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Chairman, Senate Finance Committee

COMPREHENSIVE INCOME TAX REFORM OPTIONS

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Twelve bills (7 in the House and 5 in the Senate) have been introduced in the 97th Congress which address the issues of comprehensive income tax reform. These bills all broaden the tax base and lower and flatten the marginal tax schedule. Generally the bills fall into five generic options: (1) broad-base, flat-rate with standard personal exemptions, (2) broad-base, flat-rate with high personal exemptions, (3) modified broad-base, flat-rate, (4) broad-base, progressive rate, and (5) modified broad-base, progressive rate.

Some of these bills also address certain structural problems in the current system of income taxation such as the marriage penalty, the treatment of savings, the effect of inflation in defining income from capital, and the relationship between the corporate and individual income taxes.

None of the bills propose to replace the current income tax with a broad-base consumption tax.

The five generic types of comprehensive income tax options are described below. Also described are alternatives to the current corporate income tax. In the discussion of the individual income tax, the earned-income credit is disregarded. The earned income credit could be converted to an expenditure program in conjunction with these comprehensive income tax reform proposals.

OPTION ONE: "Broad-base, Flat-rate Income Tax with Standard Personal Exemptions"

Description of proposal

This proposal would repeal all exemptions, exclusions, credits and deductions other than a standard personal exemption and a deduction for ordinary and necessary business expenses. A standard personal exemption of $3,300 for a single return, $5,400 for a joint return, and $1,000 for each dependent would be allowed. These exemptions would be indexed for inflation. A flat rate of 14 percent would be imposed on the gross income of individuals (including estates and trusts). This proposal is designed to be revenue neutral with respect to personal income tax revenue in 1984.

Arguments for proposal

(1) The proposal improves horizontal equity since similarly sized households with the same before-tax income, from whatever source, pay the same amount in income tax.

(2) Lowering the top marginal tax bracket increases economic efficiency and the incentive to earn (and report) income.

(3) The proposal reduces the marriage penalty and decreases the tax burden on two-earner couples.

(4) The proposal greatly increases the simplicity of the tax code.

(5) The proposal eliminates "bracket-creep" since the same tax rate applies to all income.

Arguments against proposal

(1) The proposal reduces progressivity in the upper income range since the marginal tax rate is flat. This increases the tax burden on lower and middle income relative to upper income households.

(2) Many well-established exclusions and deductions would be eliminated such as: the deduction for mortgage interest, the rollover of gain on the sale of a personal residence, the deduction for charitable contributions, and the exclusions for disability and retirement benefits.

(3) A number of sectors may be adversely affected by the repeal of certain tax preferences and the lowering of marginal tax rates. These sectors include real estate, natural resources, insurance, securities, and charitable organizations. The economy-wide benefits of lower tax-rates will, to some extent, offset these adverse effects.

Tax preferences specifically repealed.

The following tax preferences would be repealed:

(1) Capital gains deduction (sec. 1202);

(2) Combat pay (sec. 112);

(3) Mustering out payments (sec. 113);

(4) Other military benefits or allowances which would be taxable if received by an employee;

(5) Military disability pensions (sec. 104(a));

(6) Income earned abroad (secs. 911 and 912);

(7) R&D credit (sec. 44F);

(8) Intangible drilling costs (sec. 263(c));

(9) Mining exploration and development costs (secs. 616 and 617);

(10) Percentage depletion (secs. 613 and 613A);

(11) Residential energy credits (sec. 44C);

(12) Energy production credit (sec. 44D)

(13) Gasohol credit (sec. 44E)

(14) Reforestation expenditures (sec. 194);

(15) Vanpooling exclusion (sec. 124).

(16) Cash accounting for farms (sec. 447);

(17) Expensing of soil and water conservation expenditures (sec. 174), land enrichment expenditures (sec. 180) and land clearing expenditures (sec. 182);

(18) Income averaging (sec. 1301);

(19) Cost sharing payments (sec. 126);

(20) Dividend exclusion (sec. 116);

(21) Dividend reinvestment (sec. 305(e));

(22) Net interest exclusion (sec. 128);

(23) Certain special nonrecognition rules;

(24) Interest in excess of investment income (sec. 163);

(25) Deduction for taxes (sec. 164);

(26) Rollover of capital gain on homes (sec. 1034);

(27) Exclusion of up to $125,000 of gain on sale of home (sec. 121);

(28) Construction period interest and taxes;

(29) ACRS (sec. 168) and other accelerated depreciation methods;

(30) Rapid amortization of rehabilitations of low-income housing (sec. 167(k));

(31) Rapid amortization of pollution control facilities (sec. 169);

(32) Capital gains at death;

(33) Investment credit (sec. 38);

(34) Motor carrier operating rights (sec. 266 of the ERTA);

(35) Scholarships and fellowships (sec. 117);

(36) Meals and lodging (sec. 119);

(37) Employer educational assistance (sec. 127);

(38) Prepaid legal services (sec. 120);

(39) Employer-provided child care (sec. 129);

(40) Deferred compensation (subchapter D);

(41) Charitable deduction (sec. 170);

(42) Child care credit (sec. 44A);

(43) Targeted jobs credit (sec. 44B);

(44) Marriage penalty deduction (sec. 221);

(45) Adoption expense deduction (sec. 222);

(46) Employer health premiums (sec. 106);

(47) Medical expense deduction (sec. 213);

(48) Exclusion for social security benefits;

(49) Exclusion for unemployment compensation (sec. 85);

(50) Exclusion for public assistance, black lung benefits and other income security benefits;

(51) Exclusion for workmen's compensation (sec. 104);

(52) Disability exclusion (sec. 105);

(53) Keogh plans (sec. 401);

(54) IRAs (sec. 219);

(55) Qualified retirement plans and annuities

(56) Exclusion for group term life insurance (sec. 79);

(57) Credit for the elderly (sec. 37);

(58) Extra exemption for blind and elderly (sec. 151);

(59) Casualty loss deduction (sec. 165);

(60) Veteran's benefits;

(61) Political contributions credit (sec. 41);

(62) Interest on tax-exempt bonds (secs 103 and 103A);

(63) Tertiary injectants (sec. 193);

(64) Deferral on savings bonds (sec. 454);

(65) Inside buildup on life insurance, annuities, etc.;

(66) Research and development expenditures (sec. 174);

(67) Magazine circulation expenditures (sec. 173);

(68) Business meals and entertainment;

(69) Rental value of parsonages (sec. 107);

(70) Expenses to remove architectural barriers for handicapped; (sec. 190).

OPTION TWO: "Broad-base, Flat-rate Income Tax With High Personal Exemption"

Description of proposal

This proposal is the same as the first option except that the personal exemption amounts would be increased to insure that the tax burden on lower income taxpayers would not be increased as compared to present law.

Arguments for Proposal

The arguments for Option Two are the same as for Option One except that Option Two better protects lower income households and maintains substantial progressivity in the lower income range.

Arguments Against Proposal

The disadvantages of Option Two are identical to those of Option One except that Option Two increases the tax burden of middle income households while the tax burden on upper income taxpayers is reduced and the tax burden of lower income taxpayers is unchanged.

OPTION THREE: "Modified-broad base, Flat-rate Income Tax with Standard Personal Exemption"

Description of proposal

This proposal would repeal the same preferences repealed under Option One other than the following which would be retained: (1) military disability pensions, (2) home mortgage interest, (3) exclusion of gain on sale of home, (4) rollover of capital gain on home, (5) capital gains at death, (6) charitable contribution deduction, (7) exclusion for social security benefits, (8) disability exclusion, (9) Keogh plans, (10) IRAs, and (11) qualified pensions. A personal exemption of $3,300 for a single return, $5,400 for a joint return and $1,000 for each dependent would be allowed. The personal exemption would be indexed for inflation. A flat rate of 16 percent would be imposed on the gross income of individuals (including estates and trusts). This proposal is designed to be revenue neutral in 1984.

Arguments for proposal

The arguments for Option Three are the same as for Option One. However, Option Three retains a number of the tax preferences and does not achieve the same degree of horizontal equity as Option One.

Arguments against proposal

Option Three retains a number of well-established tax preference items; however, some important deductions and exclusions are eliminated. This may adversely effect certain sectors of the economy.

OPTION FOUR: "Broad-base, Progressive Income Tax"

Description of proposal

The proposal would repeal the same tax preferences which are repealed under Option One. The personal exemption would be $4,000 for the taxpayer and $1,000 for each dependent. Individual income would be taxed at graduated rates of 5, 15, and 25 percent. The 5 percent rate would apply to the first $5,000 of taxable income (net of the personal exemption), the 15 percent rate would apply to taxable income between $5,000 and $40,000, and the top rate of 25 percent would apply to taxable income over $40,000. The personal exemption and tax brackets would be indexed for inflation. The proposal is designed to be revenue neutral in 1984, and to retain the present-law distribution of the tax burden by income class.

Arguments for proposal

(1) The proposal would improve horizontal equity since similarly sized households with the same before-tax income, from whatever source, would pay the same amount in income tax.

(2) The proposal would significantly simplify the tax code (but less than the flat-rate proposals would).

(3) The proposal retains the progressivity of the present income tax.

(4) Lowering the marginal tax rates would increase economic efficiency and the incentive to earn (and report) income.

Arguments against proposal

(1) Many well-established exclusions and deductions would be eliminated such as: (a) the deduction for mortgage interest, (b) the rollover of gain on the sale of

a home, (c) the deduction for charitable contributions, and (d) the exclusions for disability and retirement benefits.

(2) The marriage penalty would not be eliminated.

(3) Some sectors may be adversely affected by the repeal of certain tax preferences and the lowering of marginal tax rates. These sectors include real-estate, natural resources, insurance, securities, and charitable organizations. The economy-wide benefits of lower marginal tax rates would, to some extent, offset these adverse effects.

OPTION FIVE: "Modified Broad-base, Progressive Income Tax"

Description of proposal

The proposal would repeal and retain the same preferences as Option Three. The personal exemption would be $4,000 for the taxpayer and $1,000 for each dependent. Individual income would be taxed at graduated rates of 7, 17, and 27 percent. The 7 percent rate applies to taxable income (net of personal exemption) up to $5,000, the 17 percent rate applies to taxable income between $5,000 and $40,000, and the top rate of 27 percent applies to taxable income over $40,000. The personal exemption and tax brackets are indexed for inflation. The proposal is designed to be revenue neutral in 1984, and to retain the present-law distribution of the tax burden by income class.

Arguments for proposal

The arguments for Option Five are the same as for Option Four. However, Option Five retains a number of the tax preference items, and does not achieve the same degree of horizontal equity as Option Four.

Arguments against proposal

Option Five retains a number of well-established tax preference items; however, some important deductions and inclusions are eliminated. This may adversely effect certain sectors of the economy.

CORPORATE TAX ISSUES

The corporate income tax structure contains the attributes of a relatively high maximum marginal rate and a multitude of deductions and credits limiting the tax base which have subjected the individual income tax to criticism. If the individual tax system were revised to provide lower rates and a broader income base, a similar revision would be appropriate for corporate income taxes. Without conforming changes, taxpayers with businesses which could take advantage of corporate tax incentives would be encouraged to operate in corporate form while other businesses would more likely be operated as sole proprietorships or partnerships. It has been argued that the tax system should be neutral with respect to the form in which a business is operated.

As is the case with the individual income tax, numerous credits and deductions have been enacted to provide incentives for various activities, rather than merely to reflect the costs of doing business. Examples of these incentives are the investment credit, incremental credit for research expenditures, the accelerated cost recovery system, and intangible drilling costs.

However, more than the individual tax, a repeal of these incentives in return for a lower maximum tax rate would cause a significant increase in taxes for major segments of American industry. Examples of this are the capital intensive industries

such as mining or heavy manufacturing which make use of ACRS, the investment credit and other incentives. A repeal of these incentives, if included in a revenue-neutral proposal could involve a substantial redistribution of corporate income tax liability.

If a corporate income tax were imposed at a flat rate on economic income, eliminating all deductions, credits and exemptions enacted as incentives but retaining the foreign tax credit, a rate of 25 percent, with no amount of income exempted from tax, would be necessary for the proposal to be revenue neutral. If the foreign tax credit were replaced by a deduction for foreign taxes paid, the rate could be reduced further.

An additional issue which should be considered as part of any proposal is the advisability of integration of individual and corporate income taxes. Under present law, corporate income is generally taxable when earned at the corporate level and again when dividends are paid to the shareholder or is reflected in the value of the corporation's stock and taxed upon sale or exchange of the stock by the shareholder.

If the corporate tax is considered as a "proxy" tax on the corporation's shareholders, it could be argued that the present system does not necessarily impose that tax in an efficient or equitable manner.

Several alternatives have been suggested to accomplish integration of corporate and individual taxes. For example, the Internal Revenue Code already contains a provision for corporations with few shareholders (Subchapter S) which replaces the corporate level tax with an imputation of corporate profits and loss directly to the shareholders. This procedure could be expanded to larger corporations and possibly combined with withholding by the corporation to maintain a high level of compliance.

Alternatively, corporations could be granted a deduction for dividends paid to shareholders. This type of treatment exists in situations where dividends are paid to other corporations. However, an argument could be made that this type of system would discourage retention of earnings for capital improvement and business expansion generally.

A third option could be a credit at the shareholder level for the amount of corporate tax deemed to be paid with respect to corporate income. Under the shareholder credit approach, a shareholder would make two adjustments. First, he would "gross-up" the amount of the dividend included in gross income by the amount of the corporate tax deemed paid with respect to that income. Second, he would claim a refundable tax credit for the amount of the gross-up. If the shareholder credits with respect to a corporation's dividends exceeded the amount of corporate tax

actually paid by the corporation, it would have to pay an additional tax to make up the shortfall.

The shareholder credit provides flexibility under which, for example, the credit can be denied to tax-exempt organizations and foreign shareholders for whom there is no U.S. double taxation.

If integration of the corporate and individual taxes were included in a proposal, the rate of tax applied either to individuals or corporations would have to be increased in order to avoid revenue loss.