

II. Recognize Trends to Help Guide Tax Reform

No one would argue that the world has changed tremendously in the past 20 years and even in the last two years. Advancements in technology have changed business models, education, and health care. Longer life expectancies have changed the demography of the workforce, financial planning needs, and health care costs.

A review of trends can help identify areas where the tax system needs to be modernized because the system does not reflect today's ways of living and doing business. Numerous reports and data exist to help identify trends.¹ A sampling of data and reports describing and supporting trends are noted in the footnotes for the chart below.

The chart is an example of a more detailed analysis that is needed. Items included in the chart are ones pertinent to young people.

Trends and Relevance to Our Tax System

Trend and Examples	Relevance to Tax Law Design
ECONOMIC	
Increasing global and mobile business environment: <ul style="list-style-type: none"> • Growth of virtual workplaces and markets / E-commerce • Ability to serve customers worldwide from a single location • Telecommuting and distance workers, global work teams • Increasing need for special expertise on an as-needed basis 	The tax law should not hinder alternative compensation techniques, including equity compensation. Outdated and complex worker classification rules play too great a role in hiring practices which can adversely affect employers and workers. Existing tax rules for deductions for employees who telecommute require that it be done for employer-convenience. Ease and benefits of working anywhere with today's technology should not hinder employee and employer discretion in work locations and hours. Complexity of international provisions of the federal income tax system may hinder international operations of businesses of all sizes.

Workforce²

Increased emphasis on technology literacy, adaptability to change, lifelong learning

A college degree is required for many types of work

Service economy and the possibility of serving someone

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self-employed and working out of one's home.³

Increase in number of businesses operating out of someone's home.⁴

Increase in number of self-employed individuals.⁵

Increased mobility of the workforce

Decline in defined benefit retirement plans and increase in defined contribution plans.⁶

employee or independent contractor are troublesome because the classification criteria are subjective and outdated.

Tax rules regarding retirement and benefits are focused on the employer, rather than the worker. Workers may lose

III. Use Principles of Good Tax Policy

Principles of good tax policy, such as simplicity, equity and economic efficiency, should be used to:

- Identify where current rules violate such principles and what reforms will enable rules to better meet the principles. The analysis of the equity, neutrality and economic growth principles will highlight areas of inequity that either harm or do not support opportunities for young people. Inequities are further discussed in the next section.
- Evaluate reform proposals to determine if they meet the principles of good tax policy and where such principles are not met, the principles can help identify improvements.

Various formulations of principles of good tax policy exist. The Joint Committee on Taxation and Government Accountability Office have suggested appropriate principles in reports. The American Institute of CPAs (AICPA) has suggested a set of ten principles. These formulations are all quite similar with key principles being:¹⁵

- Equity
- Simplicity
- Neutrality
- Economic growth and efficiency
- Minimum tax gap
- Transparency

IV. Bringing Equity to Tax System Spending (Tax Expenditures Review)

Key Argument. The needed funds to help benefit young people obtain necessary education and training, start retirement accounts, and start businesses, exists within the current array of special tax rules. The funds currently used for unnecessary and inequitable subsidies can be redirected to help bring more equity to the tax system and to benefit a larger group of individuals.

Definition. Tax expenditures can be thought of as special rules in a tax system that are not crucial to the basic design of that tax. For example, an income tax should consist of a tax base equal to income less expenses of producing the income. A personal income tax should also include some type of personal exemption and/or standard deduction to ensure that some portion of an individual's income is not taxed because it is needed for basic living expenses. Thus, these deductions are not tax expenditures.

The word "expenditure" is used because the special rules, such as the mortgage interest deduction or an energy credit, result in reduced revenues for the government – the same result as when the government makes a direct outlay, such as a grant. Most tax expenditures or special rules could instead be direct spending by a government agency, that is, a subsidy. For example, instead of a mortgage interest deduction, the government could provide a subsidy to individuals at the time of purchase or provide a subsidy to lenders so as to allow lower interest rates for borrowers.

¹⁵ For a list of various formulations including the ones noted in this testimony, see http://www.cob.sjsu.edu/nellen_a/TaxReform/PolicyApproachToAnalyzingTaxSystems.pdf.

Not all tax expenditures though are the equivalent of a government provided subsidy, yet they still represent a special rule not required for the basic (or normal) design of a particular tax system. For example, IRC Section 1202 allows non-corporate shareholders to exclude 50% of their gain from the disposition of qualified small business stock held over five years. This is a tax expenditure in that it is a rule not required to be in a basic income tax. It does not translate well though, to a subsidy.¹⁶ A 2002 report on tax expenditures described two types of tax



As indicated in the table, over half of the "cost" of the mortgage interest deduction benefits individuals with income greater than \$100,000.

Research shows that the mortgage interest deduction tends to help individuals afford a more expensive home rather than to enable them to buy any home.²⁰

V. Consider How to Support Modern Workforce Preparedness and Lifelong Learning

Empirical evidence: Many jobs today require a well-educated, tech sav

There is a greater need for workers to have retirement savings today than was true decades ago because people are living longer.

Tax law changes to increase the number of workers participating in retirement plans should consider the following:

- A simple system to enable all workers (employees and self-employed individuals) to have a retirement savings account. This should occur for both part-time and full-time workers and even if an employer does not help with administration or contributions.
- Retirement savings contributions should be coordinated with payroll tax deductions. A system to enable self-employed individuals to also make contributions along with self-employment tax payments should also be considered.
- Find ways to help individuals improve their financial literacy.
- Portability. Be sure the system allows for contributions to be made to the one account even if a worker changes employers or also has income from self-employment.
- Strive for simplicity.

The government can play a role in establishing accounts, simplification, and educating individuals.

Example of a new approach : The first time an individual receives a W-2 or pays self-employment tax (whichever happens first), the government could set aside a set dollar amount in a retirement account for that person. This would constitute the start of their retirement account that would be used for all future contributions; there would be only one account. When the individual works for an employer who also wants to contribute to employee retirement accounts, such funds are placed in the individual's existing account. Also, for each paycheck or quarterly estimated tax payment of a self-employed individual, an amount would be contributed to their retirement account. Individuals could be allowed to transfer their retirement account to a commercial broker for management or let it stay with the federal government. The federal government could be allowed to transfer management to third parties for a fee.

Annual reporting would be required to let individuals know their account balance and other details. Rules would continue to exist, but in more simplified form, governing how much could be contributed annually, how much employers could also contribute, the age when distributions may begin, hardship withdrawals, etc.

Benefits of this type of approach:

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- For low-income workers, the annual contribution could be made via part of the earned income tax credit (EITC) the worker receives.

VII. Support Modern Entrepreneurship

Several trends indicate that workers today are more likely to be self-employed, telecommute or work in their home, and have continual needs for new technologies (such as for hardware and software). Many existing tax rules though, work contrary to support these trends. For example, worker classification rules are unclear causing some employers to label all workers as employees, making it difficult for a self-employed entrepreneur to succeed. Strict home office deduction rules, particularly the exclusive use requirement, make it almost impossible for workers and self-employed individuals to qualify for the deduction. Thus, they are not able to properly calculate true taxable income because some valid business expenses are not deductible.

Additional reforms should be considered to help young people obtain initial funding to start a business. For example, existing tax rules could be modified to provide incentives for established businesses to donate to entrepreneur grant programs where individuals could submit business plans with the hope of being awarded business funding.