How do we get to tax reform? Lessons from the Bush Panel

The Brookings Institution

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A Summary of the Tax Reform Panel's Report

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President's Advisory Panel on Federal Tax Reform

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(Brief) History

- President George W. Bush created Panel in January 2005
- Panel Members
  - Connie Mack, III (Chair)
  - John Breaux (Vice-Chair)
  - William E. Frenzel
  - Elizabeth Garrett
  - Edward P. Lazear
  - Timothy J. Muris
  - James M. Poterba
  - Charles O. Rossotti
  - Liz Ann Sonders

(Brief) History

- Report delivered to Treasury Secretary John Snow on November 1, 2005

(Brief) History

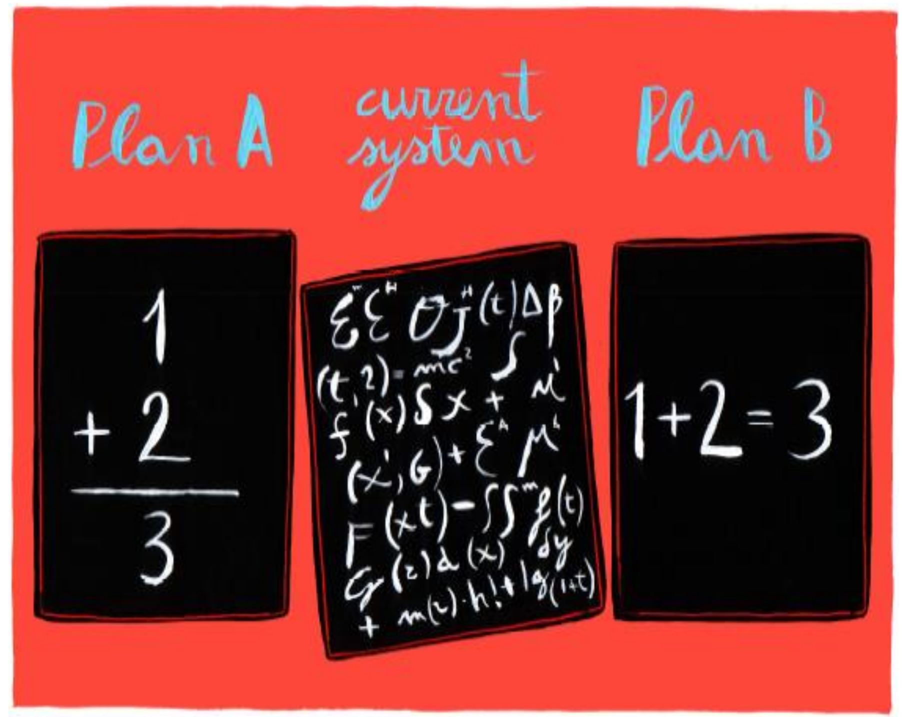
- Treasury (still) studying report…

Executive Order

- “Revenue neutral” options that would make the tax code simpler and more conducive to economic growth
  - Assumed 2001 and 2003 tax cuts would be made permanent and AMT “patch” would expire as scheduled
- Additional constraints
  - Share tax burdens and benefits in an “appropriately progressive manner” while recognizing the importance of homeownership and charity in American society
  - At least one option should use Federal income tax as base

Recommendations

- Two plans unanimously recommended
  - Simplified Income Tax Plan (SIT)
  - Growth and Investment Tax Plan (GIT)



The SIT: Household Provisions

- Eliminates the AMT
- Family Credit
  - Replaces standard deduction, personal exemptions, and child tax credit
- Work Credit
  - Replaces EITC and refundable child tax credit
- Reduced marriage penalty, eliminated phase-outs, simplified treatment of Social Security benefits
- Tax rate schedule: 15%, 25%, 30%, 33%

Major Credits and Deductions

- Home credit (available to all taxpayers)
  – Replaces the deduction for mortgage interest and limited to average regional price of housing (FHA limits)
- Charitable deduction (available to all taxpayers)
  – Above-the-line deduction for contributions >1% of income
- Health insurance
  – Equalized treatment of employer-provided and purchased coverage and limited benefit for gold-plated plans
- Eliminated deduction for state and local taxes
- Education
  – Replaced current provisions with simplified saving account and expanded Family Credit

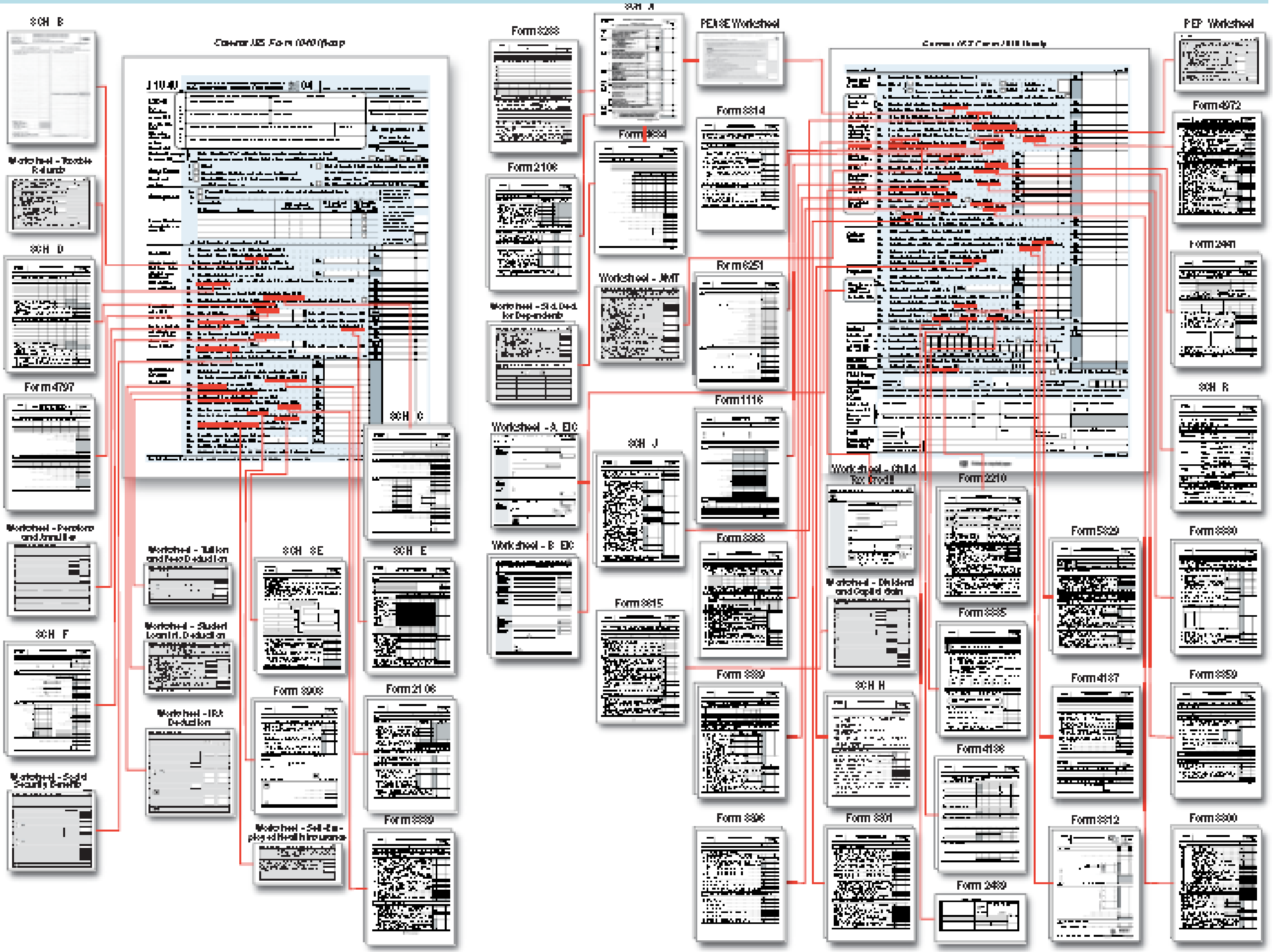
Saving and Retirement

- Defined contribution plans
  - Consolidated into Save at Work plans with simple rules and AutoSave features
- Unified savings accounts
  - Save for Retirement – new account that combines all existing individual retirement savings accounts
  - Save for Family – replaces existing savings incentives with a new account to encourage saving for medical expenses, education, new homes, and retirement

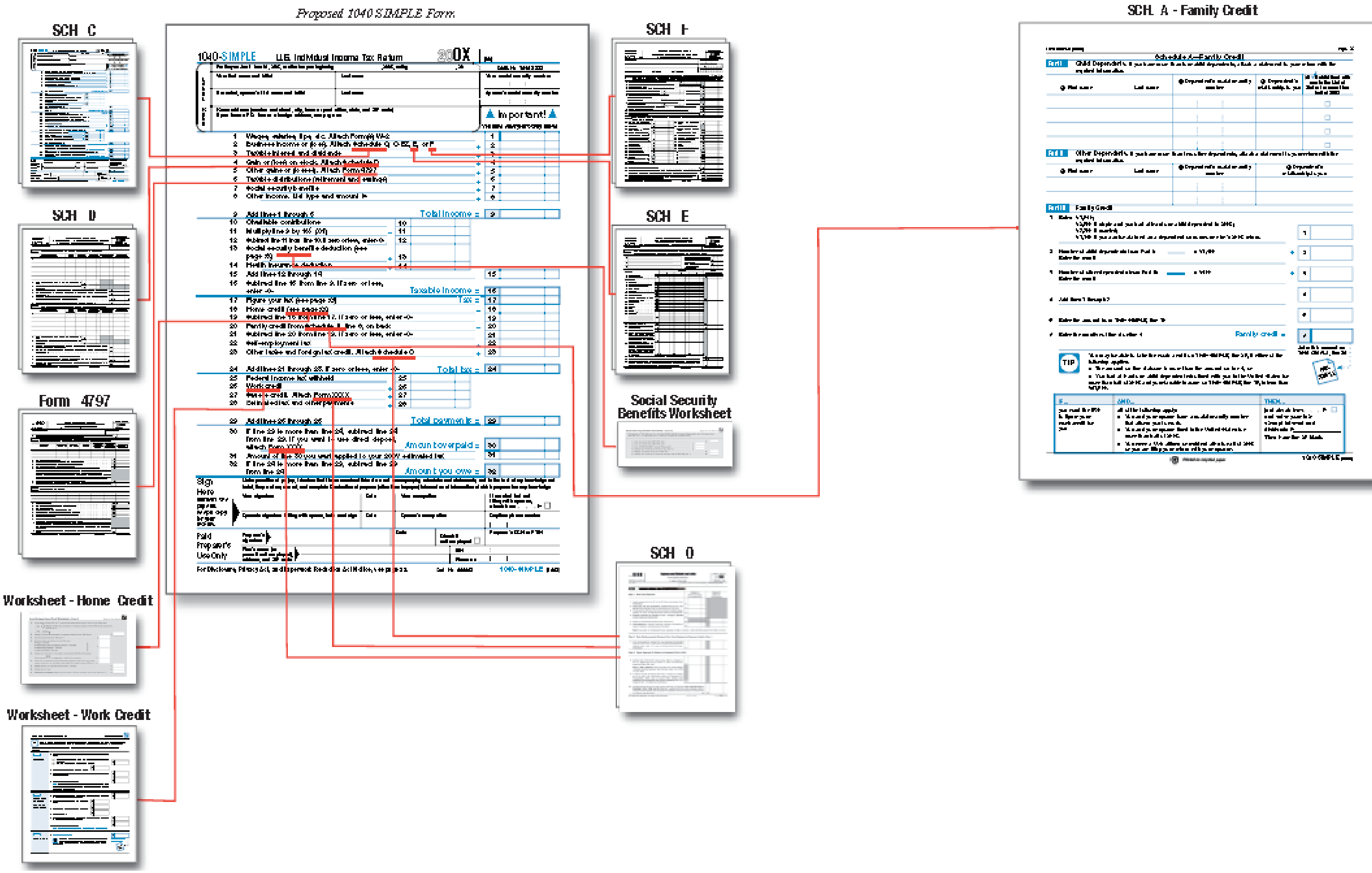
Treatment of Investment Income

- Exclude 100% corporate dividends paid out of income subject to U.S. tax
  - Corporations report to shareholders the proportion of dividends that can be excluded based on amount of income subject to tax in the U.S. relative to worldwide earnings in prior year
  - Also required to disclose domestic and worldwide revenues and income reported for financial accounting purposes
- Excludes 75% of capital gains received by individuals on sales of corporate stock (held for more than 1 year)

Current IRS Form 1040 with Related Schedules, Forms and Worksheets



Proposed SIMPLE Form with Related Schedules, Forms and Worksheets



Business Provisions

- Small business
  - Taxed at individual rates
  - Cash-basis accounting
  - Expensing
- Large business
  - Tax rate of 31.5% applies to all businesses taxed at business level (including LLCs, partnerships, S corporations)
  - Eliminates all tax preferences (except new simplified accelerated depreciation)

International

- Territorial taxation
  - Includes rules for the allocation of interest expense and parent general and administrative expenses

Growth and Investment Tax Plan

- Hybrid approach that moves system towards a consumption tax
  - Progressive tax on labor income (rates of 15%, 25%, 30%)
  - 15% tax on all capital income at the individual level earned outside of savings plans
  - 30% tax on cash-flow at the business level
- Individual provisions similar to SIT

Business System

- Businesses taxed on cash-flow:

  Receipts from Sales

  Minus: Purchases from Other Businesses

  Minus: Wages and Compensation

  Equals: Taxable Business Cash Flow

- Expensing of capital investment
- No inclusion for returns on financial assets and no deduction for financial payments (i.e., no interest deductibility)

Cross-Border Transactions

- “Destination-based” tax
  - Tax base = domestic consumption wherever produced
  - “Border adjusted”: Sales to customers abroad (exports) would be exempted from the tax while purchases from abroad (imports) would be included
  - Solves transfer pricing problem since base is domestic consumption: no incentive to over- or under-charge for sales with related parties