



TAX REFORM

STATUS

COMMISSION RECOMMENDATIONS

The President's Commission on Fiscal Responsibility and Reform (Bowles-Simpson) made the following recommendations regarding tax reform:

Individual Tax Structure

The Commission said:

“The Commission proposes tax reform that relies on ‘zero-base budgeting’ by eliminating all income tax expenditures (but maintaining the current payroll tax base, which should be modified only in the context of Social Security reform), and then using the revenue to lower rates and reduce deficits. The revenue from eliminating tax expenditures should be dedicated to three clear purposes: 1) substantially lowering marginal tax rates; 2) reducing the reduction; and 3) supporting a small number of simpler, more targeted provisions that promote work, home ownership, health care, charity, and savings. As a matter of principle, tax reform must increase or maintain progressivity.

“A ‘zero plan’ could reduce income tax rates to as low as 8 percent, 14 percent, and 23 percent. Even after adding back a number of larger tax expenditures, rates would still remain significantly lower than under current law.”

2.1.1 Cut rates across the board, and reduce the top rate to between 23 and 29 percent. Real tax reform must dedicate a portion of the savings from cutting tax expenditures to lowering individual rates. The top rate must not exceed 29 percent.

2.1.2 Dedicate \$80 billion to deficit reduction in 2015 and \$180 billion in 2020. In addition to reducing rates, reform must be projected to raise \$80 billion of additional revenue (relative to the alternative fiscal scenario) in 2015 and \$180 billion in 2020. To the extent that the dynamic effects of tax reform result in additional revenue beyond these targets, excess funds must go to rate reductions and deficit reduction, not to new spending.

2.1.3 Simplify key provisions to promote work, homes, health, charity, and savings while increasing or maintaining progressivity. Congress and the President must decide which tax

expenditures to include in the tax code in smaller and more targeted form than under current law, recognizing that any add-backs will raise rates. The new tax code must include provisions (in some cases permanent, in others temporary) for the following:

- Support for low-income workers and families (e.g., the child credit and EITC);
- Mortgage interest only for principal residences;
- Employer-provided health insurance;
- Charitable giving;
- Retirement savings and pensions.

Corporate Tax Structure

The Commission said:

“The U.S. corporate tax is a patchwork of overly complex and inefficient provisions that creates perverse incentives for investment. Corporations engage in self-help to decrease their tax liability and improve their bottom line. Moreover, corporations are able to minimize tax through various tax expenditures inserted into the tax code as a result of successful lobbying.

“Without reform, it is likely that U.S. competitiveness will continue to suffer. The results of inaction are undesirable: the loss of American jobs, the movement of business operations overseas, reduced investment by foreign businesses in the U.S., reduced innovation and creation of intellectual property in the U.S., the sale of U.S. companies to foreign multinationals, and a general erosion of the corporate tax base.

2.2.1 Establish single corporate tax rate between 23 percent and 29 percent. Corporate tax reform should replace the multiple brackets (the top being 35 percent), with a single bracket as low as 23 percent and no higher than 29 percent.

2.2.2 Eliminate all tax expenditures for businesses. Corporate tax reform should eliminate special subsidies for different industries. By eliminating business tax expenditures – currently more than 75 – the corporate tax rate can be significantly reduced while contributing to deficit reduction. A lower overall tax rate will improve American business competitiveness. Abolishing special subsidies will also create an even playing field for all businesses instead of artificially picking winners and losers.

2.2.3 Move to a competitive territorial tax system. To bring the U.S. system more in line with our international trading partners’, we recommend changing the way we tax foreign-source income by moving to a territorial system. Under such a system, income earned by foreign subsidiaries and branch operations (e.g., a foreign-owned company with a subsidiary operating in the United States) is exempt from their country’s domestic corporate income tax. Therefore, under a territorial system, most or all of the foreign profits are not subject to domestic tax. The taxation of passive foreign-source income would not change. (It would continue to be taxed currently.)

BACKGROUND

There is renewed interest in the idea of replacing our current income tax system with "something else." The "something else's" range from significant income tax base broadening to changing the tax base from income to consumption.

One or more major types of broad-based consumption taxes are included in these congressional tax proposals: the value-added tax (VAT), the national sales tax, the consumed-income tax, and the flat tax. (Public domain Congressional Research Service reports were used for some of the summary information.)

CONCEPTS

Value-Added Tax

A value-added tax is a tax, levied at each stage of production, on a firm's value added. The value added of a firm is the difference between a firm's sales and a firm's purchases of inputs from other firms. The VAT is collected by each firm at every stage of production.

There are three alternative methods of calculating VAT: the credit method, the subtraction method, and the addition method. Under the credit method, the firm calculates the VAT to be remitted to the government by a two-step process. First, the firm multiplies its sales by the tax rate to calculate VAT collected on sales. Second, the firm credits VAT paid on inputs against VAT collected on sales and remits this difference to the government. The firm calculates its VAT liability before setting its prices to fully shift the VAT to the buyer. Under the credit-invoice method, a type of credit method, the firm is required to show VAT separately on all sales invoices and to calculate the VAT credit on inputs by adding all VAT shown on purchase invoices.

Under the subtraction method, the firm calculates its value added by subtracting its cost of taxed inputs from its sales. Next, the firm determines its VAT liability by multiplying its value added by the VAT rate.

Under the addition method, the firm calculates its value added by adding all payments for untaxed inputs (e.g., wages and profits). Next, the firm multiplies its value added by the VAT rate to calculate VAT to be remitted to the government.

National Sales Tax

A national sales tax (NST) would be a federal consumption tax collected only at the retail level by vendors. The NST would equal a set percentage of the retail price of taxable goods and services. Retail vendors would collect the NST and remit the tax revenue to the federal government.

The retail price of a good or service equals the sum of the value added at all stages of production. Consequently, a VAT and a NST with the same tax rate and tax base would yield the same

amount of revenue. The operating assumption of policy makers and economists is that both taxes are fully shifted forward onto consumers; that is, the price to the consumer increases by the amount of the tax.

Typically, a family would receive a rebate of the sales tax on their spending up to the federal poverty level. The Social Security Administration would provide a monthly sales tax rebate to registered qualified families. The national sales tax would not be levied on exports. The sales tax would be separately stated and charged. Social Security and Medicare benefits would remain the same with payroll tax revenue replaced by some of the revenue from the retail sales tax. States could elect to collect the national retail sales tax on behalf of the federal government in exchange for a fee.

Consumed-Income Tax

Under this consumption tax, taxpayers would keep their assets in an account equivalent to a current IRA (individual retirement account). Net contributions to this account (contributions less withdrawals) would be deducted from income to determine the level of consumed-income. In contrast to a VAT or sales tax, policymakers would have the option of applying a progressive rate structure to the level of consumed-income. Each individual would be responsible for calculating his consumed-income and paying his tax obligation.

Flat Tax

A flat tax could be levied based on the proposal formulated by Robert E. Hall and Alvin Rabushka, two senior scholars at the Hoover Institution. Their proposal would have two components: a wage tax and a cash-flow tax on businesses. (A wage tax is a tax only on wages; a cash-flow tax is generally a tax on gross receipts minus all outlays.) It is essentially a modified VAT, with wages and pensions subtracted from the VAT base and taxed at the individual level. Under a standard VAT, a firm would not subtract its wage and pension contributions when calculating its tax base. Under this proposal, some wage income would not be included in the tax base because of exemptions. Under a standard VAT, all wage income would be included in the tax base.

Traditional Tax Simplification

Those who advocate tax simplification, although many argue for eliminating certain parts of the tax code, do not want to scrap the entire code and create a new system such as a value-added sales tax. Rather, they believe that the system can be fixed through the consolidation of requirements and the creation of uniform definitions.

Proponents of alternative tax systems point to past efforts of Congress to “simplify” the tax code as evidence that Congress is incapable achieving that goal. The skeptics say Congress has only made the code more complex over the years.

Past Congress Bill

Using a bill from a previous Congress to illustrate reform efforts, the Wyden-Coats bill reduces the number of individual tax brackets from the current six to three: 15 percent, 25 percent, and 35 percent and eliminates the Alternative Minimum Tax completely. The Wyden-Coats bill reduces the top corporate tax rate and replaces the existing six corporate rates and eight brackets with a single flat rate of 24 percent.

Small businesses with gross annual receipts of up to \$1 million will be able to permanently expense all equipment and inventory costs in a single year.

Of course, the Senators eliminate many deductions and credits to pay for the lower rates.

Individual Tax Credits, Deductions and Exclusions from Income Repealed

- Exclusion of income earned abroad by U.S. citizens
- Exclusion of certain allowances for Federal employees abroad
- Exclusion of employee meals and lodging
- Exclusion of benefits under cafeteria plans
- Exclusion of miscellaneous fringe benefits
- Exclusion of employee awards
- Exclusion of income earned by voluntary employees' beneficiary associations
- Exclusion of premiums on group term life insurance, accident and disability insurance
- Deferral of interest on savings bonds
- Deduction for moving expenses
- Miscellaneous itemized deductions subject to the 2-percent floor

Corporate Tax Credits, Deductions and Exclusions from Income Repealed

- Inventory property sales source rule exception
- Deferral of Active Income for controlled foreign corporations
- Reduced rates on first \$10 million of corporate taxable income
- Deferral of Active Financing Income
- Deferral of gain on non-dealer installment sales
- Special tax rate for nuclear decommissioning reserve fund
- Exception from net operating loss limitations for corporations in bankruptcy proceeding
- Excess of percentage over cost depletion for fuels
- Deferral of gain from disposition of electric transmission property to implement FERC policy
- Completed contract rules
- Tax credit for enhanced oil recovery costs
- Depreciation of equipment in excess of alternative minimum tax depreciation
- Lower of cost or market valuation method for inventory
- Deduction for punitive damages
- Section 199 production activity deduction
- Advance refunding of 503(c)(3) and governmental bonds

ANALYSIS

No one would dispute the notion that the U.S. tax code is too complex. As the National Taxpayer Advocate, Nina Olson has observed, “The largest source of compliance burdens for taxpayers is the complexity of the tax code. IRS data show that taxpayers and businesses spend 7.6 billion hours a year complying with tax-filing requirements. To place this in context, it would require 3.8 million full-time employees to work 7.6 billion hours. In dollar terms, we estimate that taxpayers spend \$193 billion a year complying with income tax requirements, which amounts to 14 percent of aggregate income tax receipts. One count shows the number of words in the tax code has reached 3.7 million, and over the past eight years, changes to the tax code have been made at a rate of more than one a day – including more than 500 changes in 2008 alone.”

As the Congressional Research Service (CRS) notes, “Proponents of these tax revisions are often concerned with simplifying the tax system, making the government less intrusive, and creating an environment more conducive to saving. Critics are concerned with the distributional consequences and transitional costs of a dramatic change in the tax system. Most observers believe that the problems and complexities of our current tax system are not primarily related to the number of tax rates, but rather stem from difficulties associated with measuring the tax base.”

A fundamental question one has to answer before undertaking any analysis of a tax system change is “what is your effective rate of taxation?” There is a huge difference between the marginal rate that may appear on a tax liability schedule, and the rate of taxation a business pays after all of the deductions and credits are taken.

Simplification can create the illusion of a lower rate of taxation.

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Governor Romney spoke during the campaign of limiting taxpayers to a basket of deductions of a specific dollar amount. The Simpson-Bowles Commission also made recommendations about the elimination or scaling back of those deductions. They referred to them by the technical term – “tax expenditures.”

Governor Romney was talking about personal deductions but there are some sizable business ones too. Direct expensing, which allows a business to write off modest machinery investments in the year of purchase, is part of the tax expenditure classified as accelerated depreciation. In 1986, one of the tax expenditures on the chopping block was a popular one with small businesses – the investment tax credit.

Tax expenditures are defined under the Congressional Budget and Impoundment Control Act of 1974 as “revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.”

What are the largest tax expenditures? According to the Tax Policy Center (for 2008 in \$billions):

Exclusion of employer contributions for medical insurance premiums and medical care	\$131
Net exclusion of pension contributions and earnings	117.7
Deductibility of mortgage interest on owner occupied homes	88.5
Accelerated depreciation of machinery and equipment	55.9
Deductibility of nonbusiness state and local taxes other than for owner occupied homes	49.1
Deductibility of charitable contributions	31.5
Deferral of income from controlled foreign corporations	30
Deductibility of state local property tax on owner occupied homes	29.1
Child credit	28.4

SBLC'S HISTORICAL POSITION

Let us make no mistake about it; while small business has suffered as much as anyone under the administration of the current tax code, small business has also been a significant beneficiary.

We have always held to the premise that the tax code can be a powerful economic policy tool. Indeed, from a graduated corporate rate structure to direct expensing to the mortgage deduction and countless other provisions, small business has benefited from the "manipulated" behavior brought about by these provisions. We make no apologies for that reality. We are absolutely certain the economy and nation are better for it.

More importantly, however, is the "flip-side" of that hypothesis. If anyone thinks capital is going to flow freely to small business if one merely cuts the rates and simplifies the Code, experience would suggest otherwise. At best, small business requires patient capital, and even then, the financial return on investment can be modest. Yet, in terms of job creation, innovation and economic diversity, the return on the investment by the nation is well worth it and that is why we believe the current Code includes economic incentives to direct behavior in our direction.

We opposed the Tax Reform Act of 1986 for exactly that reason. Under the guise of lowering and flattening the rates, some economic investment incentives were washed out of the Code. We are all familiar with that old adage, "Be careful of what you wish for, you might get it." It is easy to overlook the value of the current Code, and the inherent flaws of the proposed alternatives, when faced with the massive evidence of flaws of the current system.

We have identified three general problem themes regarding the current system: the overall complexity of the Code, the problems of a blended business/personal tax system, and the specific challenges of compliance by family-owned businesses. Admittedly, at times these three concepts intertwine, but we do see them as separate issues.

By a blended system, we refer to the fact the Code allows for the taxation of wages and business income under one structure for wagger earners, sole proprietors, partners, and S corporation shareholders. We point to the debacle of the 1993 increase in the personal rate structure as case in point as to the problems encountered as a result of this design feature. In the course of

increasing the tax on the wealthy, we increased the tax on the income of operating S corporations. It pulled small business into a debate it did not need to be in, and the result had an unintended, but negative impact on the retained earnings of such businesses.

Therefore, it would seem any alternative to the current system should "wall-off" the taxation of personal income from operating business income. This, unfortunately, leads us down the road of double taxation of business income, a policy the Code currently imposes on C corporations and their owners. This, in turn, will lead to a hypothetical question many small business owners may have not considered, "We can eliminate some of the complexity of the Code, but the price will be the elimination of the single taxation status so many small businesses enjoy. Will you accept the trade-off?"

As to the overall complexity, this is a result of many factors, not the least of which is that the Code has just been around too long and is a 1950's car (notwithstanding the Tax Reform Act of 1986) in a 2000's race. Times have changed. No better example of this is the long simmering debate over independent contractor/employee determinations. The 21st Century's economy is a service-based economy, a family-values economy, a technology-based economy. While we sit around here in Washington debating whether companies are forcing their employees to become independent contractors, the whole structure of what constituted a traditional employer/employee relationship has been dissolved and reformulated, and contrary to what some policy makers stuck in the 1950's labor movement may think, it is being driven as much by the interests of those providing the service, whether you call them employees or independent contractors, and technology, than by any notion of tax avoidance.

A major contributor to complexity were the frequent changes made to the tax code in the 1980's, 1990's and 2000's under a "revenue neutral" policy that was the underpinning of tax policy development during that period. We operated, and for the most part still do, on the "morsels and crumbs" theory of tax policy. Instead of making tax policy because it is the right thing to do, we are forced to ensure all actions are revenue neutral, and therefore we never fix anything straight out, we "do a little of this, and a little of that." Look no further than the estate tax relief provided, as exhibit one. What a mess!

It is easy to identify the inequities in the current system and get widespread agreement on the need to fix them; however, it is an entirely different thing to agree on how to fix them. Ironically, we helped to paint ourselves into this corner. After all, didn't we in the small business community lead the charge for the reduction in federal deficits that led to the revenue-neutral operating rule in the first place? Of course, our solution would have been to fix the problems the right way the first time and get the revenue by cutting federal spending. However, either way, the result is a tax code made more complex because we did not have the revenue to "do it right."

Finally, any new alternative must come to grips with the notion of a family-owned business. The current Code provides a host of rules designed to prevent hypothetical abuse of the Code by "manipulating" it through family ownership. "Family aggregation" rules abound through the code. Since many small businesses are family-owned, this adds an additional layer of complexity to the tax situation of these businesses.

We have not taken a position on some of the leading legislative alternatives, such as a flat tax, retail tax, or VAT. We have been debating SBLC's positions on alternatives for three decades. We have tried task forces, surveys, computer simulations, you name it, to sort out the options for us. Every effort has broken down without a result.

Just by way of example, the flat tax is very appealing on the surface, "Fill out your tax return on a post card. No muss, no fuss." But then you look at it, and you realize the only individuals who will be able to file in such a fashion are wage earners who can characterize their income by looking at a W-2. If all you do is endorse the back of a paycheck it is great, if you sign the front, it's another story.

For a business, you have all of the same problems you have under the current system in characterizing exactly what constitutes income or consumption. If a flat tax bill were ever to make it to a President's desk, we will guarantee you the law will not fit on a post card or, for that matter, on a full-sized wall poster.

A national sales tax takes us completely out of the traditional income characterization regime but plunks us right down in another bog. Ask state revenue commissioners about characterization issues in a sales tax regime. However, recent efforts by the states to develop a uniform system may ease the way down the sales tax path.

There is the issue of who will administer the new sales tax system? On a philosophical and practical level, the seller to the end user is not going to be happy in his/her role as federal tax collector. Behind the front lines, a new bureaucracy will be needed to administer, interpret, coordinate, and enforce the sales tax.

In the end, whatever is done with tax reform, our litmus test has to be, "Is it good for small business?"

OUTLOOK

The demands to produce additional tax revenues to reduce the deficit are likely to drive interest in disguising those increases in the cloak of "tax reform." In addition, the extension of various temporary tax relief provisions has become increasingly more difficult because of the challenges of finding revenue sources elsewhere to offset the relief. Add those together and you have some compelling reasons for "tax reform"