The President's Advisory Panel on

Federal Tax Reform

www.taxreformpanel.gov

Understanding Tax Bases
Staff Presentation
July 20, 2005

Clean Tax Bases

- **What is in the tax base?**
  - There are numerous deductions, credits and exclusions in the current code
    - ★ Many are designed to make system more progressive
    - ★ Many intended to encourage behavior
    - ★ Many are targeted at specific groups
  - Regardless of whether they have intended effect at appropriate costs, they narrow the tax base and require higher rates for everyone.
  - Called “tax expenditures”
    - ★ Represent revenue loss from various credits, deductions, exclusions, special rates, deferral of tax liability
    - ★ Policy makers now identify and estimate 146 tax expenditures. Majority administered through individual code.

Cleaning the tax base

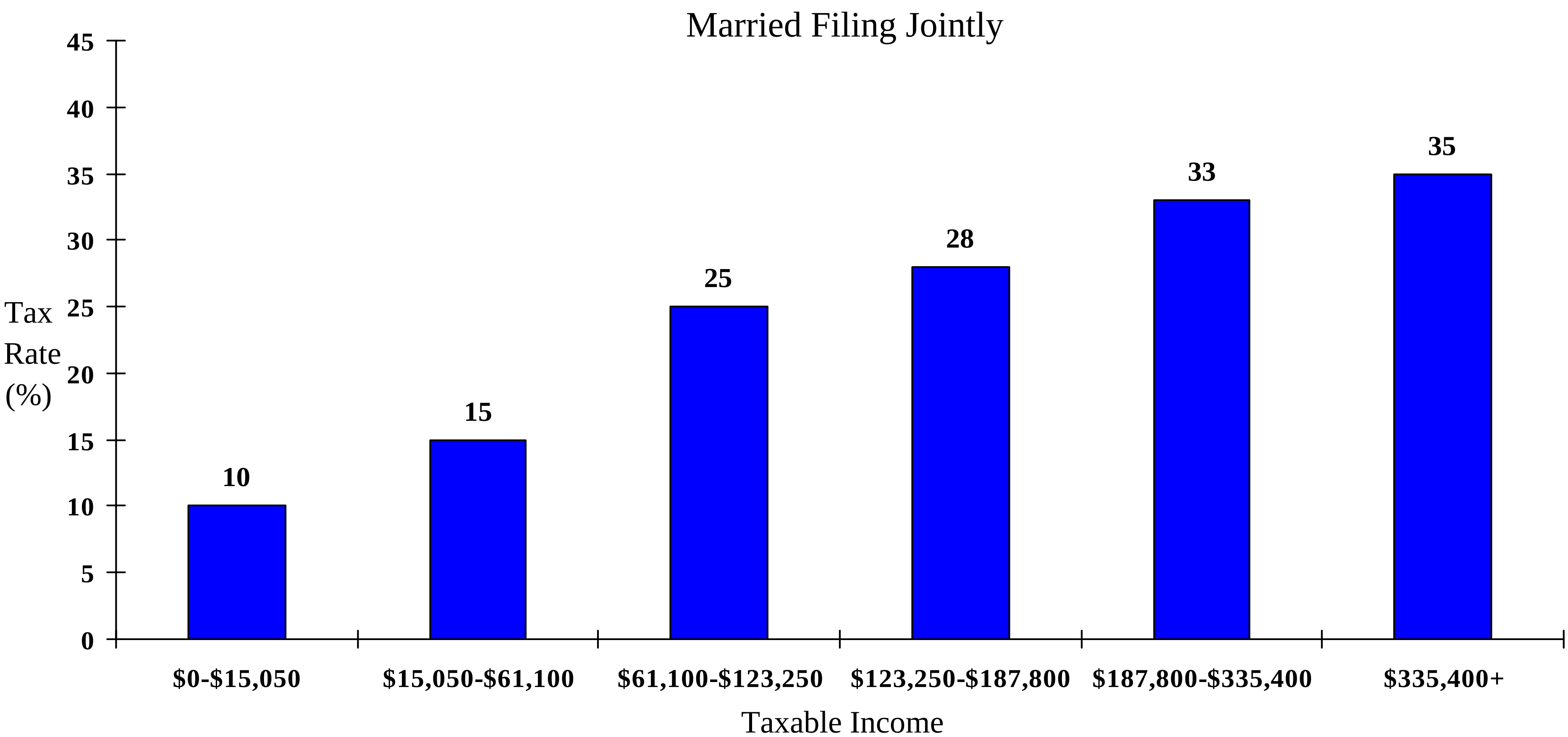
- Policy experiment:
  - Holding current law brackets constant, what tax rates would be revenue neutral?
  - What single rate would be revenue neutral?
- "Broad income tax base" (see Appendix A for more details)
  - Retain standard deduction and personal exemptions
  - No credits, no above-the-line deductions, no itemized deductions, no special deductions
  - No AMT
  - No exclusions for employer-provided fringe benefits, no exclusions for employee contributions to retirement accounts
  - Integrate corporate and individual tax
    - No double taxation of business income
    - 100% dividend exclusion at individual level and basis adjustment for retained earnings (for both individual and corporate shareholders)
    - Capital gains taxed at ordinary rates

Cleaning the income tax base

- Corporate income tax (see Appendix A for more details)
  - Eliminate credits, special rates, graduated rates, and AMT
  - No accelerated cost recovery (economic depreciation)
  - No manufacturer's deduction

- Corporate rate would be set equal to top individual rate

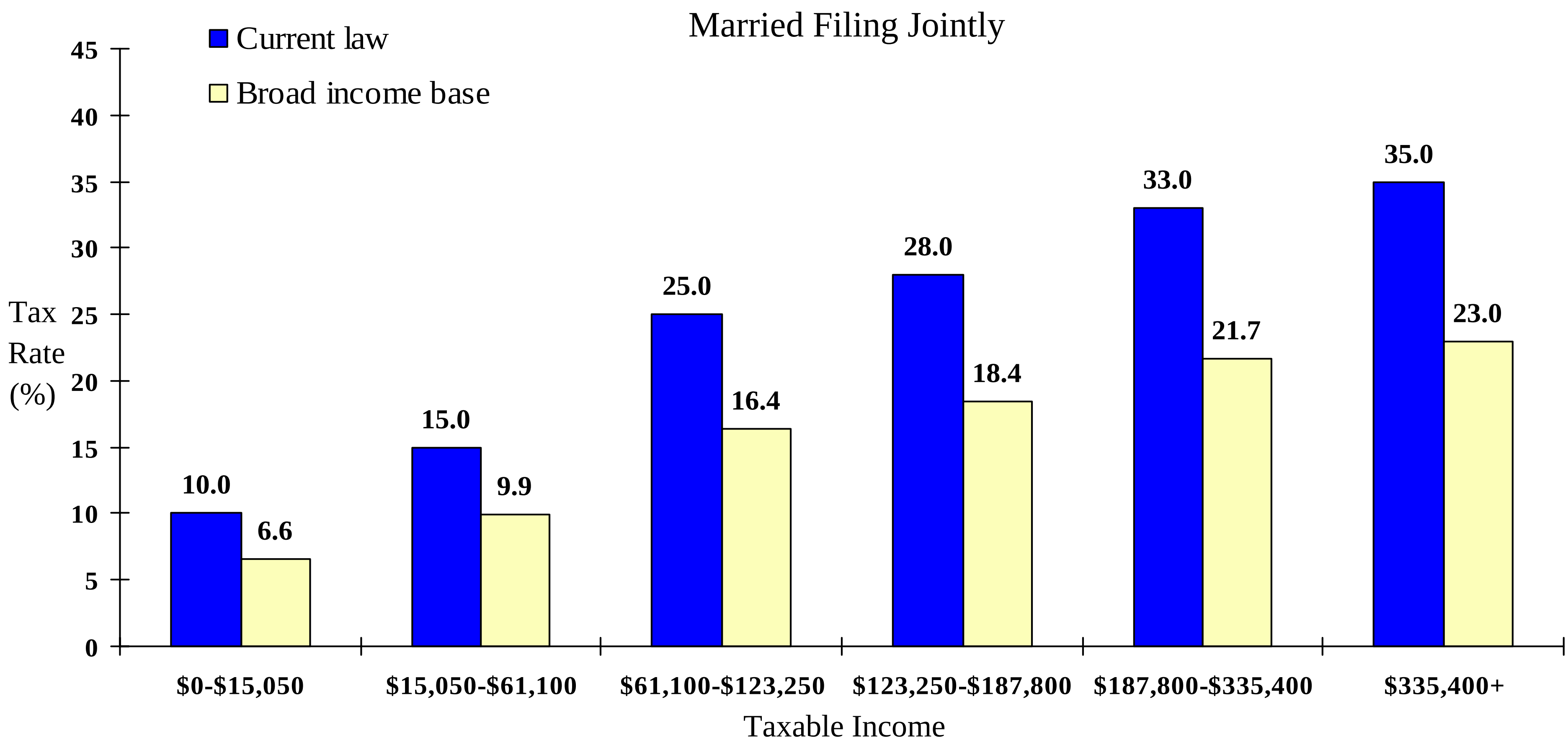
Tax Rate Schedule: Current Law



Source: Department of the Treasury, Office of Tax Analysis.

Note: Taxable income brackets are estimates for 2006.

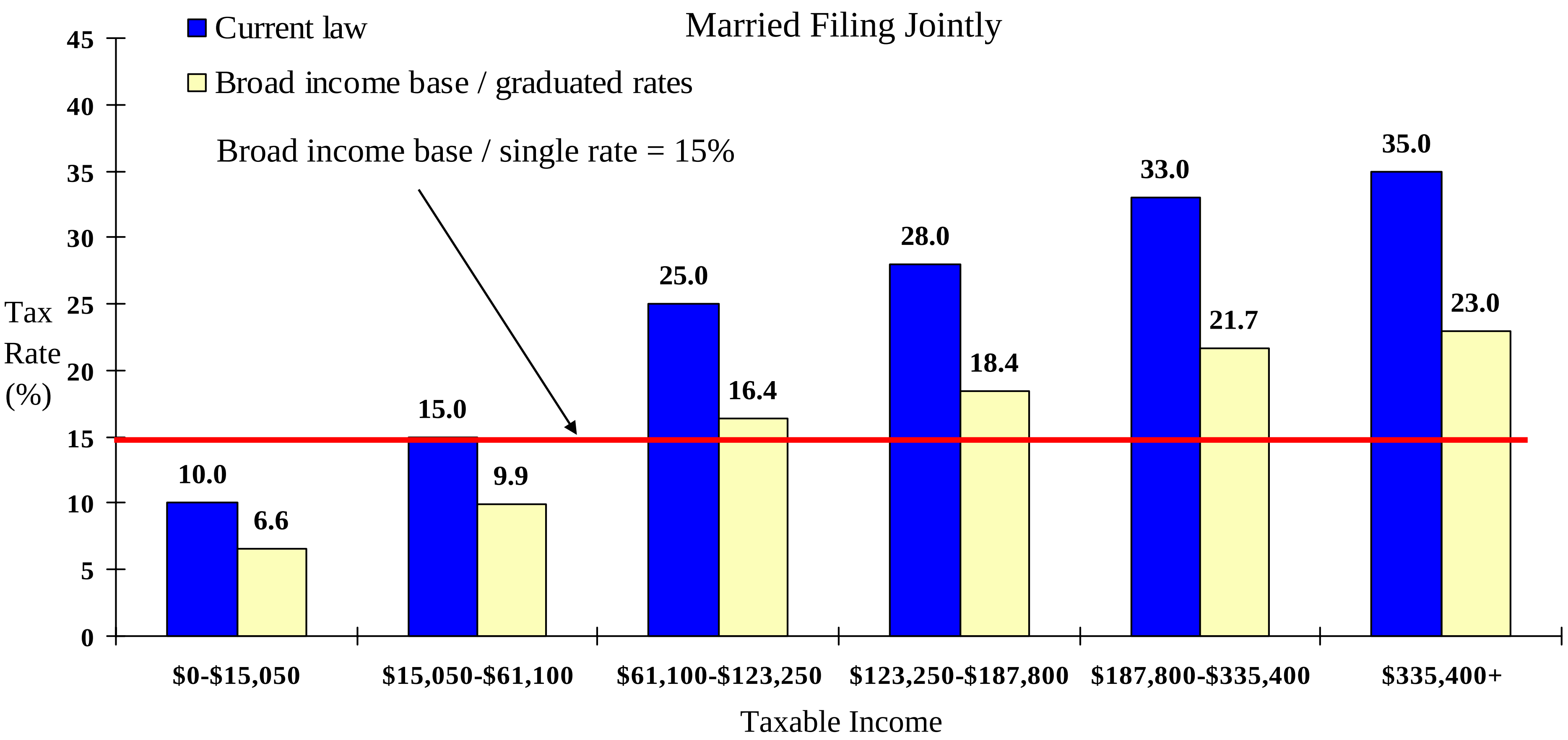
Tax Rate Schedule:
Broad Income Base with Graduated Rates



Source: Department of the Treasury, Office of Tax Analysis.

Note: Taxable income brackets are estimates for 2006.

Tax Rate Schedule: Broad Income Base



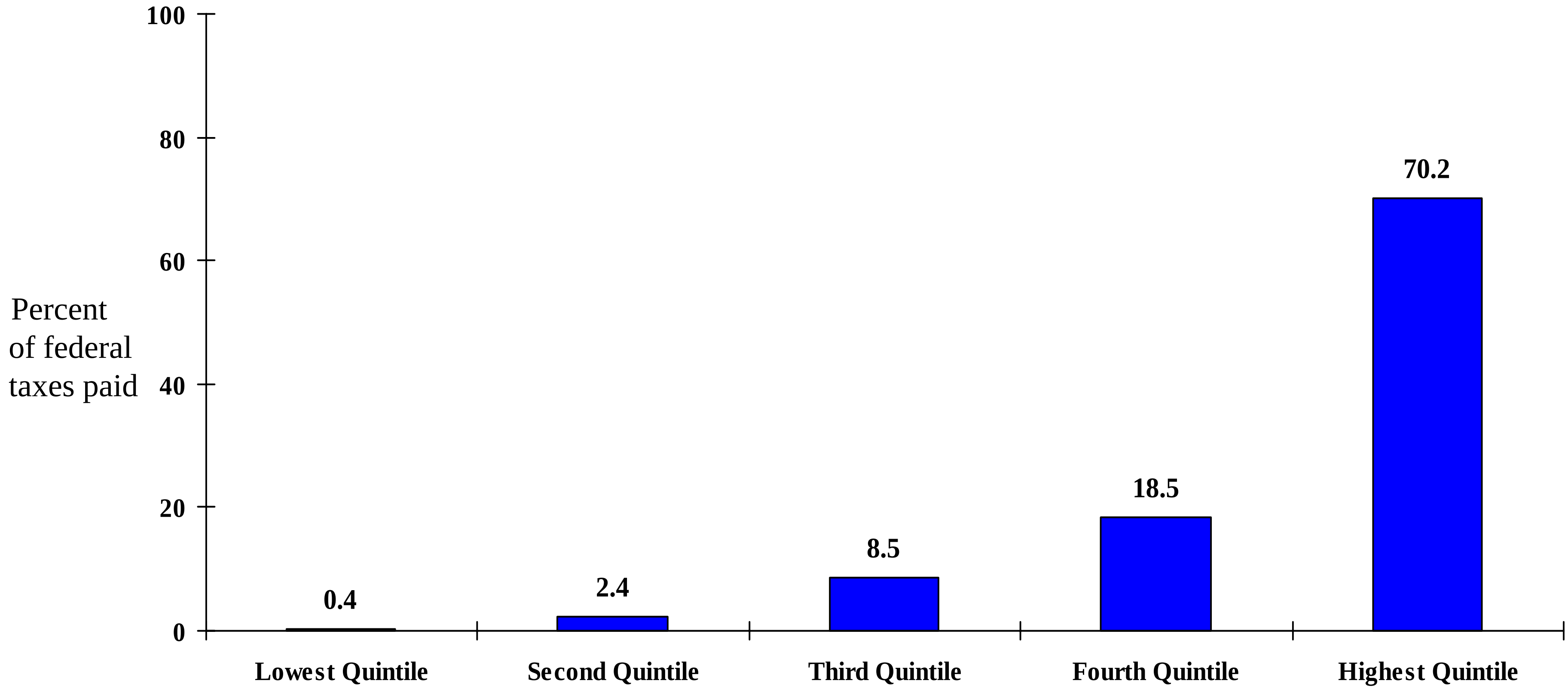
Source: Department of the Treasury, Office of Tax Analysis.

Note: Taxable income brackets are estimates for 2006.

Distributional analysis*

*See Appendix B for detail on Treasury distributional analysis

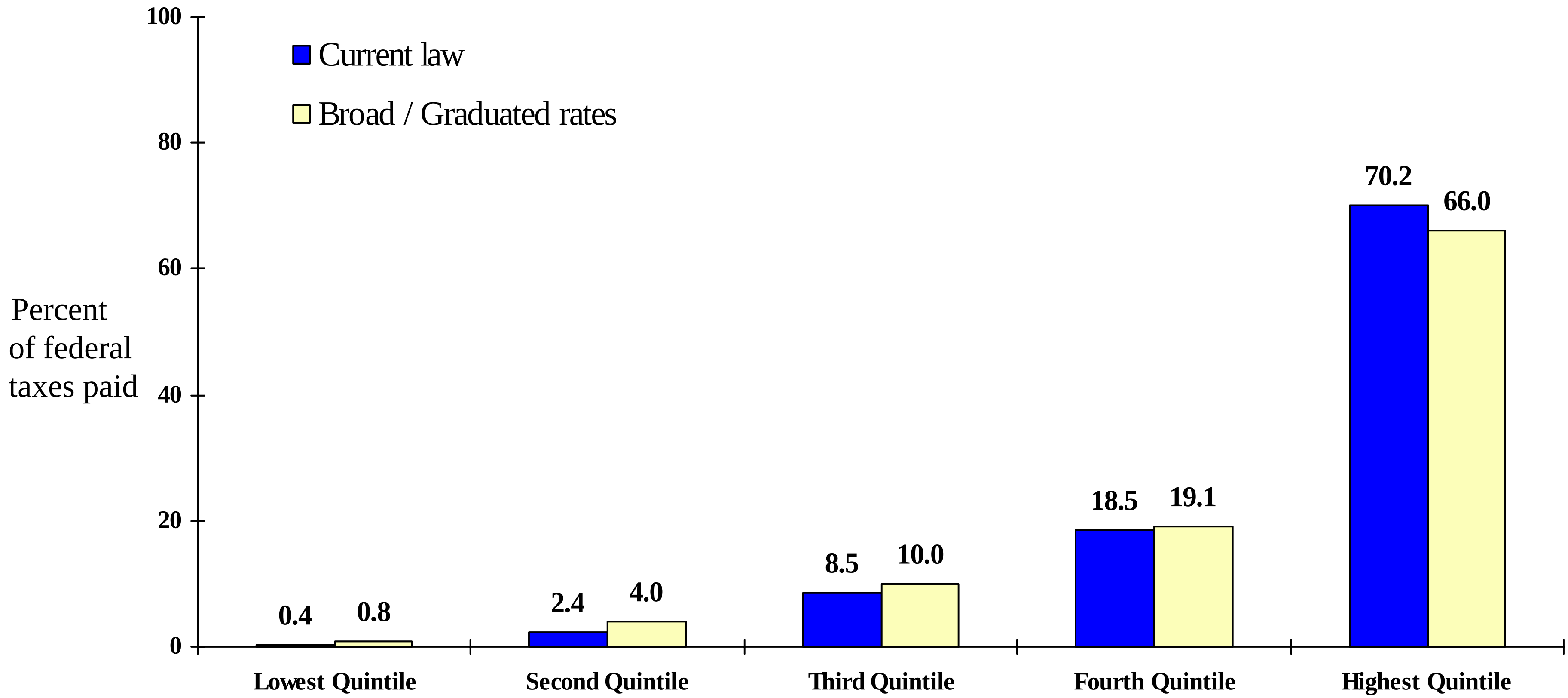
Distribution of Tax Burden: Current Law



Source: Department of the Treasury, Office of Tax Analysis.

Note: Estimates of 2006 law at 2004 income levels.

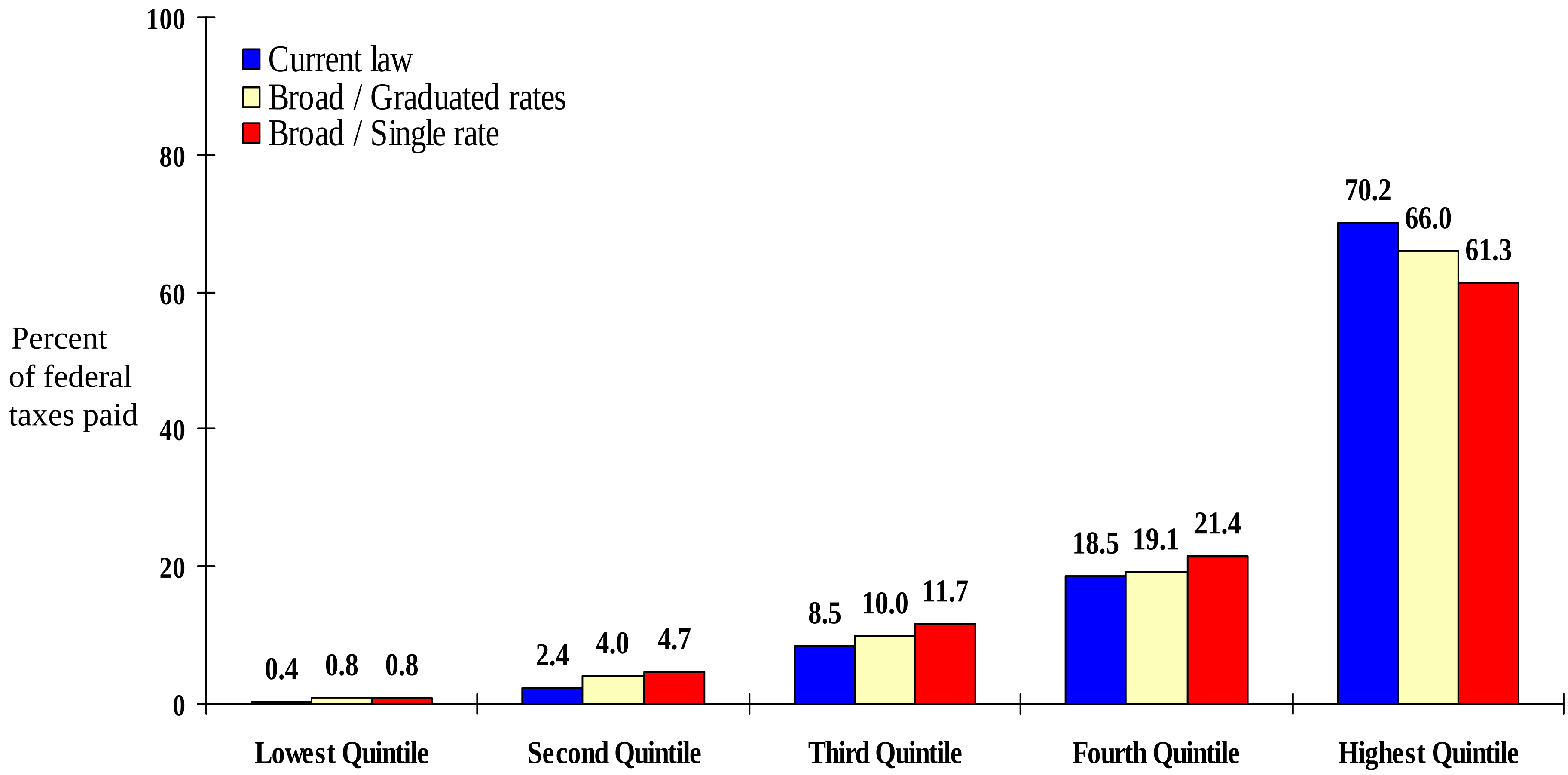
Distribution of Tax Burden: Broad Income Base / Graduated Rates



Source: Department of the Treasury, Office of Tax Analysis.

Note: Estimates of 2006 law at 2004 income levels.

Distribution of Tax Burden: Broad Income Base



Source: Department of the Treasury, Office of Tax Analysis.

Note: Estimates of 2006 law at 2004 income levels.

Experimenting with a Flat Tax Proposal

- Policy experiment
  - What is the revenue neutral Flat Tax rate?

- Replace current individual and corporate income taxes with revenue neutral Flat Tax
  - Flat Tax encourages savings and investment by eliminating the double tax on business income and the tax on the return to savings (e.g. capital gains, dividends, interest) at both the individual and business level.
  - Accordingly, the base is smaller than the broad income base.

Flat Tax

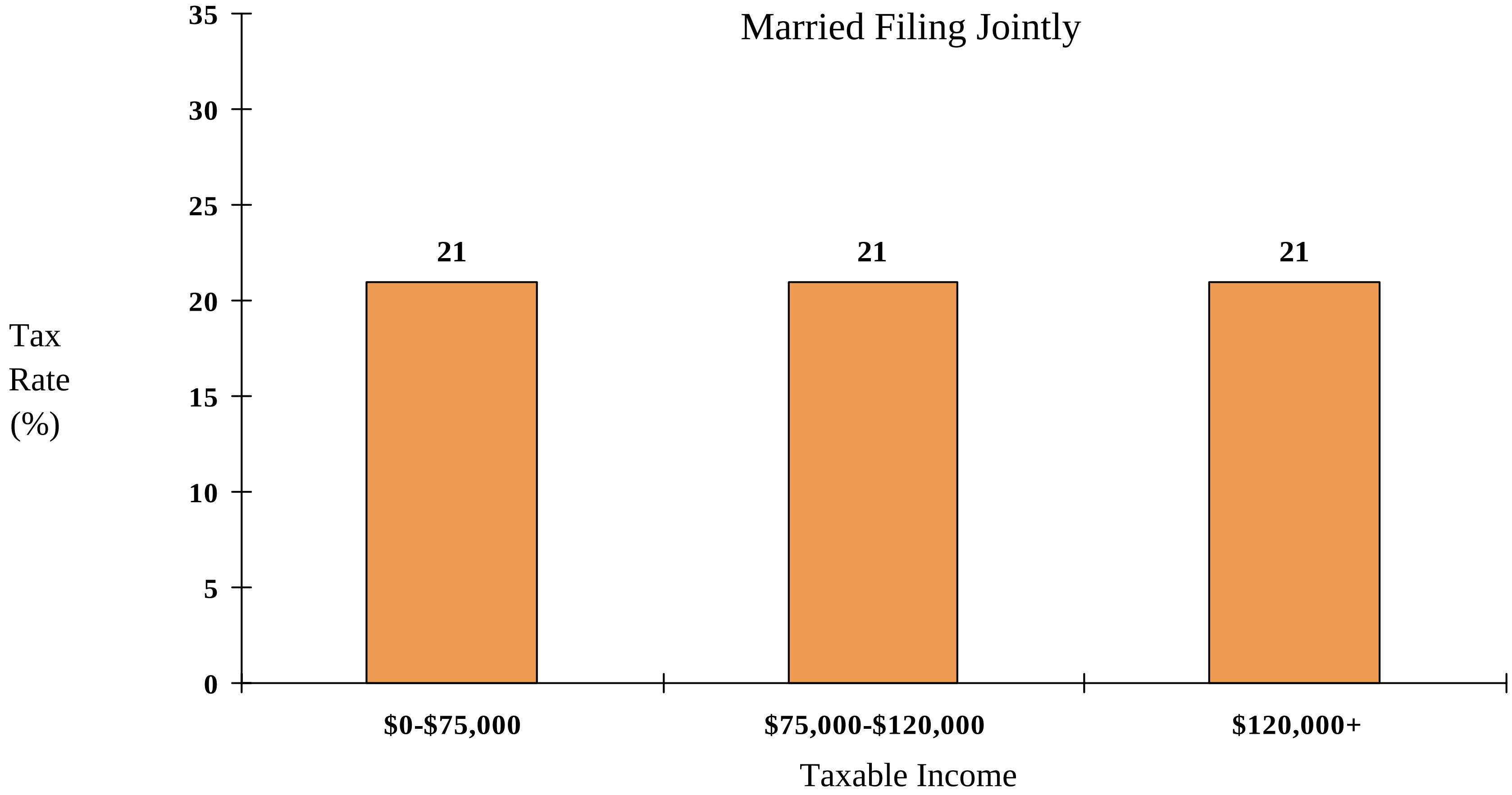
- Individual base (see Appendix A for more details)
  - Retains standard deduction and personal exemptions but at higher levels than under the broad income tax
  - No credits, no above-the-line deductions, no itemized deductions, no special deductions
  - No AMT
  - Exclude dividends, interest, and capital gains
  - No exclusions for employer-provided fringe benefits

Flat Tax

- Corporate base
  - Cash-flow
  - No interest deduction
  - Exclude dividends, interest, and capital gains
  - Eliminate credits, special rates, graduated rates, and AMT
  - Replace accelerated cost recovery system with expensing
    - ★ Businesses immediately deduct 100 percent of all investments
  - No manufacturer’s deduction

- Corporate rate would be set equal to the individual rate

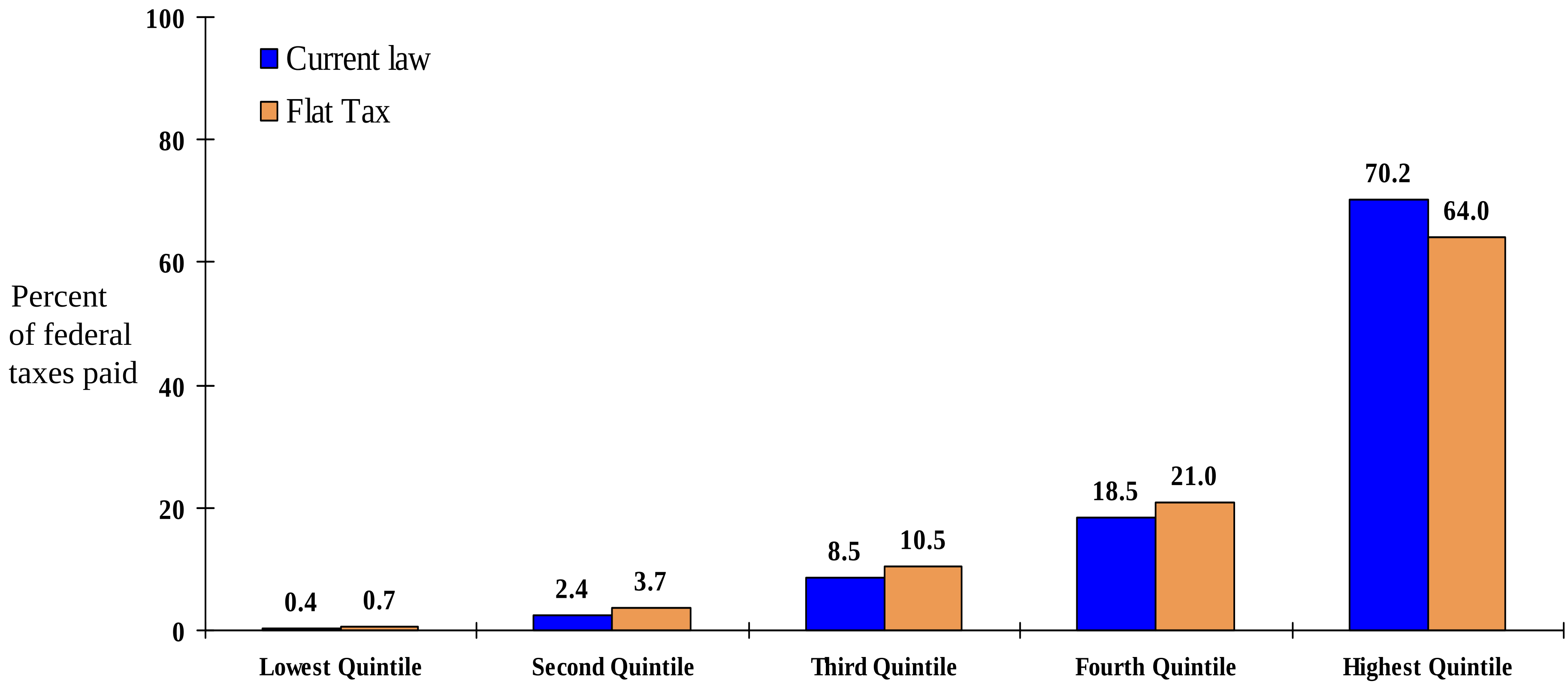
Tax Rate Schedule: Flat Tax



Source: Department of the Treasury, Office of Tax Analysis.

Note: Taxable income brackets are estimates for 2006.

Distribution of Tax Burden: Flat Tax



Source: Department of the Treasury, Office of Tax Analysis.

Note: Estimates of 2006 law at 2004 income levels.

National Sales Taxes

- Replace current <u>individual and corporate income taxes</u> with a national retail sales tax (NRST) or a value added tax (VAT)
- NRST
  - Broad tax base (see Appendix A for details)
    - ★ All retail sales of goods and services to individuals taxed except educational services, expenditures abroad by U.S. residents, food produced and consumed on farms, imputed rent on owner-occupied and farm housing
  - No rebate
  - Rate depends on compliance
    - ★ Panel requested estimates given in ranges from current level of evasion to two times the current level

National Retail Sale Tax with Broad Base and No Rebate

- Tax-exclusive and tax-inclusive sales tax rates
  - Assume a good costs $100 before tax and there is a $25 sales tax
  - Tax-exclusive rate = $25/$100 = 25%
    - This is the "markup at the cash register"
  - Tax-inclusive rate = $25/$125 = 20%

- Revenue neutral tax-inclusive rate* = 18% to 21%
- Revenue neutral tax-exclusive rate* = 22% to 27%

***Source*: Department of the Treasury, Office of Tax Analysis

Note: These rates only replace income tax revenues. The payroll tax would remain in place.

Value Added Tax

- VAT
  - All businesses taxed on difference between the value of their sales and the value of their purchases
  - Same base as NRST
  - Assume current evasion levels
  - Revenue neutral rate* = 18%

Source: Department of the Treasury, Office of Tax Analysis

Broad bases are not common for sales taxes or goods and services taxes

- NRST with typical U.S. state sales tax base
  - Typical state retail sales taxes exempt a wide variety of goods and services and some entities from their sales taxes
    - ★ Every state exempts prescription drugs, most exempt some food (or tax it at a preferential rate), many exempt clothing, and most offer a wide variety of other exemptions for goods
    - ★ Most do not broadly tax services, such as financial services, medical services, government-provided services, utilities, transportation, and communication services under their sales taxes
    - ★ State sales taxes generally exempt governments and charities (including educational institutions)
  - Revenue neutral tax-inclusive rate* = 39% to 46%
  - Revenue neutral tax-exclusive rate* = 64% to 87%

**Source*: Department of the Treasury, Office of Tax Analysis

Replacing parts of the income tax with a broad base goods and services tax

- Same broad tax base (see Appendix A for details)
  - Replacing the individual and corporate AMT
    - ★ Revenue neutral tax rate* = 1%
  - Replacing the individual and corporate AMT and reducing individual and corporate rates across the board by 50%
    - ★ Revenue neutral tax rate* = 10%
  - Replacing the corporate income tax
    - ★ Revenue neutral tax rate* = 3%

**Source*: Department of the Treasury, Office of Tax Analysis

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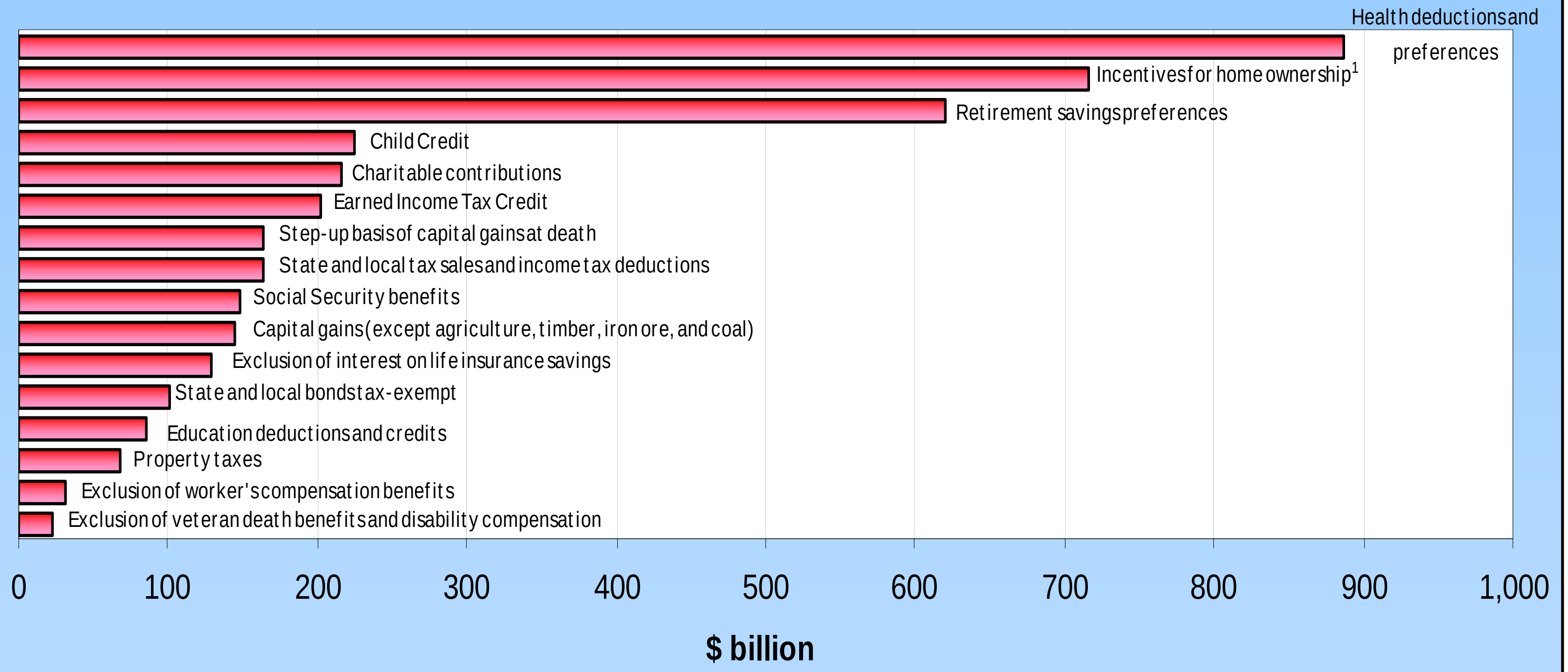
Adding tax expenditures to the "broad" bases

Largest Individual Tax Expenditures (FY 2006-2010)



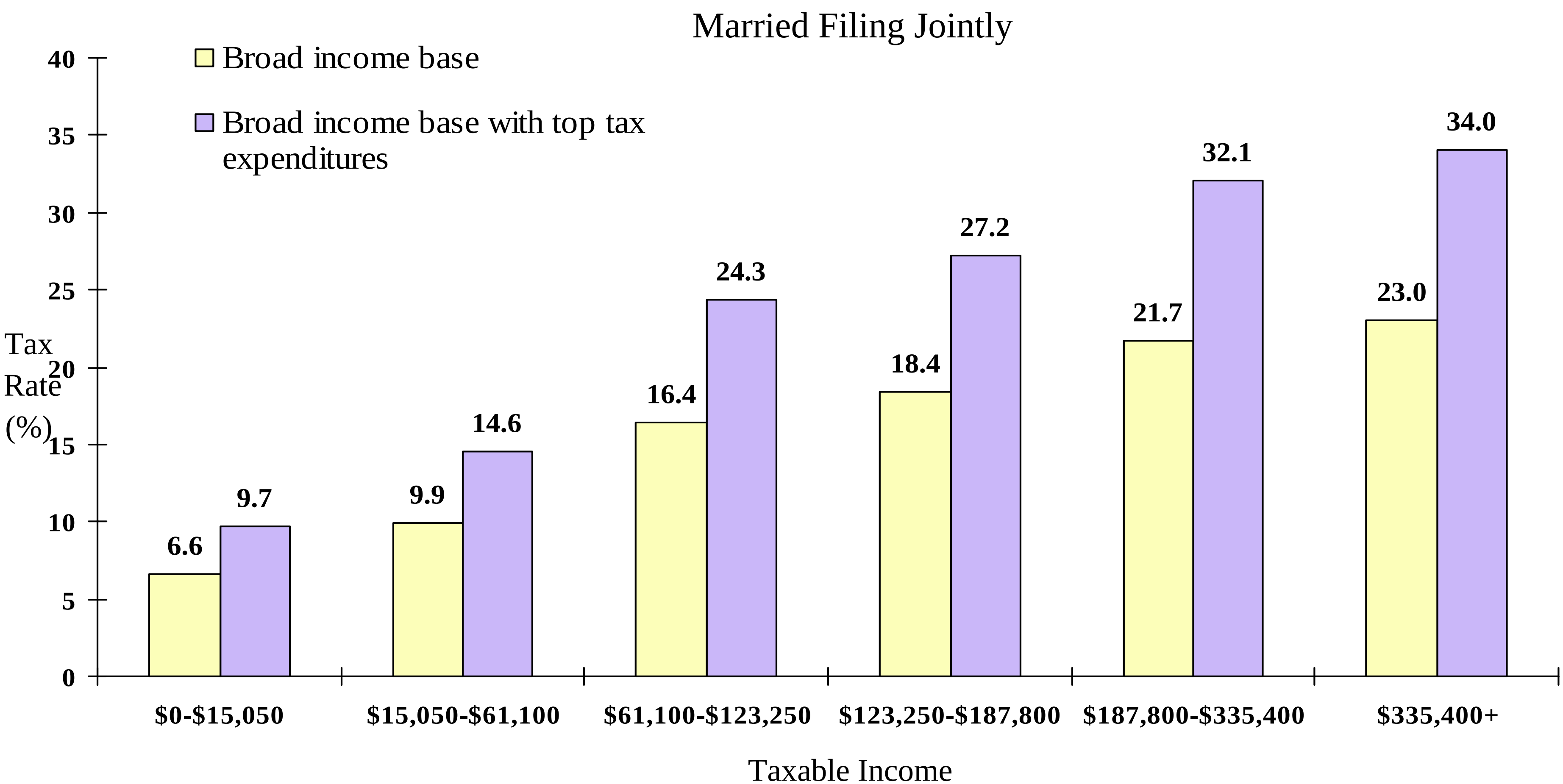
[1] Does not include exclusion of net imputed rental income on owner-occupied homes, $185.2 billion.

Source: Office of Tax Analysis, U.S. Department of the Treasury

Adding tax expenditures to the "broad" base

- Add the earned income tax credit and the top five household and business tax expenditures to the "broad" income tax base
  - Household
    - ★ Exclusions for employer contributions for health insurance and pensions
    - ★ Retirement savings preferences
      - Employee contributions to 401(k) plans and IRAs
      - Earnings on pensions, IRAs and life insurance
    - ★ Itemized deduction for mortgage interest
    - ★ Itemized deduction for charitable contributions
    - ★ Child Tax Credit
  - Business
    - ★ Accelerated depreciation, oil and gas preferences, manufacturer's deduction, graduated corporate rates, R&E credit

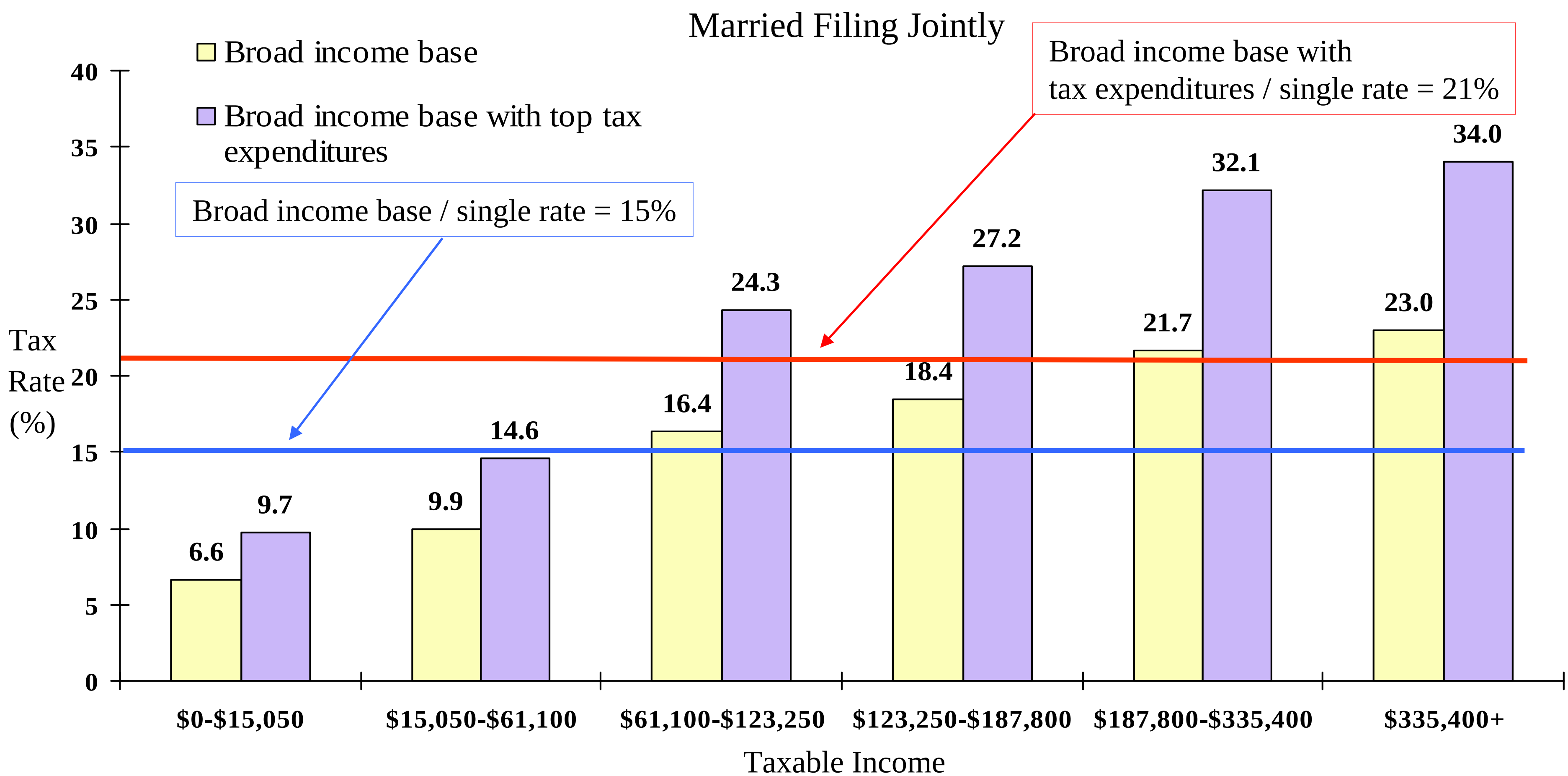
Tax Rate Schedule: Broad Income Base with Top Tax Expenditures Added Back



Source: Department of the Treasury, Office of Tax Analysis.

Note: Taxable income brackets are estimates for 2006.

Tax Rate Schedule: Broad Income Base with Top Tax Expenditures Added Back



Source: Department of the Treasury, Office of Tax Analysis.

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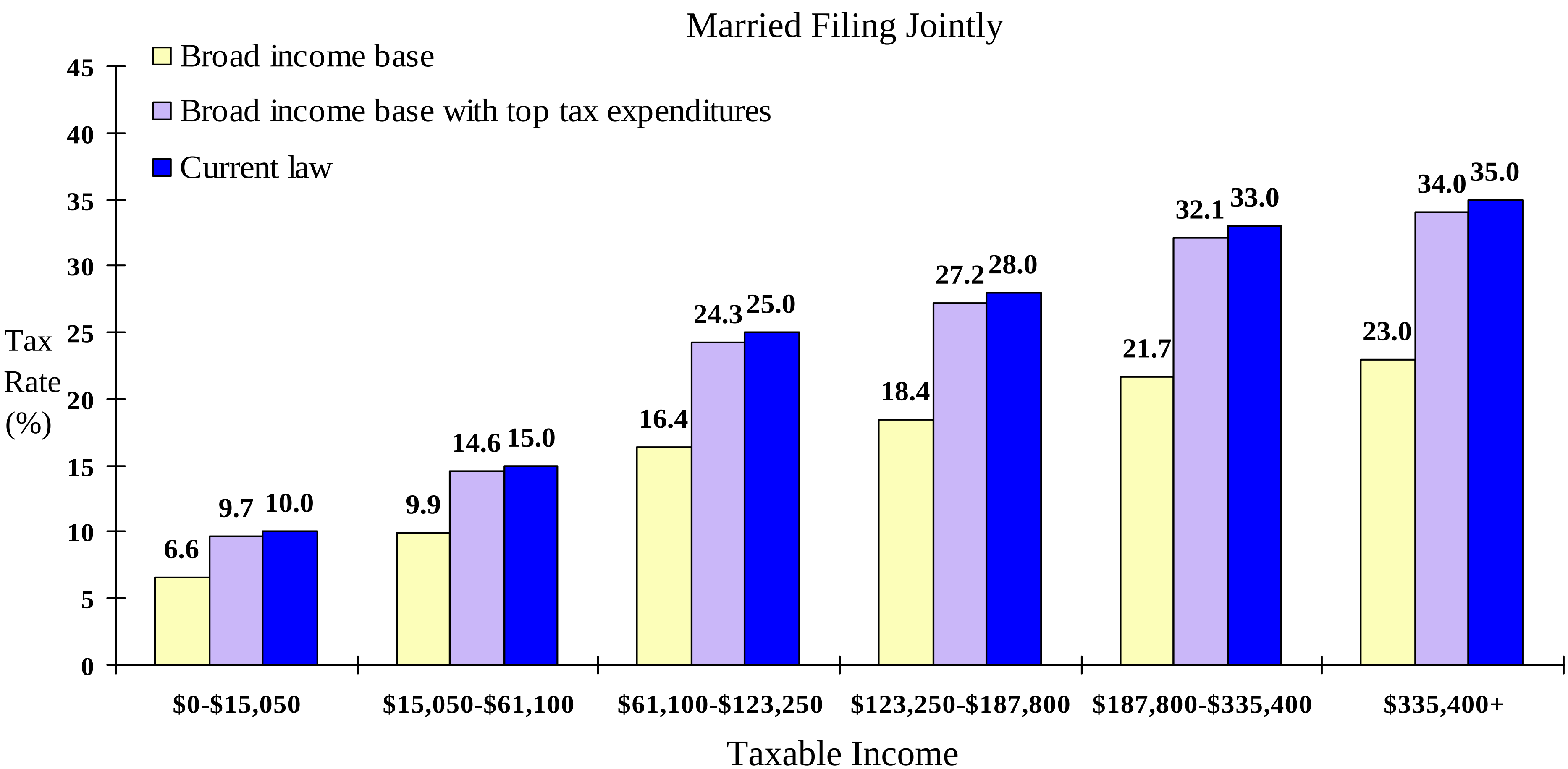
Tax Rate Schedule: Broad Income Base with Top Tax Expenditures Added Back

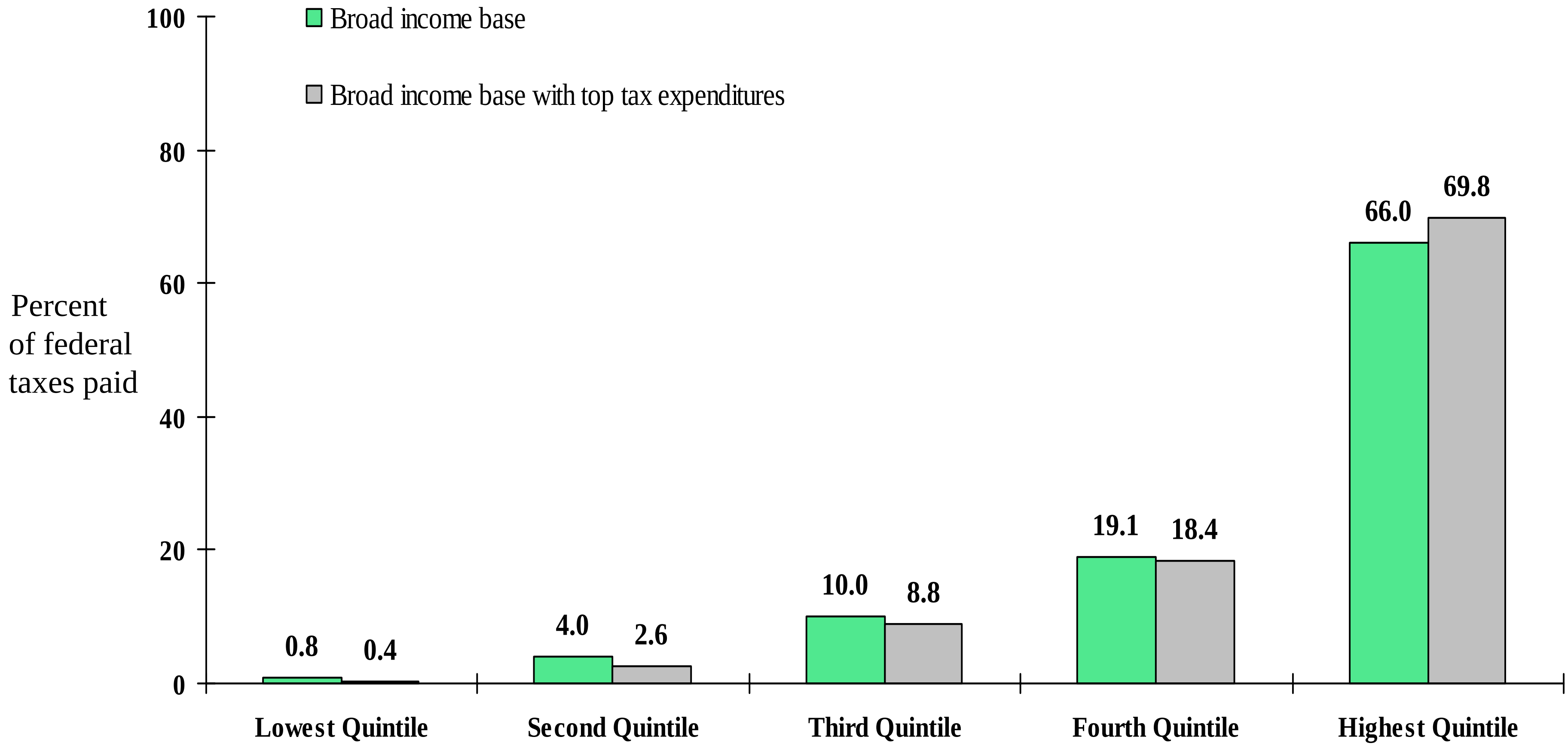


Source: Department of the Treasury, Office of Tax Analysis.

Note: Taxable income brackets are estimates for 2006.

Distributional analysis

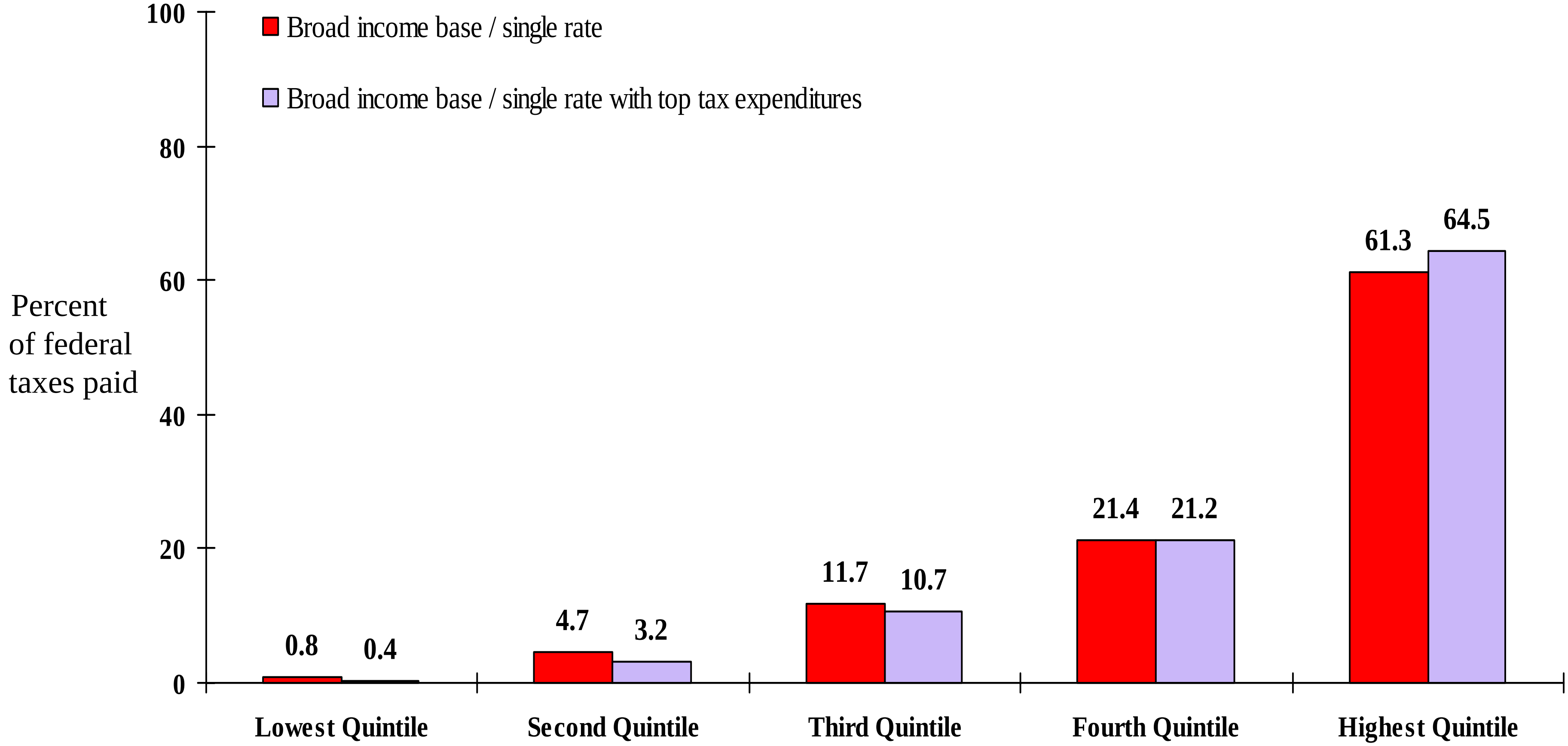
Distribution of Tax Burden: Broad Income Base with Graduated Rates and Top Tax Expenditures



Source: Department of the Treasury, Office of Tax Analysis.

Note: Estimates of 2006 law at 2004 income levels.

Distribution of Tax Burden: Broad Income Base / Single Rate with Top Tax Expenditures



Source: Department of the Treasury, Office of Tax Analysis.

Note: Estimates of 2006 law at 2004 income levels.

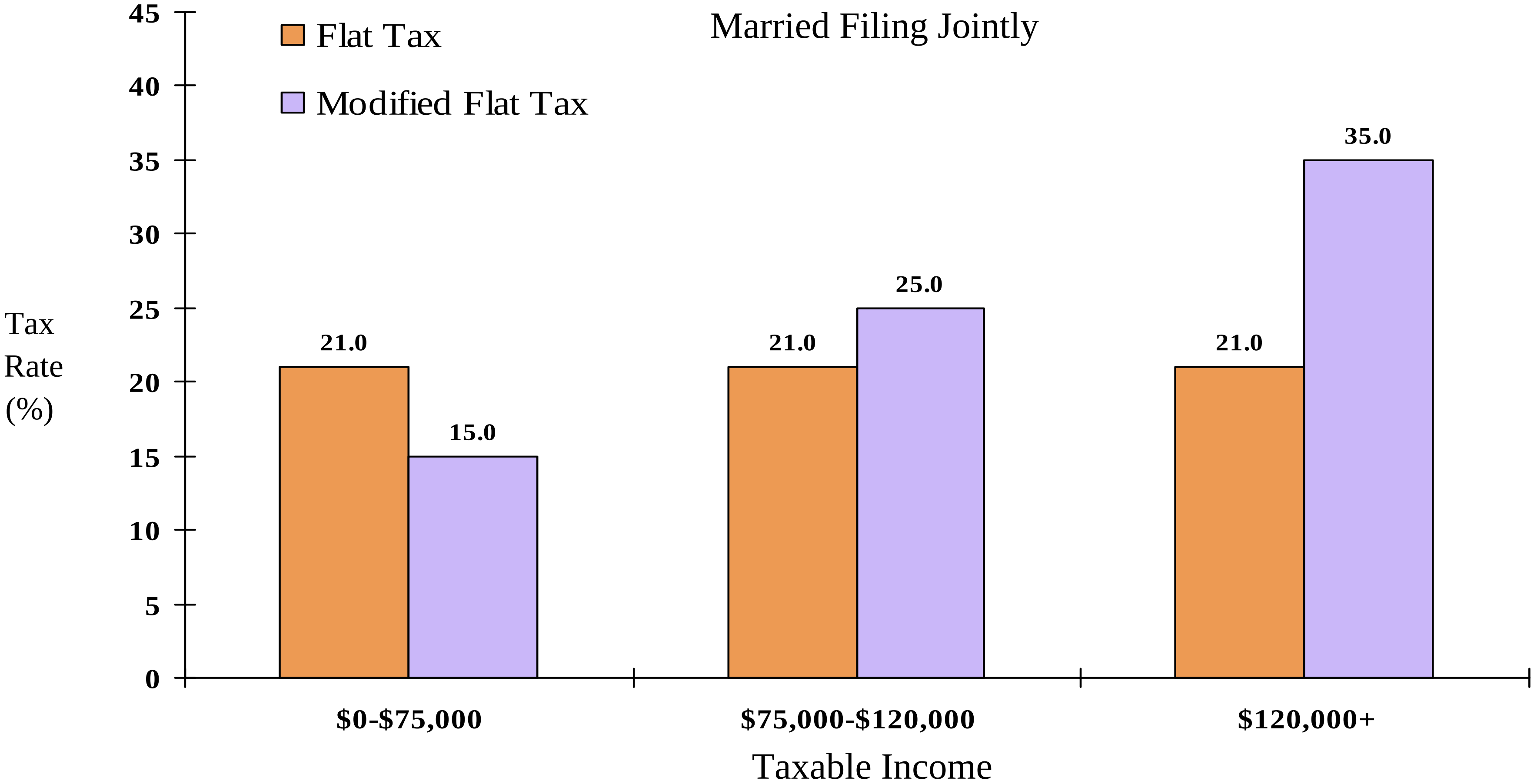
Adding tax expenditures to the Flat Tax base

- Make the Flat Tax more progressive by adding a graduated structure and the earned income tax credit
  - Modified Flat Tax
  - Keep current system rates of 15%, 25% and 35%
  - Same standard deduction and personal exemptions as Flat Tax (see Appendix A for details)
  - Tax brackets

15% bracket	Up to $75,000 joint ($37,500 single)
25% bracket	$75,000 - $120,000 joint ($60,000 single)
35% bracket	Over $120,000 joint ($60,000 single

- Add top tax preferences to Modified Flat Tax
  - Household: Exclusions for employer contributions for health insurance, itemized deductions for mortgage interest and charitable contributions, child tax credit
  - Business: Oil and gas preferences, manufacturer's deduction, progressive corporate rates, R&E credit

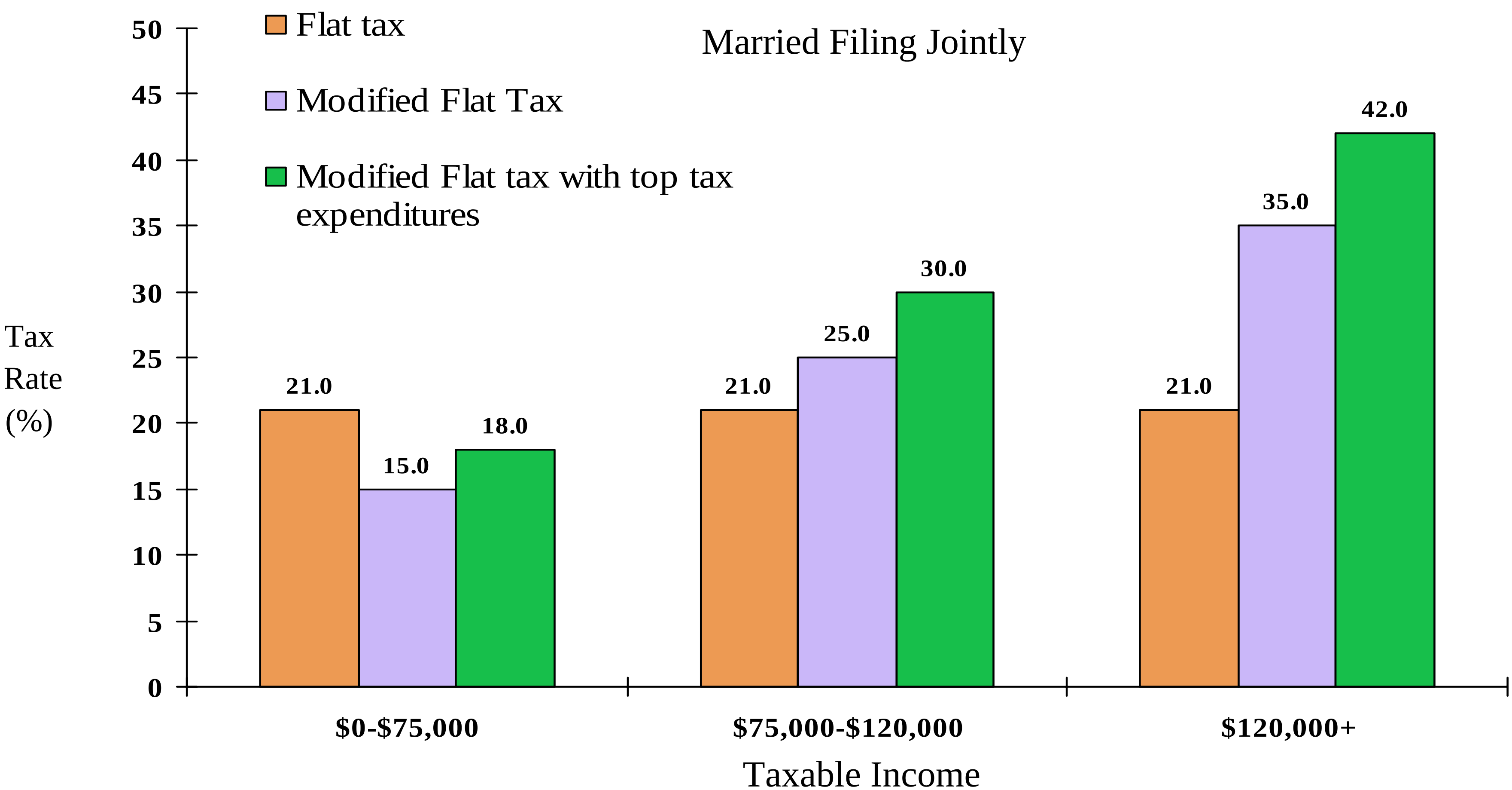
Tax Rate Schedule: Flat Tax and Modified Flat Tax



Source: Department of the Treasury, Office of Tax Analysis.

Note: Taxable income brackets are estimates for 2006.

Tax Rate Schedule: Comparison of Flat Tax and Modified Flat Taxes

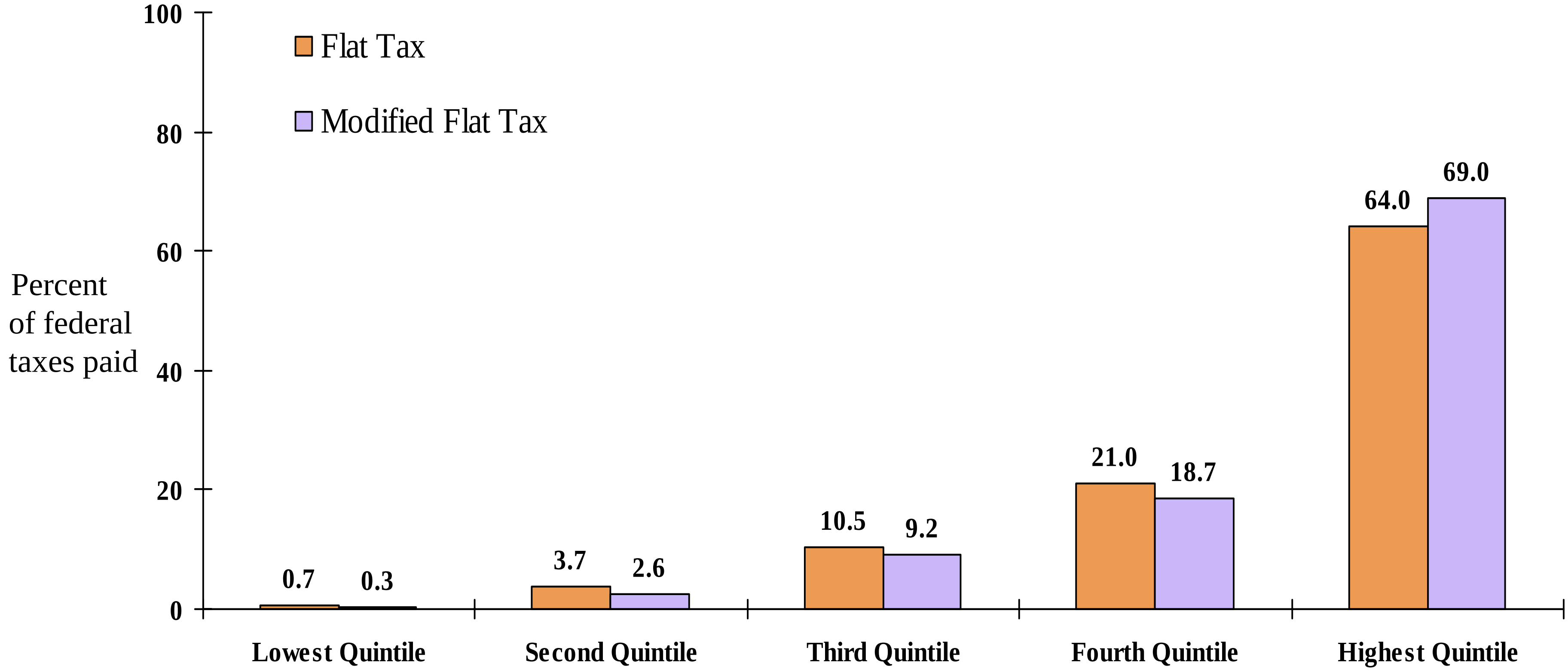


Source: Department of the Treasury, Office of Tax Analysis.

Note: Taxable income brackets are estimates for 2006.

Distributional analysis

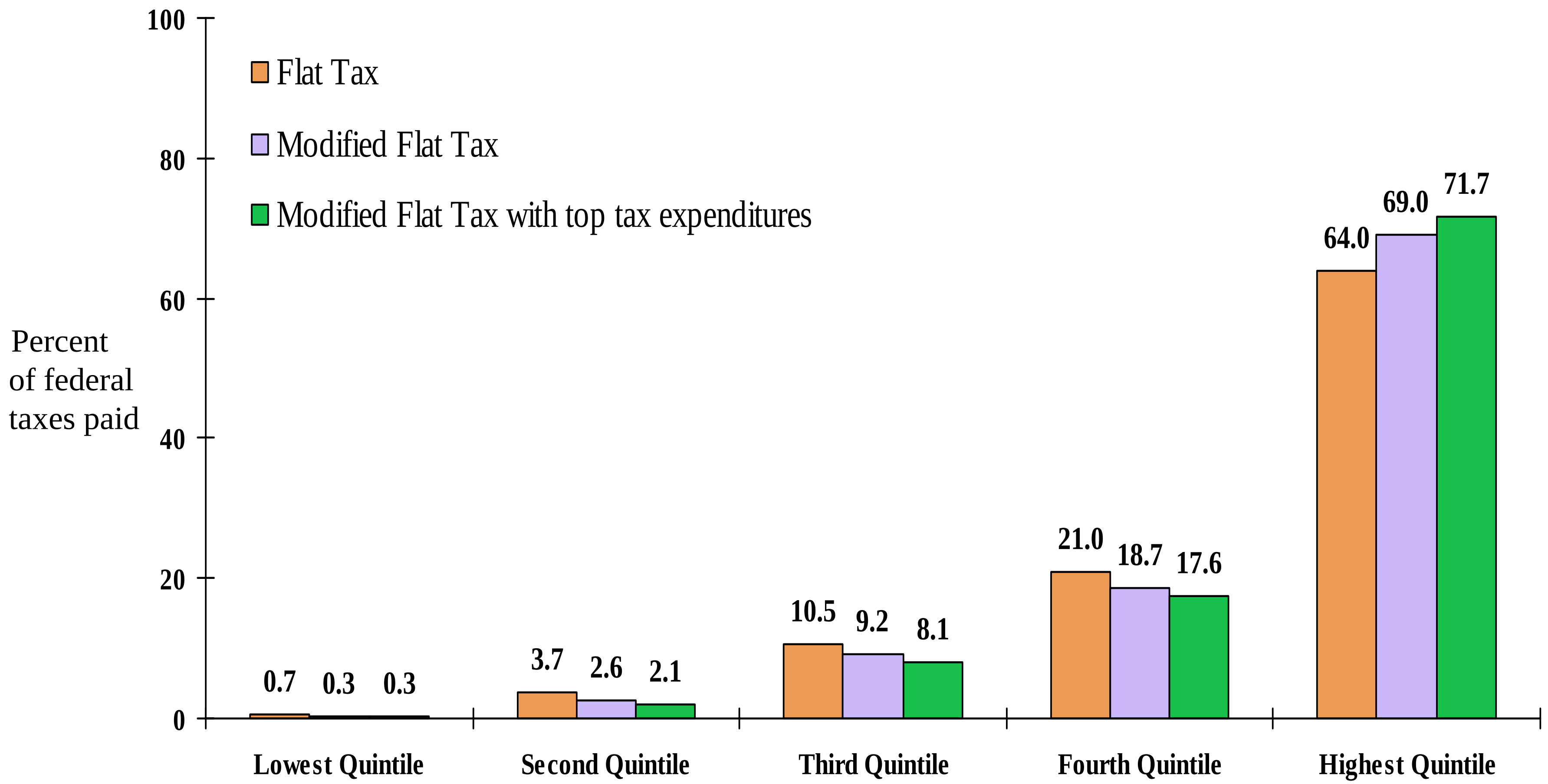
Distribution of Tax Burden: Flat Tax and Modified Flat Tax



Source: Department of the Treasury, Office of Tax Analysis.

Note: Estimates of 2006 law at 2004 income levels.

Distribution of Tax Burden: Modified Flat Tax with Top Tax Expenditures



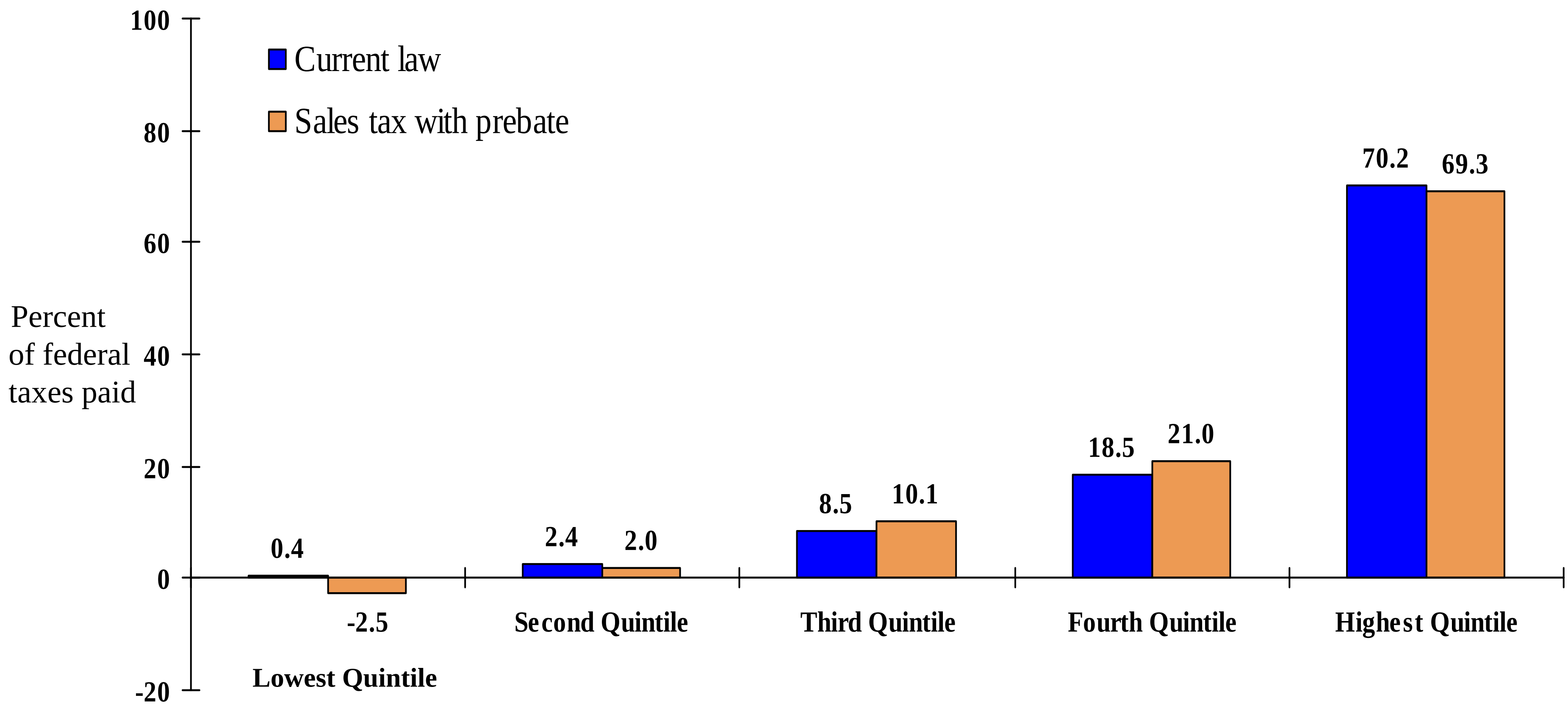
Source: Department of the Treasury, Office of Tax Analysis.

Note: Estimates of 2006 law at 2004 income levels.

National Sales Taxes with Rebates

- The Fair Tax provides a "prebate" to mitigate the distributional impact of replacing the current income tax system with a national retail sales tax
  - Prebate from Fair Tax proposal
    - ★ Tax-inclusive retail sales tax rate times the poverty guideline amount defined by Health and Human Services
      - The poverty guideline amount in 2006 for one person is $9,820 and $3,360 for each additional person in the household. The prebate amounts in 2006 would therefore be $2,494 ($4,988 for married couples) plus $853 per dependent.
  - Rates with Fair Tax prebate using same broad tax base described earlier
    - ★ NRST rate (tax-inclusive) = 25% to 33%
    - ★ NRST rate (tax-exclusive) = 34% to 49%

Distributional analysis: National Sales Tax with Prebate



Source: Department of the Treasury, Office of Tax Analysis.

Note: Estimates of 2006 law at 2004 income levels.

Appendix A

Broad Income Tax Base Description

- Under a broad income tax, the individual income tax base would include the following items that are excluded under current law: employer contributions for health insurance, pensions, and other fringe benefits; employee contributions to 401(k) plans and IRAs; earnings on pensions, IRAs, and life insurance; interest on state and local bonds; workers' compensation benefits; 85 percent of all Social Security benefits; and capital gains on homes. There would be no above-the-line deductions (except for SECA), no itemized deductions, no special standard deduction for age and blindness, no AMT, no kiddie tax, and no credits (except the foreign tax credit). There would also be no special tax rate for capital gains.
- The business income tax base would have no tax expenditures, including no accelerated capital cost recovery, no manufacturer's deduction, and no exclusion for interest on state and local bonds. There would be a single corporate rate, which is set here at the same level as the top individual rate. There would be no AMT and no credits. The individual and corporate income taxes would be integrated, which is achieved here by allowing an exclusion for dividends received and basis adjustment for retained earnings (for both individual and corporate shareholders).

Flat Tax Base Description

- The flat tax would replace the current individual and corporate income taxes. Under a flat tax, all employee compensation, including wages and employer contributions for health insurance, pensions, and other fringe benefits would be included in the individual tax base. No deduction or exclusion would be allowed for 401(k)-type or IRA contributions. Half of all Social Security benefits would be taxed. Amounts taxed separately under the business cash flow tax (see below) would be excluded from the individual tax base. Corporate dividends, interest and capital gains received by individuals would also be excluded. There would be no above-the-line deductions (except for SECA), no itemized deductions, no standard deduction, no alternative minimum tax, and no credits. Individuals would be allowed an exemption amount which in 2006 would be $13,150 for singles, $26,300 for joints, $17,200 for heads of households, and $6,150 for each dependent.
- All businesses would be taxed at the entity level under a cash flow tax. Businesses could expense (deduct immediately) 100% of all investments. Interest paid by businesses would not be deductible and interest received would not be taxable. There would be no AMT or credits under the business tax.

Modified Flat Tax Base Description

- The Modified Flat Tax would replace the current individual and corporate income taxes. Under a Modified Flat Tax, all employee compensation, including wages and employer contributions for health insurance, pensions, and other fringe benefits would be included in the individual tax base. No deduction or exclusion would be allowed for 401(k)-type or IRA contributions. Half of all Social Security benefits would be taxed. Amounts taxed separately under the business cash flow tax (see below) would be excluded from the individual tax base. Corporate dividends, interest and capital gains received by individuals would also be excluded. There would be no above-the-line deductions (except for SECA), no itemized deductions, no standard deduction, no AMT, and no credits (except the EITC is allowed here). Individuals would be allowed an exemption amount which in 2006 would be $13,150 for singles, $26,300 for joints, $17,200 for heads of households, and $6,150 for each dependent.
- All businesses would be taxed at the entity level under a cash flow tax. Businesses could expense (deduct immediately) 100% of all investments. Interest paid by businesses would not be deductible and interest received would not be taxable. There would be a single business tax rate, set at the same level as the top individual rate. There would be no AMT or credits under the business tax.

Value Added Tax (VAT)/National Retail Sales Tax (NRST)

- The VAT or NRST would replace the current individual and corporate income taxes. Under a VAT, all businesses would be taxed on the difference between the value of their sales and the value of their purchases (including purchases of equipment and other capital goods). Under a retail sales tax, all retail sales of goods and services to individuals would be taxed. Under the tax modeled here all retail sales are taxed except educational services, expenditures abroad by U.S. residents, food produced and consumed on farms, and imputed rent on owner-occupied and farm housing. If a single rate VAT and an NRST have the same base and the same rate of noncompliance, the same rate should be required to be revenue neutral from either tax.
- Rebates are meant to mitigate the impact of a VAT/NRST as a replacement for the current income taxes. The rebate ("prebate") considered in the policy experiments shown is the NRST tax (inclusive) rate times the poverty guideline amount defined by HHS (with double the one person amount for married couples). The poverty guideline amounts in 2006 for one person is $9,820 and $3,360 for each additional person in the household. The revenue neutral tax-inclusive NRST rate with this rebate is 25.4%. The rebate amounts in 2006 would therefore be $2,494 ($4,988 for married couples) plus $853 per dependent.

Appendix B

Detail on Treasury Distributional Analysis

- Families are ranked by cash income
  - Cash income consists of wages and salaries, net income from a business or farm, taxable and tax-exempt interest, dividends, rental income, realized capital gains, cash transfers from the government, and retirement benefits. Employer contributions for payroll taxes and the federal corporate income tax are added to place cash on a pre-tax basis. Cash income is calculated on a family rather than on a tax return basis. The cash incomes of all members of a family are added to arrive at a family's cash income used in the distributions.
- Incidence assumptions
  - The taxes included are individual and corporate income, payroll (Social Security and unemployment), excises, customs duties, and estate and gift taxes. The individual income tax is assumed to be borne by payers, the corporate income tax by capital generally, payroll taxes (employer and employee shares) by labor (wages and self-employment income), excises on purchases by individuals in proportion to relative consumption of the taxed good and proportionately by labor and capital income and excises on purchases by businesses and customs duties proportionately by labor and capital income, and the estate and gift taxes by decedents. Individual income taxes are estimated at 2004 income levels under 2006 law (unless otherwise specified), adjusted for the effects of unindexed parameters and ignoring the EGTRRA, JGTTRA and WFTRA sunsets.
- Individuals with negative incomes are excluded from the lowest income deciles.