Federal Tax Reform Update

Presented at the Federation of Tax Administrators Revenue Estimating and Tax Research Conference, October 10, 2005

Tom Neubig, Ernst & Young LLP

“Drivers” For Tax, Entitlement, Social Security Reforms?

- Rise in taxpayers subject to AMT
  - In 2003, 2 million tax returns had AMT liability of $11 billion.
  - In 2010, 20% of all taxpayers, and more than 90% of taxpayers with AGI between $100,000 and $500,000, will have AMT liability totaling total $90 billion.
  - Repeal of the AMT would cost $1.2 trillion over 10 years

- Many 2001/2003 Individual Tax Cuts Face Expiration
  - Lower rates on dividend and capital gains income expire in 2008
  - Individual rate cuts expire in 2010

- Aging of American workforce
  - 2008 is the first year of retirement for the "Baby Boomers"
  - Need for increased private savings
Tax Reform Advisory Panel

• “Bipartisan Advisory Panel on Tax Reform” appointed by President in January 2005
  – Former Sen. Connie Mack (R-FL) (Chairman)
  – Former Sen. John Breaux (D-LA) (Vice-Chairman)
  – Other Panel members:
    Bill Frenzel    Timothy Muris
    Elizabeth Garrett  Charles Rossotti
    James Poterba    Liz Ann Sonders
    Edward Lazear

Fundamental Tax Reform - PROCESS

• Panel will submit “options” for reform to the Treasury Secretary by September 30, 2005 – Delayed to November 1
• Treasury expected to make recommendations to the President – Timing now uncertain – May not be public recommendations
• President Bush expected to submit his tax reform legislative recommendations to the Congress in 2006 – Not necessarily in the January budget
Panel Mandate

- Advisory Panel’s mandate:
  - **Simplification**: Simplify tax laws to reduce costs and administrative burdens of compliance
  - **Fairness**: Balance the burdens and benefits of the tax structure in an appropriately progressive manner while recognizing the importance of homeownership and charity in American society
  - **Economic Growth**: Promote long-run economic growth and job creation, and better encourage work effort, saving, and investment, so as to strengthen the competitiveness of the United States in the global marketplace

Panel Restrictions

- Options will be revenue neutral
  - *Panel will use the revenue assumptions in the Bush FY06 budget as its “baseline” – these assume expiring rate reductions from the 2001 and 2003 tax changes don’t take effect*
  - *Thus tax reform will be a tax cut from “current law”*
- At least one option should use the current Federal income tax as the base for its recommended reforms
  - Income tax reforms likely to move to consumption tax treatment
- Retain an incentive for home ownership and charitable giving
  - Retain “an” incentive, not “the current” incentive
Panel Discussions

- Panel has held 10 public meetings to date
- Key topics:
  - Complexity burdens on individuals and businesses
  - Effect of the tax code on savings and investment
  - Pros/cons of income v. consumption taxes
    - International competition
    - Overall economic effects
    - Transition issues
    - Effect of reform on states
  - Cost recovery/tax incentives

1986 “Revenue Neutral” Tax Reform
JCT Final Estimate, but Similar to Treasury’s 1984 Proposal and President’s 1985 Proposal

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<th>Income in class</th>
<th>% Change</th>
<th>Income Tax</th>
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<td>&lt;$10k</td>
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<tr>
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<table>
<thead>
<tr>
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<th>$billions</th>
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<tbody>
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<tr>
<td>Corporate</td>
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<td>Excise</td>
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<tr>
<td>Total</td>
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Fundamental Tax Reform Approaches

- Revise current Code: incremental income tax reform
  - “86 Act” approach – broaden base to make permanent current tax rates and repeal AMT
  - Simplify savings incentives, depreciation, debt/equity
  - Exempt more retirement savings, further reduce double taxation of corporate income
- Flat tax
  - total employee compensation taxed at individual level
  - all businesses taxed under a cash flow tax (expensing with no interest deduction)
- National retail sales tax
- European-style value-added tax
- “Hybrid” consumption/income tax

Potential Tax Rates for Different Bases

- Broad based income tax
  - 15% flat rate
  - Cut existing rates by over one third: 6.6-23%
- Comprehensive flat tax 21%
- National retail sales tax
  - Comprehensive, no rebates: 22-27% (tax exclusive)
  - Typical state base: 64-87% (tax exclusive)
- Value added tax 18%
  - Replace individual and corp. AMT 1%
  - Replace corp. income tax 3%
  - Replace AMT & cut regular rate 50% 10%
Largest Individual Tax Expenditures

Top 12 Individual Tax Expenditures ($billions) FY 2006-10

- Exclusion of employer contributions for medical insurance/care 760.2
- Deductibility of mortgage interest on owner-occupied homes 445.5
- Exclusion of pension contributions & earnings: 401(k)/IRA/Keogh 374.9
- Capital gains exclusion on home sales 247.2
- Net exclusion of pension contributions/earnings: Employer plans 241.0
- Deductibility of non-business state and local taxes 231.4
- Deductibility of charitable contributions 227.8
- Exclusion of net imputed rental income on owner-occupied homes 185.2
- Step-up basis of capital gains at death 164.4
- Child credit 164.0
- Non-business capital gains 144.2
- Exemption of interest on State and Local bonds 134.9
- Exclusion of interest on life insurance savings 129.5

Source: OMB, U.S. FY2006 Budget

Largest Corporate Tax Expenditures

Top 10 Corporate Tax Expenditures ($billions) FY 2006-10

- Deduction for U.S. production activities 42.9
- Deferral of income from controlled foreign corporations 42.7
- Exclusion of interest on State and local bonds 42.7
- Expensing of research and experimentation expenditures 30.7
- Graduated corporate income tax rate 19.6
- Credit for low-income housing investments 17.6
- Exclusion on interest on life insurance savings 14.1
- Special ESOP rules 11.1
- Inventory property sales source rules exception 11.0
- Exemption of credit union income 7.6
- Extraterritorial income exclusion 6.4
Potential Consumption Tax Proposals

• All of the proposals are likely to include some movement toward consumption tax treatment
• Exempting investment income and expensing can be done as part of an “income” tax
  – The price is some limitation on interest deductions.
• A low rate value added tax to replace all/part of the individual income tax, corporate tax and/or payroll tax could be proposed
• A Comprehensive Business Income Tax or Flat Tax (X-Tax) would move toward consumption taxation

Potential Individual Income Tax Reform

• Goal of simplicity, fairness (retaining current tax distribution) & growth (savings incentives)
  – Repeal of Individual AMT
  – Make expiring rate reductions permanent
  – Repeal some deductions (e.g., S&L taxes) & credits
  – Convert mortgage interest deduction to a credit at a 15% rate
  – Switch up-front saving incentives to no tax on investment income
  – Collect some tax on fringe benefits at business level
Potential Business Tax Reform

• Resurrection of 1992 Treasury corporate integration proposal to eliminate corporate/non-corporate, debt/equity distinctions
• CBIT – Comprehensive Business Income Tax
  – Taxes all businesses, including non-corp., at entity level
  – Provides expensing of capital investment
  – Disallows interest deduction
  – Exempts business interest, dividends and other distributions of earnings at recipient level
  – No pass-through of “preference” items

Other Business Tax Reform Options

• International tax reform
  – Territorial proposal – devils’ in the detail
• Repeal corporate tax “preferences”
• Book tax conformity
• Collect income and payroll tax on certain employee fringe benefits at the business level
• Difficult to lower corporate tax rate below top individual marginal tax rate for both planning and tax accounting reasons
Issues for State Revenue Estimators

- Treasury will present both traditional and “dynamic” revenue estimates of reform
  - Several models estimate moving to a pure consumption tax would increase national income by 2-6%
- Treasury estimates will assume no sunset of lower tax rates: less base expansion will be needed for revenue neutrality
- It will be difficult to lower regular marginal tax rates so incentives (e.g., expensing, savings incentives) will be done through base expansions and contractions
- Non-corporate businesses likely to be brought into the tax base, but with offset at individual level

Summary

- It is very likely that the 1986 Tax Reform Act’s shift of taxes away from individuals will be repeated
- The tax shift likely will be to all businesses, not just corporations
- The top individual tax rate and corporate tax rate are not likely to be lowered – incentives will take the form of deductions and credits
- Major changes to the Federal tax bases are likely to be proposed, which will make estimating State income tax changes difficult