Tax Reform - What's on the Table and What Might It Mean for You and Your Clients?

Professor Annette Nellen
College of Business
San José State University

Cal CPA Society – Tax Interest Group

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Table of Contents

Section	Page
Introduction	1
Why is Tax Reform on the National Political Agenda	2
Income Tax versus Consumption Tax	6
Design Features versus Type of Tax	8
The Panel's Two Proposals	9
How to Evaluate Tax Reform Proposals	15

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designed to help you answer these questions and educate your client as to what tax reform might mean to them, to businesses, and to the economy.

This outline looks at the following aspects of tax reform:

1) Why tax reform is on the national political agenda
2) Income tax versus consumption tax
3) Design features versus type of tax
4) The Advisory Panel's two proposals
5) How to evaluate tax reform proposals
6) Where to find more information

The accompanying slide presentation has additional information about the President's Advisory Panel and specific ideas on how to help clients understand tax reform and what it means for them.

Why Tax Reform is on the National Political Agenda

Key reasons offered for revamping or replacing the federal income tax include: simplification and economic growth. In announcing his plan for tax reform in 2004, President Bush suggested that there was a need to "fundamentally reform the tax code to make it simpler, fairer, and pro-growth."[3] Some of the specific concerns often cited about our income tax include that it discourages savings, taxes corporate income twice, provides a preference for corporate debt over equity (because interest is deductible, but dividends are not), taxes inflationary gains, incluometon eleletiba a ot c cev(Tj0.13824 Tc) Tj-0.07632 Tc (f) Tj-0.24 Tc Tc (c

excludable from income. And, only 8% of those surveyed could identify that there is an AMT formula that omits certain tax preferences from the determination of AMT.[7]

§ About 15 to 25% of eligible individuals do not claim the EITC.[8]

§ "The number of pages in the Internal Revenue Code and regulations has more than doubled over the past twenty years. Today's 'short' income tax form takes more than 11 hours to prepare - about the same as the 'long form' did a decade ago."[9]

§ Taxpayers worked over 3.5 billion hours in 2004 to complete their income tax forms – about 26 hours on average.[10]

The problem of the federal income tax being too complex has been a topic of discussion for many years. The Tax Reform Act of 1976 (P.L. 94-455) called for the Joint Committee on Taxation (JCT) to study the problem. In September 1977, the staff of the JCT issued a report to the congressional tax committees explaining why the tax law had become complex and made suggestions for simplification.[11] Twenty years later, Congress requested that the JCT study problems of the tax law by issuing to each Congress (when funded to do so), a report on the overall state of the Federal tax system including possible simplification proposals.[12] In April 2001, the JCT issued an immense 3-volume report, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification* (JCS-3-01) which reviews the entire code and explains sources of complexity and possible solutions. Within two months of the issuance of the JCT's report, the Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) was enacted which *increased* the comple9j0.02544 Tc (s) Tj-0.10176 -0.0765k oe edc iP.s ro P.s

Country	Household net saving rates % of disposable household income
Canada	1.4
France	11.1
Germany	10.7
Japan	

In July 2003, the Senate Finance Committee held a set of hearings on the competitiveness of U.S. firms from both the perspective of U.S.-based firms and U.S.-owned foreign operations. Several witnesses noted areas where U.S. tax laws had not kept up with changes in today's global marketplace and ways of doing business. As noted in testimony by the Assistant Secretary of the Department of the Treasury: "Many areas of our tax law are in need of reform to ensure that our tax system does not impede the efficient, effective, and successful operations of U.S. companies and the American workers they employ in today's global marketplace."[18]

4. The tax gap is too large

The IRS estimates that for 2001, the tax gap (the difference between taxes owed and taxes paid on time) was between $312 billion to $353 billion for all types of taxes. This means that the rate of non-compliance with federal taxes is between 15% and 16.6%. The IRS estimates that its enforcement and collection efforts eventually bring the uncollected amount down to between $257 and $298 billion.[19] The National Taxpayer Advocate notes that with 130 million individual taxpayers in the U.S., on average, each of these individuals pays about $2,000 annually to "subsidize" this non-compliance. The IRS estimates that 67% of this tax gap is due to non-filing and under-reporting by sole proprietors whose income is not subject to W-2 and 1099 reporting. The National Taxpayer Advocate also notes that the tax gap has grown at "ever-expanding rates" in the past 20 years. The gross tax gap was estimated at $76 billion in 1981, $127 billion in 1992 and $310 in 2001. Thus, the gap increased 67% from 1981 to 1992, but from 1992 to 2001, increased 144%[20]

The 2004 annual report of the IRS Oversight Board noted that public attitudes towards cheating on tax returns have worsened since 1999. In 1999, 11% of Americans indicated that it was okay to cheat at least a little on their tax return, that number was 13% in 2002 and 17% (almost one in five people) in 2003.[21]

5. The system is not neutral

The current U.S. tax system is frequently used to create incentives to either encourage a particular activity or discourage a particular activity (that is, it is not neutral). Just about any economic, social or environmental "problem" can be allev oo

"cheaper" than having a tax preference for bond interest. However, such analysis is rarely performed due to its difficulty and the ease of adding preferences to the tax law. Also, once a tax preference is added to the tax law, there is not systematic approach to evaluating them regularly for effectiveness and value. Such preferences get added to the list of "tax expenditures" and measured frequently, but with no evaluation of their value.[23]

Some preferences have evolved to the point of, arguably, losing sight of their underlying purpose. For example, a home mortgage deduction is allowed to encourage home ownership. However, the current tax rule allows for deduction of mortgage interest on two homes, rather than just one, and on debt up to $1.1 million, far greater than the average home cost in the U.S. This rule also allows an interest deduction for home equity loans which have nothing to do with acquiring a home, but allow homeowners to deduct interest on loans used for personal expenditures – something a non-homeowner is unable to do. The charitable contribution deduction yields the same benefit to an individual making a donation to a private university or symphony orchestra as for someone donating to an organization to help those who might be viewed as more in need of philanthropic support (such as people who are poor or ill). In addition, a desire to help families and individuals pay for higher education has yielded several different provisions all aimed at the same goal. How many different types of preferences are needed for one goal?

With respect to the likely impact of the tax rules on investments, the Advisory Panel's Final Report notes the following effective tax rates on different investme itnannm e l tTj(t) Tj88 T Tj02 Tc (m) Tj-0.10176 Tc (e) T

7. The federal income tax violates the equity and fairness principle

The selective nature of deductions, exemptions and credits arguably causes taxpayers with similar levels of economic income to pay different amounts of tax. For example, an individual with significant medical expenses might get a deduction whereas an individual with an equal amount of education expenses will not get a deduction and so will pay more tax even thought their income and cash availability amounts are similar.

Also, the deduction of state income and property taxes (although not for A912 Tc (l) Tj0.012 Tc (l) Tj0.012 Tc (l) Tj0

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- Medium – gross receipts over $1 million and less than or equal to $10 million
  - Could use “simplified and expanded cash accounting” (page 128)
  - For inventory, can follow Rev. Proc. 2002-28
- Large – gross receipts over $10 million
  - Today, there are only about 150,000 active U.S. businesses of this size (page 129)
  - Flat tax rate of 31.5%
  - Taxed at entity level as corporations meaning that owners can exclude distributions of U.S. earnings and exclude 75% of capital gains on sale of interests in large businesses.
  - Partnerships, S corporations and LLCs of this size will have domestic earnings subject to tax at the entity level. Rationale to treat all large corporations the same is to allow fewer opportunities for tax shelters and simplify taxation of the owners.
  - All tax preferences eliminated except for accelerated depreciation including R&D credit, §199 deduction, and deductions for state and local taxes.
  - Panel recommends a study on use of financial statement income for tax purposes for further simplification.

§ Small and Medium Businesses

- § Subject to individual tax rates
- § Panel recommends that rules on contributions, distributions, liquidations and allocations of income for passthrough entities be simplified and that a partnership of only a married couple be allowed to be treated as a sole proprietorship. Apparent goal is to have all U.S. businesses subject to just a single layer of tax, at least for domestic earnings.
- § Special recordkeeping for small and medium businesses: Must use “designated bank accounts into which they would deposit all receipts and from which they would make business expenditures.” No personal expenditures could be made from the account. Banks would have to give the business an annual summary of inflows and outflows which would also be reported to the IRS. Issuers of debit and credit cards wouldinna ts u0 Tc (/F3 11.0.05

§ Transition recommendations for businesses:

- Phase-out for depreciation deductions on existing depreciable assets.
- Phase-out for interest expense deductions on existing debt.
- 4-year phase-in for border-tax adjustments (tax on imports).
- Special rules for financial institutions.
- Perhaps others for credits and other items.

The panel notes the tension between transitional relief, tax rates and the economic growth and efficiency gains expected from a consumption tax.

For further details of both plans, see Chapters 5 to 7 and the Appendix of the report available at http://taxreformpanel.gov/final-report/.

Commonalities of the Two Proposals

Current	Proposed pa( ) Tj0.05088 Tc (t) Tj0 Tc (h) Tjj0.05088 Tc

Current	Proposed
Home mortgage deduction - if itemize deductions - 2 homes - up to $1,100,000 of debt - home equity debt possible rather than non-deductible personal debt	Home credit - 15% of mortgage interest paid - limited to average regional price of housing ($227,000 to $412,000) - only for debt to acquire, build or substantially improve a principal residence - no need to itemize - 5-year phase-in recommended (pages 74 and 238) - benefits all homeowners rather than just the 35% that itemize today - reduce the inequity of current system where over 55% of the "cost" of mortgage interest deductions go to about 12% of taxpayers with cash income of $100,000 or more - eliminates the incentive to overinvest in housing and purchase of luxury homes and vacation homes subsidized by a tax deduction - eliminates the benefit homeowners get from the home equity loan rules while non-homeowners incur non-deductible personal interest
Health insurance - generally only allowed to use pre-tax dollars if provided by employer	Health insurance - All taxpayers may purchase with pre-tax dollars up to the amount of an average premium ($5,000 individual and $12,500) - Should make more taxpayers aware of the cost so they can make better insurance decis s x dors may pux Tc (0.24) Tj0.0(x) T4 Tj0.0777

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Current	Proposed
Educational savings plans (Coverdell, 529, savings bonds)	Save for Family Account - For all taxpayers. - Annual $10,000 contribution limit; after-tax. - Grows tax-free. - Would also replace various health accounts and flexible spend

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