing a joint return, the couple pays the same tax as a pair of unmarried individuals each with $30,000 of income. With progressive taxation, the tax liability on $30,000 would be less than half of the tax liability on $60,000. Thus the married couple has a marriage bonus: the joint return results in a smaller tax liability than the combined tax liability of the spouses if they were not married.

[110] Such a system could *not* have standard deductions.

[111] For some recent articles calling into question the justification for joint returns and the assumption of pooling of income among members of a household, see Marjorie E. Kornhauser, "Love, Money, and the IRS: Family, Income Sharing, and the Joint Income Tax Return", 45 *Hastings L. J.* 63 (1993); Edward J. McCaffery, "Taxation and the Family: A Fresh Look at Behavioral Gender Biases in the Code", 40 *UCLA L. Rev.* 983 (1993); and Lawrence Zelenak, "Marriage and the Income Tax", 67 *S. Cal. L. Rev.* 399 (1994).

ried couple benefits from more time that may be used for unpaid work inside the home, child care, other activities or leisure. It could, of course, be argued in response that the "leisure" of the non-earner may in fact consist of necessary jobhunting or child care, in which case the one-earner married couple may not have more ability to pay income tax than the two-earner married couple with the same income.

The preceding discussion involved issues of equity or fairness. Some analysts also argue that a marriage penalty leads to economic inefficiency by distorting individuals' choices. While the present-law income tax creates a "price" of marriage, there is no statistical evidence that people's decisions to marry or divorce have been distorted by the marriage penalty or bonus. On the other hand, the decision regarding which household members should work may be altered by taxation of income of the family unit. Assume that, at present, one spouse works and the other does not. Under joint filing, both spouses face identical marginal income tax rates on an additional dollar of family income. Thus, the first dollar of a nonworking spouse is taxed at the marginal tax rate of the last dollar of the working spouse. This may impose a high rate of tax on the potential income that the non-working spouse could earn. In addition, the non-working spouse will have his or her potential earnings subject to the payroll tax, further reducing the after-tax wage. This could discourage labor force participation by both spouses. Some evidence exists that married women's decision to work is sensitive to the after-tax wage they receive.[112]

Tax reform and marriage penalties

As explained above, a marriage penalty or bonus arises from the interaction of the percentage of a family's total income earned by each family member and tax rates that increase with income. A marriage penalty generally exists under present law when couples earn roughly equal incomes. A marriage bonus generally exists when one person earns a substantial majority of family income. Consumption tends to be distributed more equally among family members than is income. Thus, the individual portion of the USA Tax may create a marriage penalty for more taxpayers than it would create a marriage bonus. A subtraction method VAT, a credit-invoice VAT, and a retail sales tax would be marriage neutral because they would tax all consumption at the same rate. If an exempt amount of consumption is permitted under any of these three types of taxes, a marriage or family penalty may be created if the exempt amount for a family, when divided by the number of persons in the family, is less than the exempt amount each family member could claim as an individual. Oppositely, a family bonus may be created if the exempt amount for a family, when divided by the number of persons in the family, is greater than the exempt amount each family member could claim as an individual.

[112] The distinction is not actually between men and women, but between what economists term "primary" and "secondary" earners. See Charles L. Ballard, John B. Shoven, and John Whalley, "General Equilibrium Computations of the Marginal Welfare Costs of Taxes in the United States," *American Economic Review*, 75, March 1985, pp. 128–138. Ballard, Shoven, and Whalley review the labor supply literature and use estimates of labor supply responses that differ between primary and secondary workers to calculate the efficiency loss to the economy from discouraging work by secondary earners.

The consumption-based flat tax of H.R. 1040 would provide a "basic standard deduction" for married couples filing jointly that equals twice the basic standard deduction of a single filer. An "additional standard deduction" may be claimed for each dependent, including the tax filer. If one of the individuals earns wage income that is less than the value of the sum of the basic standard deduction for a single person plus the additional standard deduction, the couple will receive a bonus of a lower total tax liability by marrying and filing jointly. For all other couples, the flat tax is marriage neutral because the basic standard deduction for a single individual is half of that of a married couple and the marginal tax rate is constant for all levels of taxable income.[113]

2. Taxation of the family and distortion of household choice

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 or consumption at different tax rates is not neutral between individuals or between sources of income, or types of consumption. Such nonneutralities can distort taxpayer behavior. Such nonneutralities cause taxpayers to make decisions that result in an inefficient use of their own and the economy's resources. 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 taxpayers to engage in activities that, while they offer a positive private return, produce no net return to the economy. One 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).

Economists observe that income taxes are intertemporally nonneutral. By taxing both wage income and any return on after-tax wages saved, income taxes increase the cost of future consumption compared to present consumption. This may create a bias against saving. Aside from the distortion of consumer behavior, a bias against saving may inhibit economic growth because saving is necessary to finance investment in productivity enhancing training, equipment, and research. Some advocates of consumption-based taxes point to the fact that the saving rate of the United States and the growth rate of the United States have fallen from levels that prevailed 25 years ago and are low in comparison to that of other developed countries.

Intratemporal nonneutrality

The present Federal income tax imposes different tax rates on different individuals. Taxing different individuals at different mar-

[113] If another member of the family earns income, that individual may separately file and claim the basic standard deduction for a single filer and the additional standard deduction if the individual is not claimed as a dependent on another taxpayer's return. In such a case the family's total tax liability is lower than that of a family that has equivalent earnings but in which the earnings were all earned by a married couple.

ginal 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, as in a consumption-based flat tax, generally reduces the potential for private profit from bracket arbitrage and may free the taxpayer's time and resources for other endeavors. Similarly a VAT or retail sales tax would eliminate bracket arbitrage both by their single rate structure and by virtue of not being levied directly or individually. Under a tax system with increasing marginal tax rates on consumption such as the USA Tax of S. 722 (104th Cong.) taxpayers would benefit by devoting effort to avoiding bunching large purchases in one year.

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.[114] Thus, high-tax bracket taxpayers might be more likely to borrow, and to borrow from low- or zero-bracket taxpayers.[115] This nonneutrality could distort credit markets by effectively charging different interest rates to different taxpayers, depending upon a factor that has no direct relation 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.[116] 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 persist.

The present Federal income tax also imposes different effective tax rates on different sources of income. For example, income from

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[114] 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.

[115] Examples of zero-bracket taxpayers with available loanable funds may be few among individual taxpayers, but tax-exempt organizations and pension funds would be examples of potential zero-bracket lenders.

[116] 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.

investments in corporate equity generally is 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. A premise of consumption-based taxes is to avoid such distortion of investment decisions by effectively exempting investment income from direct taxation.

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.[117] Such nonneutralities can arise under consumption-based taxes if certain consumption goods are exempt from tax, or taxed at lower rates, than are other goods. Exclusion of health care services and health insurance from a consumption tax base also may lead individuals to consume more of these services than they otherwise would. Taxpayers also may arrange their affairs to increase tax-preferred sources of income or consumption, 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. In addition to exclusions of particular sources of income or types of consumption, a consumption base may shrink if taxpayers can arrange their affairs to take advantage of general exemption amounts or lower rates of tax. Under a consumption-based flat tax like H.R. 1040 or a cash-flow individual consumption tax, it can be advantageous to shift wages (flat tax) or consumption (cash-flow) to taxpayers who have not fully used their personal exemption or who are in a lower tax bracket.

The present Federal income tax generally favors families who own their own home over families that rent their housing.[118] Some analysts claim that this has led to too much investment in owner-occupied housing at the expense of alternative capital investments in the economy and leads families to own larger homes at the expense of other consumption goods. Consumption-based taxes generally would treat neutrally the decision to buy versus rent housing.[119]

A consumption-based 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,

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[117] 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.

[118] Mortgage interest costs and real estate taxes are deductible for many taxpayers and capital gain accrued on owner-occupied housing can benefit from deferral and exclusion in certain circumstances.

[119] The effect of tax reform on housing is to be the subject of a future hearing before the House Committee on Ways and Means.

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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 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.[120] The potential distortion in favor of present, rather than future, consumption may be important because it may give the family a disincentive to save, and saving is necessary for economic growth.[121] Household saving is an important component of national saving. National saving and household saving have been lower during the past several years than in any of the three previous decades. Table 28, reports personal saving rates in the United States.

Consumption-based taxes do not have the bias against saving that is inherent to an income tax. Thus, a consumption-based tax may improve intertemporal efficiency. 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.[122] Other studies have argued that large behavioral response to changes in the after-tax rate of return need not occur.[123] 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,[124] while others find little or a negative response.[125]

[120] 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.

[121] For discussion of the importance of saving to the national economy, see Joint Committee on Taxation, *Description and Analysis of Proposals to Replace the Federal Income Tax* (JCS-18-95), June 5, 1995, pp. 61-68. For a review of trends in saving in the United States see Joint Committee on Taxation, *Description and Analysis of Tax Proposals Relating to Individual Saving and IRAs* (JCS-2-97), March 3, 1997, pp. 57-67.

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

[123] 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.

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

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

Table 28.—Personal Saving as a Percentage of Disposable Personal Income, Selected Years, 1929–1996

Year	Personal saving as a percentage of disposable personal income
1929	3.2
1939	2.6
1944	25.1
1949	3.9
1954	6.3
1959	7.0
1964	7.7
1969	7.0
1974	9.3
1975	9.0
1976	7.6
1977	6.6
1978	7.1
1979	7.4
1980	8.2
1981	9.1
1982	8.8
1983	6.6
1984	8.4
1985	6.9
1986	6.2
1987	5.0
1988	5.2
1989	4.8
1990	5.0
1991	5.7
1992	5.9
1993	4.5
1994	3.8
1995	4.7
1996 [1]	4.8

[1] Arithmetic average of first three quarters.

Source: Department of Commerce, Bureau of Economic Analysis.

3. Taxation of the family and fairness

Standards of comparison

Discussion of the fairness of a tax cannot take place without a standard by which fairness can be judged. While most analysts rely on the notion of "ability to pay" (i.e., the taxpayer's capacity to bear taxes), there is no agreement regarding the appropriate standard by which to assess a taxpayer's ability to pay.

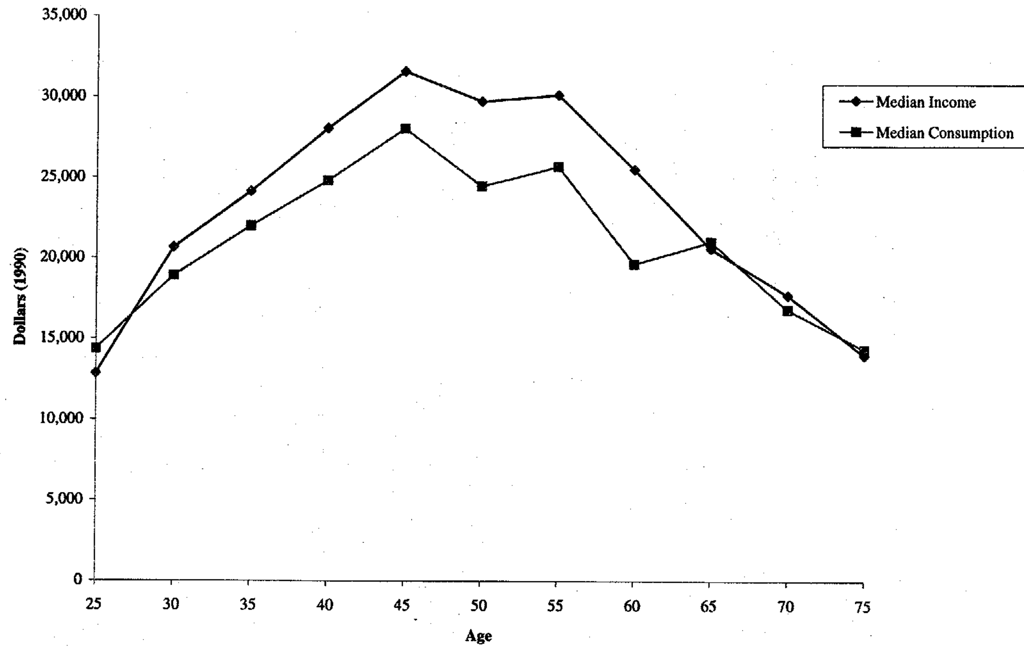
Annual income

Many analysts have long advocated a comprehensive measure of income as a measure of ability to pay.[126] Although income is commonly measured on an annual basis, it is recognized that there are significant shortcomings with using annual income as an indicator of ability to pay. First of all, an individual may be subject to wide swings in income from year to year. In this case, a "snapshot" of income in any one year would be a misleading indicator of ability to pay. An individual's income generally varies more from year to year than does that individual's consumption expenditures, as individuals save money for "a rainy day" when their income is high and dissave to finance consumption purchases when their income is low. Second, over the course of a lifetime, annual income will vary according to age, where income is low during school years, peaking toward the end of one's working years, and declining in retirement. Low annual income may incorrectly indicate a low ability-to-pay for college students or retirees, and probably should not be considered equal to the ability-to-pay at the peak of one's career.

Figure 6 illustrates these points. Figure 6 plots the income and consumption patterns of households headed by persons of various ages in 1990. As the figure shows, in 1990 young and old households had both lower income and lower consumption than middle aged households, whose head of household generally is in his or her prime earning years. The figure also shows that the consumption of the young and old tends to exceed their income, while the income of middle aged households exceeds consumption. In general, the rise and fall of income across the age profile is greater than the rise and fall of consumption. Figure 6 does *not* plot the income and consumption of a particular household, or group of households, as they age, but it is suggestive of the experience of a household as its income and consumption changes as the head of household ages.

[126] See, for example, Henry Simons, *Personal Income Taxation*, (Chicago: University of Chicago Press), 1938; and Richard Goode, "The Superiority of the Income Tax," in Joseph Pechman (ed.), *What Should Be Taxed: Income or Consumption?* Washington, D.C.: Brookings Institution, 1980.

Figure 6.--Income Consumption Profile, By Age, 1990



Source: Attanasid, "Personal Saving in the United States," Poterba (ed.), INTERNATIONAL COMPARISONS OF HOUSEHOLD SAVING, 1994.

Lifetime income

Accordingly, many economists have argued that lifetime income (or some average of income over several years) is a better indicator of ability-to-pay.[127]

Over an individual's lifetime, consumption is roughly equal to income,[128] but as noted above consumption is likely to be high relative to income in low-earning years and low relative to income in high-earning years. Therefore, if consumption tax liabilities are borne in proportion to consumption, a broad-based consumption tax appears regressive if compared to an annual measure of income and appears less regressive and perhaps even proportional when lifetime income is used as the measure of ability-to-pay.

It has been widely observed that annual consumption is much less variable than annual income, and that annual consumption is more likely to be a function of lifetime income than annual income.[129] Based on this observation, some have even advocated annual consumption itself as a measure of ability to pay since it is a good proxy for average lifetime income.[130] Others have advocated consumption itself not because it is a good proxy for income, but because it is a better measure than income of economic well-being. If a tax system is considered "fair" when two individuals with the same wealth at the beginning of their lives and the same abilities to earn wage income are taxed equally, then consumption is a better tax base than income. This is the case because (if an individual neither receives nor leaves bequests) the present value of lifetime consumption equals the present value of his lifetime earnings, while the present value of lifetime income will vary with the timing of savings. The present value of a consumption tax is then proportional to economic well-being but the present value of an income tax will vary for individuals with equal measures of economic well-being and, in fact, will increase with the rate of savings.[131]

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 single-rate consumption 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 situ-

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[127] If individuals do not have easy access to well developed financial markets, the appropriateness of lifetime income as a measure of ability-to-pay should be qualified. For example, if an individual is credit-constrained, lifetime income may overestimate a low-income individual's ability to pay.

[128] Lifetime income may exceed lifetime consumption (in present value) when an individual receives large bequests or gifts (and these receipts are not considered income). Lifetime income may be less than lifetime consumption (in present value) when an individual makes bequests or gifts (and these payments are not considered consumption).

[129] See, for example, Milton Friedman, *A Theory of the Consumption Function*, Princeton, N.J.: Princeton University Press, 1957.

[130] See James M. Poterba, "Is the Gasoline Tax Regressive?" in (David Bradford (ed.), *Tax Policy and the Economy*, vol. 5, (Cambridge: The MIT Press), 1991.

[131] The Treasury Department discusses the relative merits of a consumption and income tax base in its 1977 tax reform study. See, Department of the Treasury, *Blueprints for Basic Tax Reform*, January 17, 1977, pp. 38–41.

ated 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, whether under an income-based or consumption-based tax, 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. The consumption-based flat tax of H.R. 1040 also is progressive because it exempts some initial level of wage income from taxation. Similarly, a single- or multi-rate consumption tax can be progressive if it exempts an initial level of consumption. 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.[132] 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 percent at an income of $75,000, to 19.6 percent at an income of $1 million.[133]

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[134] 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.[135] 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

[132] 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.

[133] 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.

[134] 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.

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

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.

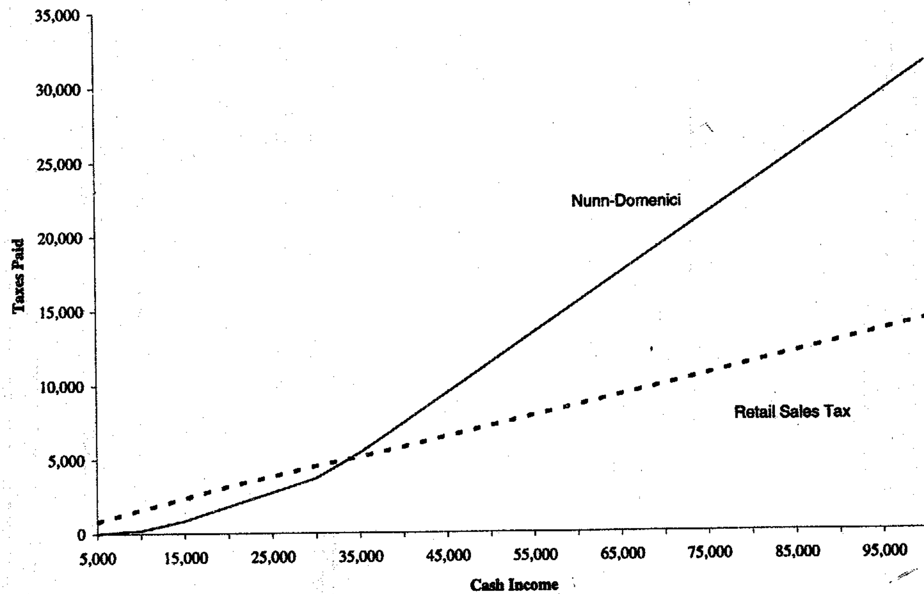
The preceding discussion has implicitly assumed that the tax base is unchanged while the marginal tax rate structure is altered. However, if the tax base is changed at the same time the rate structure is altered, it is not possible to make a general statement about how tax liability would change. For 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 amounts of those bonds, then the tax liabilities of higher-income taxpayers might increase even as their marginal tax rate fell.

Figure 7 shows the difference in the pattern of tax payments that might occur under a multi-rate versus a single-rate consumption tax. While the figure graphs taxes against cash income, the hypothetical taxes are based on consumption. For purposes of this figure, families with different levels of income are assumed to consume different proportions of their income. The proportions of income consumed are based on actual U.S. experience as reported in the Consumer Expenditure Survey.[136] Thus, lower-income individuals are assumed to consume a higher proportion of their income than are higher-income individuals. The curving line labeled "Nunn–Domenici" in the figure is modeled after the multi-rate tax schedule and family living allowance for joint filers in years after 1999 as provided in S. 722 (104th Cong.). Marginal tax rates vary from eight percent to 40 percent. The line labeled "Retail Sales" uses the same consumption data and assumes that all consumption is subject to a 15-percent retail sales tax but does not assume that there is a family-level rebate as would be provided by H.R. 3039 (104th Cong.).[137]

[136] The consumption proportions are based on John Sabelhaus's review of the Consumer Expenditure Survey. The consumption proportions used by the staff of the Joint Committee on Taxation in preparing Figure 4 are based on Sabelhaus's "net worth saving" methodology as reported in Table 2 of John Sabelhaus, "What Is The Distributional Burden of Taxing Consumption?" *National Tax Journal*, 46, September 1993, p. 336. The staff of the Joint Committee on Taxation linearly interpolates the saving rates for income levels between those reported by Sabelhaus.

[137] This figure should not be interpreted to represent the total tax liabilities likely upon replacement of the current income tax system with a consumption-based tax system. The figures do not include business level taxes, either those of present law or of the proposals described in Part III.

Figure 7.--Comparison of Consumption Tax with Graduated Rates to a Retail Sales Tax



Source: Joint Committee on Taxation Staff Calculation.

As discussed above, a degree of progessivity can be achieved by exempting an initial level of income on consumption. Such exemptions are not easily achieved if taxes are not imposed at the individual level. Exempting certain consumption items from the tax base, such as food, clothing, and housing, may have comparable effects, but as such exemptions would apply to individuals who have a low ability to pay taxes and to individuals who have a greater ability to pay taxes, such exemptions generally are costly to provide in terms of revenue lost for progressivity gained.[138] In addition to creating nonneutral taxation of different consumption goods, the greater revenue required may necessitate higher rates of tax which would exacerbate any economic distortions that exist under the tax.

Each of the consumption-based tax restructuring proposals described in Part III address perceived regressivity in the applicable tax system in different manners. The manner in which a regressivity offset is provided is dependent upon several factors, including the extent to which the offset can be delivered within the system. The national retail sales tax of H.R. 3039 (104th Cong.) would subject to tax a broad base of consumption, but would provide all families with a rebate equal to the tax on a minimum amount of consumption. The minimum amount of consumption would be based upon the poverty level for the family in question or, if less, the amount of wages of the family. The rebate would not be phased-out for families that have incomes in excess of the poverty level. Because the sales tax would be collected by businesses and not consumers, the rebate would be delivered by adjusting the amount of payroll taxes withheld from the wages of employees. Special rules would be needed for self-employed individuals. Most VATs enacted to date provide regressivity offsets by excluding from the tax base certain "basic necessities" (e.g., unprepared food, medicine, or children's clothing) or by providing increased tax rates on deemed "luxury items" (e.g., caviar). The offsets are provided within the VAT system, but can be a source of complexity (because of the need to distinguish tax-preferred goods from other goods) and can be inefficient. The inefficiency arises because while exempting food, for example, from a VAT provides benefit to low-income families for whom expenditures on food represent a substantial portion of their budget, such an exemption offers a greater dollar benefit to higher-income families who generally spend more on food annually than do lower-income families. As a result, the cost of the exemption in forgone tax revenue is large relative to the benefit delivered to lower-income families.

The consumption-based flat tax of H.R. 1040 subjects both individuals and businesses to tax, but provides family-based exemption amounts within the individual portion of the tax. As discussed above, except for these individual exemptions, H.R. 1040 is equivalent to a subtraction method VAT. Thus, the consumption-based flat tax could be viewed as designed as a two-level (rather than single, business-level) tax in order to provide a regressivity offset

[138] U.S. Department of Treasury, *Tax Reform for Fairness, Simplicity and Economic Growth, Vol. 3, Value-Added Tax*, November 1984.

within the tax system.[139] The offset is available to all families and is not phased-out as "income" rises. The USA Tax of S. 722 (104th Cong.) also would apply consumption taxes at two levels. There is a business-level, subtraction method VAT that is imposed on a broad base of consumption without offsets. In addition, there is an individual-level, cash-flow tax that provides regressivity offsets through (1) family-based exemption amounts, (2) graduated marginal tax rate schedules, (3) a credit for the employee share of payroll taxes and (4) an earned income credit similar to that of present law. The exemption amounts and payroll tax credit are not phased-out as income increases.

In assessing the progressivity of the tax system it may be appropriate to account for other taxes in addition to the present law income tax. Most families earn wage and salary income. Over the past 40 years the payroll tax has become an increasingly important tax to American families. Figure 8 shows that since 1982 the total payroll tax liability (employee and employer shares combined) of the median income family may exceed that family's income tax liability.[140] For example, in 1995 the median income for a four-person household was $49,531. If that household income was comprised entirely of wage or salary income and, if that household filed a joint return claiming the standard deduction and four personal exemptions, the household's income tax liability would have been $4,947. The employee's share of the payroll tax liability would have been $3,789. Likewise, the employer's share of the payroll tax liability would have been $3,789, for a total payroll tax liability of $7,578.

Because the wage base for the OASDI portion of the payroll tax is limited to the first $65,400 of wages or salary in 1997,[141] some analysts conclude that payroll tax makes the present-law tax system substantially less progressive. On the other hand, the social security system is a program of taxes and benefits. Other analysts observe that when taxes and benefits are combined, the overall program is progressive. Nevertheless, in analyzing the progressivity of tax reform proposals, it may be important to distinguish those which taxes the proposal would replace. With the exception of the USA Tax, the proposals reviewed in this publication would retain the present-law payroll taxes as a part of the new tax system. The USA Tax would provide a credit for payroll taxes paid. While not repealing the payroll tax, for the family this would have the effect of completely offsetting the burden imposed by the payroll tax.

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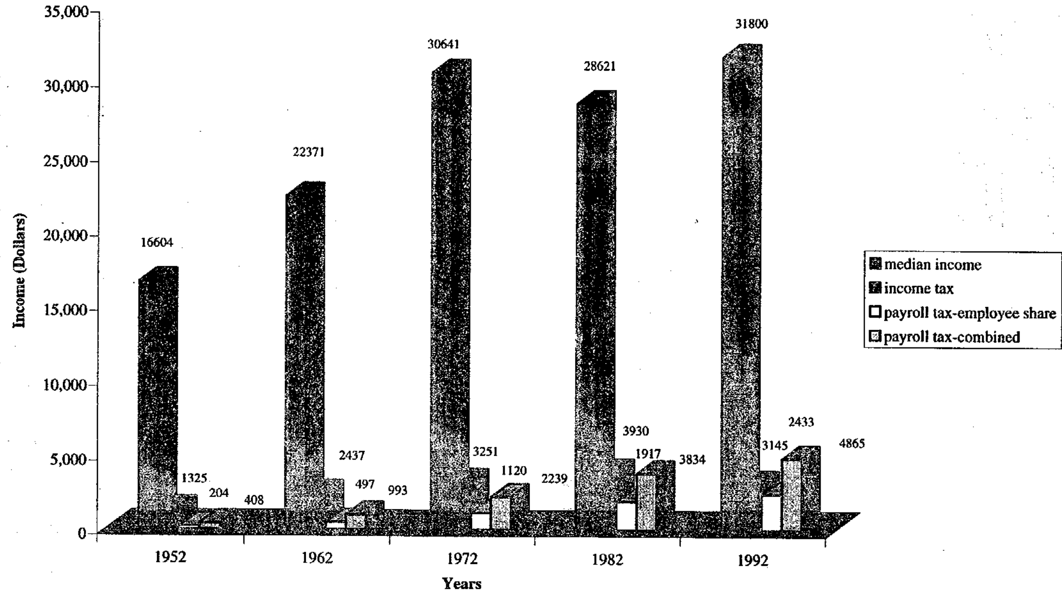
[139] A consumption-based flat tax may be structured as a two-level tax for other reasons as well. For instance, requiring the filing of a tax return may serve as annual reminder to the taxpayer of a portion of his or her cost of government.

[140] For Figure 8 the income tax computation and payroll tax computation assume wage income comprised total family income of the median income family of four, that only one family member earned that income, and that the family claimed the standard deduction. All income and tax values are reported in the figure in constant 1982–84 dollars. Data underlying Figure 8 are in Appendix Table B.1.

[141] The 1.45-percent rate employee rate and 1.45-percent employer rate for the Medicare portion of the payroll tax applies to all wages and salaries.

Figure 8.--Income, Income Tax Liability, and Payroll Tax Liability of Median Income Family, Constant 1982-84 Dollars, Selected Years



Source: Appendix Table B.1.

Economic incidence of consumption-based taxation

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. 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.

To determine the incidence of any tax, it is necessary to determine which individuals bear the burden of the tax and how this burden changes over time. A consumption tax can lead to increases in the general price level in the economy or to reductions in nominal wages and profit rates. For wage earners, the distinction is unimportant, because they will suffer the same reduction in buying power whether their nominal wage falls or the prices they face increase. In either case, their real wage falls. However, the distinction is important for individuals with income fixed in nominal dollars—those with government transfers and those receiving or paying interest. For example, individuals whose income consists only of non-indexed government transfers are burdened if prices rise, but not if wages fall. Whether a consumption tax leads to nominal wage and profit declines or to price increases will depend on the monetary policy of the Federal Reserve, and cannot be predicted on the basis of economic theory. Part IV.D.3., below, discusses further the economic effects that may occur if prices change or if wages change.[142]

C. Compliance and Simplification

One of the common complaints about the current income tax system is that it is extremely complex. The complexity leads to the use of resources in order to learn the rules of the tax and to prepare returns for the Government's collection of the tax. Individuals, businesses, and the Government all use resources in the process of collecting the tax revenue. Expenditures by individuals and business have been estimated by researchers. Expenditures by the Government show up in the staffing and budget requirements. A purported benefit of replacing the current income tax with a consumption tax is that the latter would be simpler and fewer resources would be used in the collection of the same amount of revenue.[143]

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[142] These issues are explored in greater detail in Joint Committee on Taxation, *Methodology and Issues in Measuring Changes in the Distribution of Tax Burdens* (JCS–7–93), June 14, 1993, pp. 51–60.

[143] The House Committee on Ways and Means plans a future hearing on the overall effects on simplicity, compliance, and administration of alternative tax systems. This present discussion provides an overview of issues relevant to families and does not delve into compliance and administrative costs of businesses or the government.

Table 29 and Figure 9, below, report projections for 1997 on the type of tax return filed by individuals.[144] The data show that more than 40 percent of individual income tax filers file the short forms, Form 1040A or 1040EZ, or use the IRS's TeleFile service. This may suggest that filing burdens are modest for 50 million filers. On the other hand, the table shows that an estimated 35.3 million estimated tax returns will be filed in 1997. If those filing estimated returns file four such returns per year, an estimated 8.8 million taxpayers will be filing four such quarterly returns in addition to their annual tax return. Among the tax restructuring proposals reviewed in this document, two retain some form of individual filing: the consumption-based flat tax of H.R. 1040 and the USA Tax. Two other proposals would eliminate all individual filing: the national retail sales tax and a VAT. While such proposals may eliminate returns for many families, families that run businesses (e.g., sole proprietors, farmers) would still have to file returns of some sort as a business entity. In addition, if certain levels of consumption or certain low-income families are to be exempt under a retail sales tax or a VAT, it may be necessary for families to file some sort of documentation to verify that they qualify for the benefits of exemption.

Table 29.—Projected Federal Individual Income Tax Returns Filed in Calendar Year 1997, by Type of Return

Form	Number of returns (thousands)
Paper returns:	
Paper Form 1040	60,088
Paper Form 1040A	18,362
Paper Form 1040E–Z	14,271
Paper Form 1040PC	7,057
Total paper returns	99,779
Electronic returns:	
Electronic Form 1040	2,259
Electronic Form 1040A	5,297
Electronic Form 1040E–Z	5,889
Total electronic	13,445
Other:	
TELE file	6,248
Forms 1040NR, 1040–PR, 1040–SS	446
Total other	6,694
All individual income tax returns	119,918

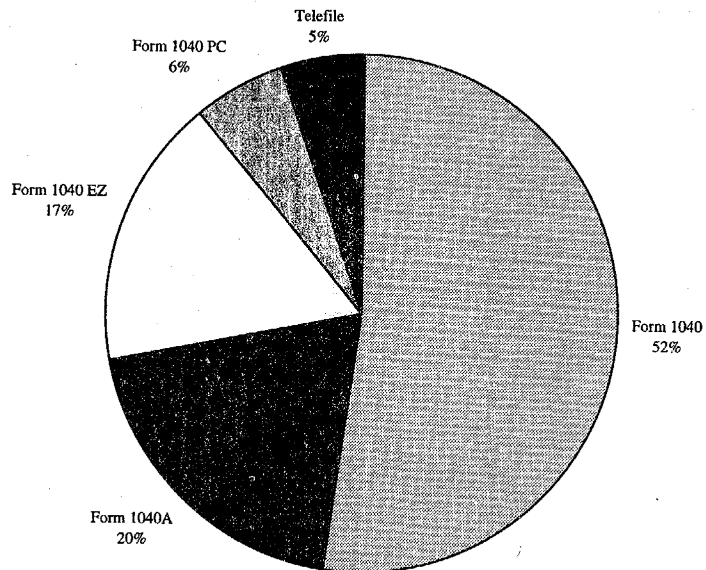
[144] Projections are reported in Philip Cormany, "Projections of Returns to Be Filed in Calendar Years 1997–2003," Internal Revenue Service, *SOI Bulletin*, 16, Winter 1996–1997, pp. 102–110.

Table 29.—Projected Federal Individual Income Tax Returns Filed in Calendar Year 1997, by Type of Return—Continued

Form	Number of returns (thousands)
Addendum:	
Form 1040–ES (Individual Estimated Tax)	35,347

Source: Philip Cormany, "Projections of Returns To Be Filed in Calendar Years 1997–2003," Internal Revenue Service, *SOI Bulletin,* 16, Winter 1996–1997, pp. 102–110.

Figure 9.--Projected Individual Tax Returns to be Filed in 1997 by Type of Return



Source: Calculations from data in Table 29.

Tax returns alone do not represent the compliance costs imposed on families. Compliance costs are imposed on families in learning about the tax rules, maintaining records, and preparing and filing returns. Surveys of individual taxpayers have attempted to measure the value of time and money spent on filing tax returns. A pair of national surveys conducted in 1983 for the IRS by Arthur D. Little estimated that the total burden on individuals was 1.6 billion hours.[145] Using data from a mail survey of Minnesota households for the 1982 tax year, Slemrod and Sorum estimated that on average, a taxpayer spent 21.7 hours annually on tax matters. For the population as a whole, this amount translated into about two billion hours and a combined cost in time and money of between five and seven percent of total revenue.[146] In a similar survey conducted by Blumenthal and Slemrod for the 1989 tax year, on average, a taxpayer spent 27.4 hours.[147] About half of the subjects in the later survey paid for professional assistance in filing their return, spending an average of $132 per taxpayer for that assistance. The total resource cost per taxpayer was $354, virtually the same as the cost in 1982, adjusted for inflation. Across both periods, higher compliance costs were associated with higher-income returns, self-employment income, and the presence of itemized deductions and capital gains. The expenditures of time and money for taxpayers who had self-employment income was significantly greater than for those who did not.

One of the reasons for the complexity and the costs of the current system is the attempt to relate tax liability to the "ability to pay" of the taxpayer. Because income is used as the yardstick for ability to pay, income needs to be measured properly, which can be difficult in the case of certain capital income. One element of simplicity provided by a consumption-based tax system is that capital income need not be measured. Another reason for the complexity of the current system is the existence of special incentives for particular activities. These special treatments involve exceptions from the general rules in order to encourage behavior that is deemed worthwhile. A cost of these incentives is that taxpayers must familiarize themselves with the relevant rules and, especially in the case of individual taxpayers, may need to keep records that they would not otherwise. To the extent that a consumption tax could be instituted on a comprehensive base, this kind of complexity could be reduced. If there are numerous exceptions provided, whether for efficiency or equity reasons, the consumption tax would be made more complex.

For individual consumption taxes, such as the USA Tax, nonbusiness taxpayers would still be required to file returns. Under the tax prepayment approach, the determination of the base may be simpler, since capital income is ignored. One would have to make distinctions between wage and nonwage income so that only the former is included in the base. Under the cash-flow approach, tax-

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[145] Arthur D. Little, *Development of Methodology for Estimating the Taxpayer Paperwork Burden*, Final Report to the Department of the Treasury, Internal Revenue Service, June 1988.

[146] Joel Slemrod and Nikki Sorum, "The Compliance Cost of the U.S. Individual Income Tax System," *National Tax Journal*, 37(4), December 1984, pp. 461–74.

[147] Marsha Blumenthal and Joel Slemrod, "The Compliance Cost of the U.S. Individual Income Tax System: A Second Look After Tax Reform," *National Tax Journal*, 45(2), June 1992, pp. 185–202.

payers would not have to determine the income from capital assets, merely the proceeds from their sales. But borrowing and lending transactions would have to be reported to a greater extent than under current law. In a pure cash-flow approach, only the total amounts would need to be reported: borrowings to increase the tax base and repayments to reduce it. If special provisions are provided to exempt some borrowing, as under S.722 (104th Cong.), the system increases in complexity.

Replacement of the current income tax with a retail sales tax or a VAT would remove the filing requirement from nonbusiness taxpayers. Depending upon the level of exemption for small business, these VATs would require all businesses to file separate returns. For corporations and partnerships, this requirement would be little change from the present, but for sole proprietors, there would no longer be a form (Schedule C) that would be attached to the individual return. Rather, they would file a new, different form that may resemble the current Schedule C.[148] Similarly, under the consumption-based flat tax of H.R. 1040, these taxpayers would have to file a business return in addition to filing an family return on which they would report wages and claim the standard deduction and personal exemptions. As noted above, the survey evidence indicates that expenditures of time and money for taxpayers who had self-employment income was significantly greater than for those who did not. If such families still must report income or sales and maintain records, the gains in simplicity for families may be greatest for those with wage, salary, interest, and dividend income, relatively simple returns under the present-law income tax.

Under the current income tax, a potentially significant amount of activity that is legally subject to tax may escape taxation. A forecast made by the IRS in 1990 projected that in tax year 1992, the amount of income taxes not paid by individuals and corporations may have been as great as $127 billion.[149] This does not include the amount of income tax that would be recovered through enforcement actions (examination, collection, and criminal investigation).

Part of the difference between the amount of tax collected and the estimated amount due to the Government arises from the existence of a subset of the economy that largely carries on transactions in cash and avoids detection. A 1980 estimate of the size of this "underground economy" in the United States placed it at between 4.5 percent and 6 percent of gross national product.[150] It is sometimes claimed that a retail sales tax or a VAT would aid in collecting taxes from the activities of the underground economy, since even individuals who engage in criminal enterprises purchase goods and services from the legitimate sector of the economy. For goods that are purchased by individuals using cash from illicit activities, a retail sales tax or VAT could collect tax on the portion of value added prior to retail (where the transaction may still be done off the books). The opportunity to pick up extra revenue from

[148] For the consumption-based flat-tax proposals, there would also be a separate form for all sole proprietorships, partnerships, and corporations.

[149] Research Division, Internal Revenue Service, Department of the Treasury, "Income Tax Compliance Research: Net Tax Gap and Remittance Gap Estimates," Publication 1415, April 1990.

[150] Vito Tanzi, "The Underground Economy in the United States: Estimates and Implications," *Banca Nazionale del Lavoro Quarterly Review*, No. 135, December 1980.

these sources depends upon how much revenue is currently being collected under the present-law tax of the workers and shareholders of the firm producing the good that is sold to the person using cash from illicit activities. Another component to the underground economy is the noncriminal provision of services by individuals who take cash payments and do not report the receipts. Those services may still escape a retail sales tax or VAT, since the service provider could continue to take cash and not report the receipt. No tax would then be collected on the value added by the service provider, which is similar to the situation under current law, where no tax is collected on the income of the service provider.

D. Other Issues

1. Housing[151]

The treatment of housing under a broad-based consumption tax poses difficult issues because: (1) the amount of housing services that ought to be subject to tax (i.e., the consumption element) is not observable on an annual basis in the case of owner-occupied housing; (2) housing may be acquired for, or converted to, consumption, investment, or business purposes, or any combination thereof; (3) in order for the tax to be perceived as fair, renters and owners of housing should be treated similarly; and (4) housing, other than new construction, is often acquired from persons who are not dealers in housing. In addition, the taxation of housing under a consumption tax may present analytical difficulties to those who believe that a consumption tax is intended to be a tax on consumption, yet feel that a portion of an owner-occupier's investment in housing represents savings that should not be subject to tax.

Under the present-law income tax, mortgage interest costs and real estate taxes are deductible for many taxpayers. Thus, substantial portions of the housing costs of many owners of owner-occupied housing are deductible against income, while generally none of the housing costs of renters are deductible against income. In addition, the capital gain accrued on owner-occupied housing can benefit from deferral an exclusion in certain circumstances. For these reasons, many analysts conclude that the present-law income tax favors owner-occupied housing over rental housing.

The retail sales tax and VATs generally would treat newly acquired owner-occupied housing and rental housing as subject to tax. This would make owner-occupied housing less attractive relative to rental housing than under the present-law income tax. Because the consumption-based flat tax is equivalent to a subtraction method VAT, as described above, it too would provide neutral treatment between owner-occupied and rental housing. Whether such alternative tax systems are fully neutral between owner-occupied and rental housing depends upon their treatment of existing owner-occupied housing. If owner-occupied housing of current owners is not subject to tax, such owners may have the incentive to remain in their present residence longer than they otherwise would, creating an inefficiency in the housing market. The USA Tax would provide an exclusion for certain mortgage interest payments. In

[151] The House Committee on Ways and Means intends to hold a separate hearing on the tax reform and housing. The present discussion briefly outlines some issues related housing.

this regard, like the present-law income tax the USA Tax would relatively favor owner-occupied housing.

2. Charities[152]

Many analysts view the deduction permitted to families and businesses for contributions to charities as important to charitable activities in the United States. With the exception of the USA Tax, the tax reform proposals reviewed in this pamphlet do not provide a direct tax benefit to the family for charitable contributions.

While factors other than tax benefits also motivate charitable giving, the preponderance of evidence suggests that the itemized charitable deduction has been a stimulant to charitable giving, at least for higher-income individuals. In general, the effect of replacing the current income tax with a consumption-based flat tax, the VAT, or the retail sales tax may depend in part on how each of these taxes would treat purchases of goods and services by charitable organizations and whether the treatment accorded purchased by charitable organizations affects the perceptions of would-be donors. None of the consumption-based flat tax, the VAT, or the retail sales tax would tax gifts made to charitable organizations, but all would tax purchases of goods by individuals. As a result, taxpayers who do not itemize under present law may see an increased benefit to making charitable donations. Depending upon the tax rate of the replacement tax, high-tax bracket itemizers under current law may see a reduced benefit to making charitable donations.

3. Transition issues[153]

Changes in asset prices

The introduction of a consumption tax may affect the prices of existing assets, the overall level of prices, and the level of interest rates. Those changes could lead to windfall losses and benefits for certain taxpayers. Any such effects could be important to families. In light of these windfalls, a shift to a consumption-tax base may cause one to design specific transition rules to reduce the windfall effects.

Part IV.A.1., above demonstrated that a consumption tax is equivalent to a tax on wages plus a tax on capital existing at the time of the tax's introduction. This one-time capital tax may change the price of existing assets. In the absence of specific transition rules, the introduction of a consumption tax will result in increased tax liability on the returns to existing assets. The income tax contains numerous provisions that provide preferential treatment to certain assets. The result of these provisions is to cause the spread between before-tax and after-tax returns to vary across assets, with smaller spreads for assets with tax-preferred treatment. Since a consumption-tax regime will tend to equalize the tax treatment across different assets, the relative prices of these assets

[152] The House Committee on Ways and Means held a public hearing on tax reform and charities on May 1, 1996. For a discussion of issues related to tax reform and charities, see Joint Committee on Taxation, *Impact on State and Local Governments and Tax-Exempt Organizations of Replacing the Federal Income Tax*, JCS-4-96, April 30, 1996.

[153] The House Committee on Ways and Means intends to hold a public hearing on tax reform and transition from the present-law income tax to a replacement tax system at a later date. The present discussion provides a brief overview of issues relevant to families in the transition from the present-law income tax to a new tax system.

would change. Specialized or immobile assets in sectors losing their relatively favorable tax treatment would be expected to experience price declines.[154] In particular, owner-occupied housing could experience price declines since the consumption of owner-occupied housing services may lose its current tax-favored treatment under many consumption tax plans.[155]

Changes in price level

While the imposition of a consumption tax could lead to a fall in the value of existing assets, the distribution of that loss across equity and debt holders will depend upon what happens to the price level.

Because a broad-based VAT is commonly believed to increase prices by the amount of tax, it is generally expected that under certain conditions a VAT may increase the price level. The degree by which it would raise the price level depends on the rate of tax and the comprehensiveness of the base. In general, any increase will be less than the rate of tax. For example, if a 10-percent VAT is levied in an economy where consumption is 70 percent of output (because, typically, investment goods are excluded from a consumption-based VAT, and government as well as certain other consumption goods are zero-rated), the most the price level may be expected to increase would be 7 percent. The increase will ultimately be determined by macroeconomic policy, especially monetary policy. If the Federal Reserve does not accommodate the upward pressure on prices from the tax by increasing the supply of money, the overall price level would not be expected to increase (although the price of taxed goods *relative* to zero-rated goods would still increase). Finally, it is also important to note that since the VAT only raises the price level when it is imposed, any increase in the price level would most likely be a one-time event.[156]

Since nominal price levels are determined in part by the independent actions of the Federal Reserve, they cannot generally be predicted in advance. For example, while it is usually assumed that a consumption tax increases the prices of taxed goods, it also is conventional to expect that a wage tax reduces nominal after-tax wages, and a tax on existing capital reduces its value. These assumptions are valid only if the Federal Reserve reacts differently to economically equivalent tax changes.

When prices rise, the value of all income falls, unless the income is specifically indexed to changes in the price level. For example, an individual living entirely on an indexed Social Security pension will not be affected by a uniform price increase.[157] Similarly, an in-

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[154] Shounak Sarkar and George R. Zodrow, "Transitional Issues in Moving to a Direct Consumption Tax," *National Tax Journal*, 46(3), September 1993, pp. 359–376.

[155] Housing services may be taxed, in advance, at the time of the purchase of a house under a credit-invoice or subtraction-method VAT. Under an individual consumption tax of the tax prepayment type, such as the flat tax, houses are purchased with after-tax dollars and owner-occupied housing services (the returns of that housing purchase) are untaxed, the same treatment accorded financial assets such as stocks, bonds, and savings accounts.

Note that certain tax restructuring proposals (e.g., S. 488 and 722 of the 104th Cong.) would retain some preference for housing.

[156] For a survey of the effects of introducing a VAT or increasing VAT rates on price levels and inflation, see Alan A. Tait, *Value Added Tax, International Practice and Problems* (Washington, D.C.: International Monetary Fund), 1988.

[157] This assumes that the fraction of the pension that is taxed, and the applicable tax rate, are fixed.

dividual receiving Medicare services will be partially protected against the price rise, because the in-kind transfer of health care is effectively indexed.[158] In contrast, recipients of unindexed private pensions will experience a decline in purchasing power when prices rise.

If, on the other hand, nominal wages and the returns to old assets fall, only certain types of income are affected. Recipients of fixed nominal transfers are not hurt by the tax. Such transfer payments include both indexed payments mentioned above, as well as non-indexed government transfers such as Aid to Families with Dependent Children (AFDC). In addition, any private contracts with fixed nominal payments are unaffected by the tax. In particular, holders of existing bonds receive the same nominal interest payments as before, since the introduction of the tax does not change any contractual agreements between issuers and holders. If prices rise, the value of all capital income, both financial and physical, is reduced, but if factor returns fall, only income from existing physical assets is reduced in value.

The reason bondholders are unaffected by the consumption tax while owners of physical assets are burdened is that the returns to bond investment can be consumed directly. That is, the output of a bond is cash, the consumption value of which does not change if prices do not increase. On the other hand, owners of physical capital are hurt by the tax when factor returns fall. The value of output from such capital is reduced, because the owners are liable for the consumption tax when the produced goods are sold.

If the price level does rise with the imposition of a consumption tax, and if the price increase is not anticipated (for example, through an increase in nominal interest rates so that the real value of the money repaid to the lender is unchanged), then borrowers will benefit at the expense of lenders because they will be able to repay their obligations with cheaper dollars. The losses imposed by the consumption tax's one-time levy on existing wealth will be shared by equity and debt holders. By contrast, if the price level does not increase, then equity holders suffer the entire decline in existing asset values and debt holders are held harmless.

Changes in interest rates

The replacement of the present income tax with a consumption tax could be expected to affect the level of interest rates. The ultimate effect would depend upon the nature of the demand for and supply of savings. At one extreme, suppose that the supply of capital is extremely responsive to the after-tax rate of return (for example, if capital is mobile across international borders and the aggregate supply of foreign capital is large relative to the supply of capital in the United States). Then the elimination of the income tax would have no effect on the after-tax rate of return received by savers, since the world interest rate would continue to prevail. At the other extreme, suppose that businesses have an inexhaustible menu of investment opportunities available to them that can yield a given before-tax rate of return. In this case, the elimination of

[158] Food stamps are another example of an indexed transfer since the nominal value of food stamps available to individuals is indexed to the price of a designated basket of food.

the income tax would lead to an increase in the after-tax rate of return by the amount of the tax. For intermediate cases, the interest rate will change in some measure between the extremes.

Any increase in interest rates will increase the return on existing assets and thus will help to offset the reduction in wealth caused by the imposition of the consumption tax. The extent of this offset in any individual's case is sensitive to the pattern of consumption. If the individual is elderly, for example, and expects to consume his existing assets shortly after the consumption tax is introduced, any increase in return on those assets will do little to offset the one-time decrease in the value of the assets. On the other hand, if the individual has a much longer consumption horizon, an increase in return on existing assets may go a long way toward offsetting the one-time decrease in value.[159]

In the longer run, any increase in investment that is spurred by the switch to a consumption tax will lead to a larger capital stock. With a larger capital stock, the productivity of labor (the extra output for an extra unit of labor services) will increase, but the productivity of capital will be smaller, reducing somewhat equilibrium interest rates.

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[159] David F. Bradford, "Consumption Tax Alternatives: Implementation and Transition Issues," mimeo, Princeton University.

APPENDIX A:

The Marriage Penalty or Bonus Under the Federal Income Tax

Background

The marriage penalty in the current income rate structure dates from changes in the structure of individual income tax rates in 1969.[160] To understand the effect of those changes, one needs to go back to 1948, when separate rate schedules for joint filers and single returns were introduced. Before 1948, there was only one income tax schedule, and all individuals were liable for tax as separate filing units. With a progressive income tax, a married couple with only one spouse earning income could reduce its combined tax liability if it could split the income and assign half to each spouse. While the Supreme Court upheld the Commissioner's right to deny contractual attempts to split income,[161] it ruled that in States with community property laws, income splitting was required for community income.[162] As income tax rates and the number of individuals liable for income taxes increased before and during World War II, some States adopted, or considered adopting, community property statutes to give their citizens the tax benefits of income splitting.

In the Revenue Act of 1948, income splitting was allowed to all married couples by establishing a separate tax schedule for joint returns. That schedule was designed so that married couples would pay twice the tax of a single taxpayer having one-half the couple's taxable income. (This relationship between rate schedules is the same as that between joint returns and separate returns for married couples under present law.) While this new schedule equalized treatment between married couples in States with community property laws and those in States with separate property laws, it introduced a marriage bonus into the tax law for couples in States with separate property laws.[163] In 1969, an individual with the same income as a married couple could have had a tax liability as much as 40 percent higher than that of the married couple. To address this perceived inequity, which was labeled a "singles penalty" by some commentators, a special rate schedule was introduced for single taxpayers (leaving the old schedule solely for married individuals filing separate returns). The bracket breakpoints and standard deduction amounts for single taxpayers were set at about

[160] In 1951, a separate rate schedule was created for unmarried heads of household with dependents ("head of household" status). Since the bracket breakpoints and standard deduction were more than half of those for joint returns, marriage penalties arose for some taxpayers eligible for filing as head of household.

[161] *Lucas v. Earl*, 281 U.S. 111 (1930).

[162] *Poe v. Seaborn*, 282 U.S. 101 (1930).

[163] Since income splitting had been available in community property States prior to 1948, a marriage bonus had already existed in such States.

60 percent of those for married couples filing joint returns. This schedule created a marriage penalty.

In 1981, Congress created a deduction for two-earner married couples. The maximum deduction equaled ten percent of the lesser of: (1) the earned income of the spouse with lower income or (2) $30,000. The two-earner deduction which was, in part, created to alleviate the work disincentive effects of high marginal tax rates on the second earner's income was repealed in 1986 in conjunction with the enactment of generally lower tax rates.

Additional facets of present law such as the limitation on itemized deductions, the phaseout of personal exemptions, the partial inclusion of social security benefits in taxable income, and the phaseouts provided for various provisions can exacerbate the marriage penalty. Many households are affected by the marriage penalty or marriage bonus. One study estimated that in 1994, 52 percent of married couples would face a marriage penalty, with an average penalty of about $1,244, while 38 percent would face a marriage bonus, with an average bonus of about $1,399.[164]

Under present law, the size of the standard deduction and the bracket breakpoints follow certain customary ratios across filing statuses. The standard deduction and bracket breakpoints for single filers are roughly 60 percent of those for joint filers. The standard deduction and bracket breakpoints for head of household filers are about 83 percent of those for joint filers. With these ratios, unmarried individuals have standard deductions whose sum exceeds the standard deduction they would receive as a married couple filing a joint return. Thus, their taxable income as joint filers may exceed the sum of their taxable incomes as unmarried individuals. Furthermore, because of the way the bracket breakpoints are structured, as joint filers they may have some of their taxable income pushed into a higher marginal tax bracket than when they were unmarried. In addition, unlike the other bracket breakpoints, the threshold for the 39.6-percent tax rate is the same for all filing statuses, $271,050 in 1997. To eliminate the marriage penalty caused by the rate structure, the standard deduction and bracket breakpoints for all unmarried filers would have to be 50 percent of those for joint filers. This is the current ratio for individuals who are married, but file separate returns.[165]

Developments subsequent to 1970 have added additional facets to the marriage penalty that primarily affect lower-income taxpayers. There are three features of the current individual income tax system that create a marriage penalty for low-income individuals: the variation of the size of the standard deduction by filing status, the phaseout of the earned income credit (EIC) as income increases, and the variation of the size of the EIC by number of dependent children.[166]

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[164] Daniel R. Feenberg and Harvey S. Rosen, "Recent Developments in the Marriage Tax," *National Tax Journal*, 48, March 1995, pp. 91–102.

[165] Note that even with such a rate structure, a marriage bonus would exist in the case of an individual with no taxable income marrying an individual with taxable income. The individual with no taxable income is, in essence, allowing some of his or her standard deduction to go "unused." By marrying an individual with taxable income, some of the taxable income of the couple can be reduced by the "unused" portion of the standard deduction.

[166] For a more detailed discussion of the marriage penalty and low-income households under present law, see Joint Committee on Taxation, *Background and Information Relating To Three Tax Cut Proposals for Middle–Income Americans: A $500 Per–Child Tax Credit, A Reduction in*

Because the EIC increases over some range of income and then is phased out over another range of income, the aggregation of incomes that occurs when two individuals marry may reduce the amount of EIC for which they are eligible.[167]

Marriage may reduce the size of a couple's EIC not only because their incomes are aggregated, but also because the number of dependent children is aggregated. Because the amount of EIC does not increase when a taxpayer has more than two dependent children, marriages that cause the resulting family to have more than two dependent children will result in a smaller number of children giving rise to the EIC than when their parents were unmarried. And even when each unmarried individual brings just one dependent child into the marriage there is a reduction in the amount of EIC, since the maximum credit for two children is generally much less than twice the maximum credit for one child.

These three features can cause unmarried individuals who are eligible for the EIC to face significant marriage penalties. For example,[168] in 1995, two individuals each with one dependent child, one with wage income of $14,000 and the other with wage income of $10,000, faced a marriage penalty of $3,841.

Description of Figures A.1–A.3

Below are "contour maps" showing the size of marriage penalties and bonuses for individuals of different filing statuses under projected tax schedules for 1997. For all of these calculations, all of the income of the individuals is assumed to be earned income. The separate income of one spouse is shown on the horizontal axis, the separate income of the other spouse is shown on the vertical axis. The point at the intersection of two income levels indicates the marriage penalty or bonus for the couple. Marriage penalties are shown as positive numbers in the map, marriage bonuses are shown as negative numbers.

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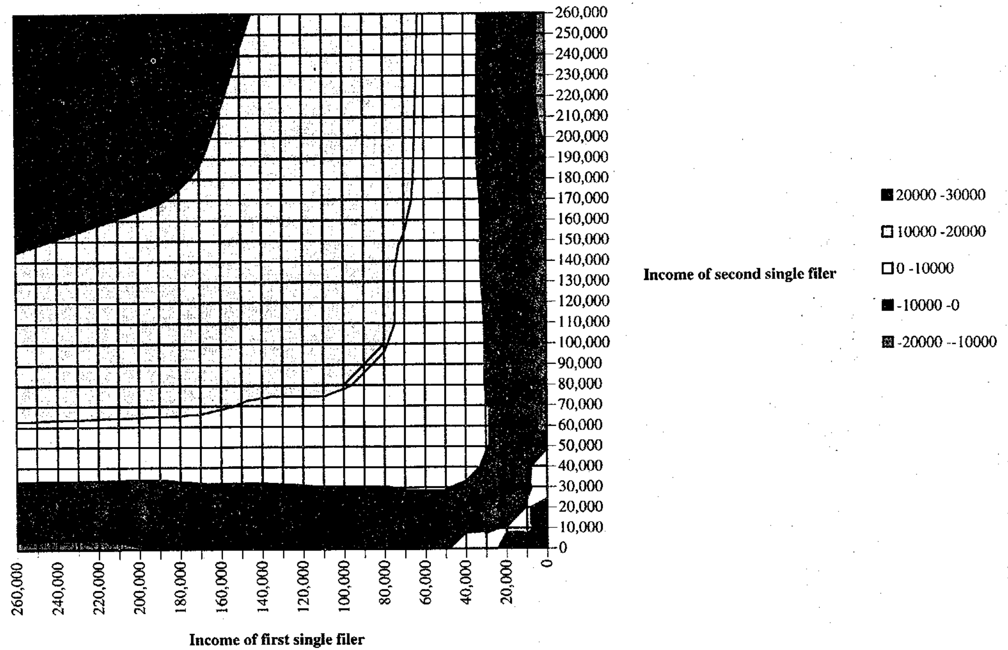
the Marriage Penalty, and a Deduction for Education and Job Training Expenses (JCX–7–95), March 1, 1995.

[167] In the case of two individuals with very low wage income, marriage may *increase* the amount of their EIC available for a dependent child. If the individual with the dependent child is in the phase-in range of the EIC, the aggregation of incomes upon marriage could increase the amount of the EIC.

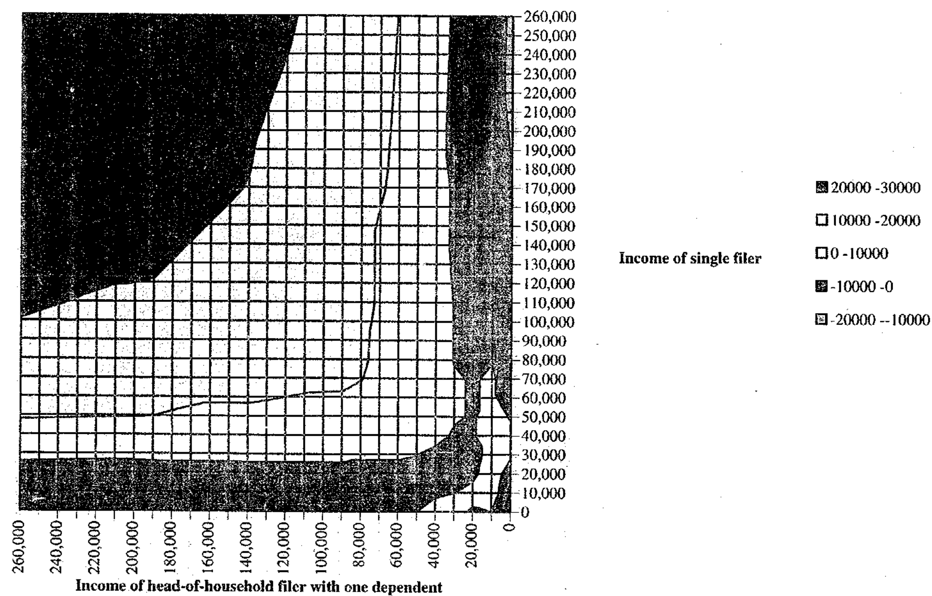
[168] The amount of the marriage penalty would have been even larger if each individual had two or more children.

Figure A.1.--Marriage penalty / (bonus) for two single filers



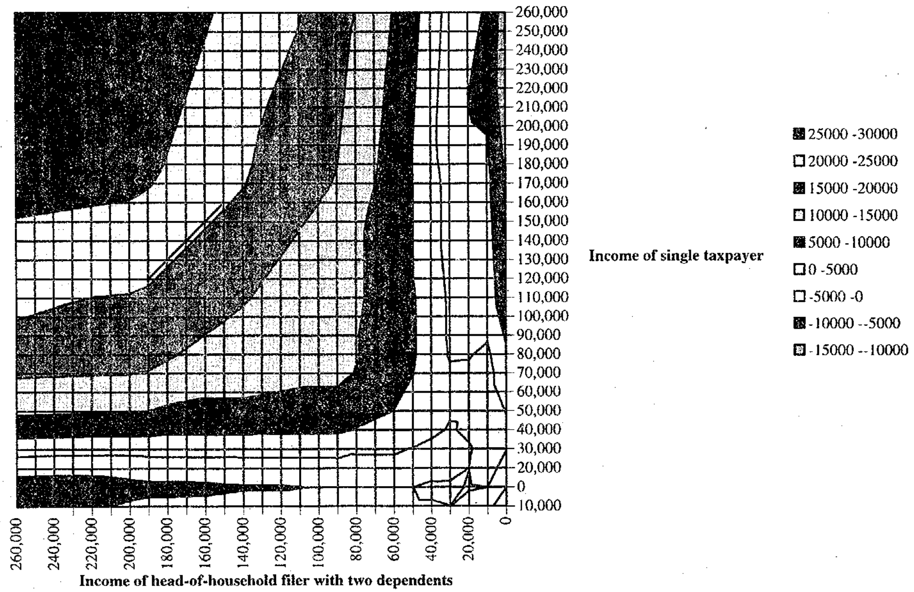
1997 Projections.
Both filers are assumed to take the standard deduction.
All income is assumed to be earned income.

Figure A.2.--Marriage penalty / (bonus) for single filer and head of household filer with one dependent



1997 Projections.
Both filers are assumed to take the standard deduction.
All income is assumed to be earned income.

Figure A.3.--Marriage penalty / (bonus) for single filer and head of household filer with two dependents



1997 Projections.
Both individuals are assumed to take the standard deduction.
All income is assumed to be earned income.

APPENDIX B:

Income Tax and Payroll Tax Liabilities of Median Income Families

Table B.1.—Income Tax and Payroll Tax Liabilities of Median Income Family of Four, Selected Years, 1952–1992

Year	Median income family of four[1]	Income tax liability[2]	Employee's payroll tax liability[1]	Combined payroll tax liability[2,3]
1952	$4,400	$351	$54	$108
1957	4,488	508	95	190
1962	6,756	736	150	300
1967	8,994	942	290	580
1972	12,808	1,359	468	936
1977	18,723	2,491	965	1,930
1982	27,619	3,792	1,850	3,700
1987	37,086	3,553	2,652	5,304
1992	44,615	4,412	3,413	6,826

[1] Median income of family of four as reported by Bureau of Census, in nominal dollars.

[2] Income tax computation and payroll tax computation assume wage income comprised total family income, one family member earned that income, and the family used the standard deduction.

[3] Combines the employee's and employer's share of the payroll tax.

Source: Calculations by staff of the Joint Committee on Taxation.

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