

## **White Paper on Federal Tax Reform Panel Proposals**

In January 2005, President Bush created the President's Advisory Panel on Federal Tax Reform. The panel was directed to develop policy recommendations to make the tax code simpler, fairer, and more conducive to economic growth. On November 1, 2005, the Federal Tax Reform Panel delivered its final report to Treasury Secretary John Snow. The report will serve as a starting point for the Treasury Department's recommendations to President Bush.

The final report can be found at: <http://www.taxreformpanel.gov/final-report/>, with the Executive Summary in Chapter One. The report is a result of months of testimony on the most popular reform plans and issues, including AMT, but it leaves unanswered some of the essential questions about future possibilities. Paramount among the uncertainties is how the recommendations will be revised by Treasury and whether these changes can gain bipartisan support in Congress. The viewpoints of the ranking members of tax-writing committees will be critical. Many observers on and off Capitol Hill are taking a wait-and-see approach with regard to implementation of the panel's recommendations by Congress.

The panel has recommended two tax reform plans: the Simplified Income Tax Plan (SITP) and the Growth and Investment Tax Plan (GITP). The two plans are virtually identical except for the number of tax brackets and the taxation of businesses and capital income, as discussed below. A table outlining both tax reform plans follows this summary.

Simplification in Reporting. Form 1040 will be cut by more than half, from 75 lines to 32, allowing the form to fit on both sides of a four inch by six inch index card.

Changes to Tax Rates, Credits and Exemptions. Under the SITP the current six tax brackets will be reduced to four: 15 percent, 25 percent, 30 percent and 33 percent. The GITP reduces the tax brackets to only three: 15 percent, 25 percent and 30 percent. Under both plans, the AMT and Corporate AMT tax would be repealed. The personal exemption, standard deduction, and child tax credit would be replaced with a Family Credit that is available to all taxpayers who are

married and/or have dependents. The Earned Income Tax Credit would be replaced with the Work Credit and, together with the Family Credit, benefit working taxpayers with children. Finally, the so-called marriage tax “penalty” in the current tax code would be eliminated by making the tax benefits for married couples twice the amount for single filers.

Itemized Deduction Changes. The plan would eliminate the state and local tax deduction. Also, charitable contributions will no longer be itemized, but instead would be a deduction available to all taxpayers who donate more than 1 percent of earnings. It would also limit the employee exclusion for employer-provided health care to \$11,500 (for married) or \$5,000 (for single).

The Home Credit. The plan establishes a limited home mortgage interest credit to replace the deduction currently offered. The Home Credit would be 15 percent of mortgage interest paid, with the phase-out limitations ranging from \$227,000 to \$412,000. Any amount under \$227,000 would receive the full 15 percent of mortgage interest paid benefit, with any amount over \$412,000 receiving no credit. If the amount ranges between \$227,000 and \$412,000, the taxpayer is able to take less than the full 15 percent credit. To adjust for variations in housing markets, the Home Credit limit is based on the average cost of housing within the taxpayer’s area. The panel also recommended lengthening the time a taxpayer must own and use a principal residence before gains from the sale of the home can be exempt from tax. The Home Credit would apply only to a loan secured by the taxpayer’s principal residence and used to acquire, construct, or substantially improve that residence. The deduction for interest on mortgages on second homes and interest on home-equity loans would be eliminated.

Savings plans. The plans include three savings accounts: Save at Work, Save for Retirement, and Save for Family, which are very similar to the employee retirement savings accounts, retirement savings accounts, and lifetime savings accounts. A refundable saver’s credit and an automatic enrollment feature would accompany the accounts. The two accounts that would operate outside of the workplace allow maximum annual contributions of \$10,000.

Investments. If the dividends are from U.S. companies and paid out of domestic earnings, then SITP excludes 100 percent of the tax on the dividends received. Capital gains from domestic companies' income received are 75 percent excluded, thereby leaving a rate between 3.75 percent and 8.25 percent. Interest income would be taxed at regular income tax rates. The GTP would tax both dividends and capital gains at the 15 percent rate applicable under current law, with interest income also being taxed at the 15 percent rate.

Business tax breaks. The primary differences between the SITP and GITP involve business taxation. Rules on depreciation will allow quicker write-offs for short-lived assets, such as computers. And more types of small firms will be permitted to use the simpler cash method of accounting. Under the SITP, small businesses would be taxed at individual rates, with simplified cash-basis accounting. Under the GITP, sole proprietorships would be taxed at individual rates and other small businesses at 30 percent on cash flow, the same rate that would apply for larger businesses. For larger corporations, the SITP would impose a 31.5 percent tax with accelerated depreciation reduced to four classes--two for real estate and two for other property--and a territorial tax system for income from foreign operations. The GITP would apply expensing for all new investment, provide no deduction for interest paid, and install a destination-basis system with border tax adjustments. Under both plans, the corporate AMT would be repealed.

The following tables are published in the Executive Summary of the Tax Reform Panel's final report.

<b>The Current Tax System</b>	
<b>Provisions</b>	<b>Current Law (2005)</b>
<b>Households and Families</b>	
Tax Rates	Six tax brackets: 10%, 15%, 25%, 28%, 33%, 35%
Alternative minimum tax	Affects 21 million taxpayers in 2006; 52 taxpayers million in 2015
Personal exemption	\$3,200 deduction for each member of a household; phases out with income
Standard deduction	\$10,000 deduction for married couples filing jointly, \$5,000 deduction for singles, \$7,300 deduction for heads of households; limited to taxpayers who do not itemize
Child tax credit	\$1,000 credit per child; phases out for married couples between \$110,000 and \$130,000
Earned income tax credit	Provides lower-income taxpayers refundable credit designed to encourage work. Maximum credit for working family with one child: \$2,747; with two or more children: \$4,536
Marriage penalty	Raises the tax liability of two-earner married couples compared to two unmarried individuals earning the same amounts
<b>Other Major Credits and Deductions</b>	
Home mortgage interest	Deduction available only to itemizers for interest on up to \$1.1 million of mortgage debt
Charitable giving	Deduction available only to itemizers
Health insurance	Grants tax-free status to an unlimited amount of premiums paid by employers or the self-employed.
State and local taxes	Deduction available only to itemizers
Education	HOPE Credit, Lifetime Learning Credit, tuition deduction, student loan interest deduction; all phase out with income
<b>Individual Savings and Retirement</b>	
Defined contribution plans	Available through 401(k), 403(b), 457, and other employer plans
Defined benefit plans	Pension contributions by employers are untaxed
Retirement savings plans	IRAs, Roth IRAs, spousal IRAs – subject to contribution and income limits
Education savings plans	Section 529 and Coverdell accounts
Health savings plans	MSAs, HSAs, and Flexible Spending Arrangements
Dividends received	Taxed at 15% or less (ordinary rates after 2008)
Capital gains received	Taxed at 15% or less (higher rates after 2008)
Interest received (other than tax-exempt municipal bonds)	Taxed at ordinary income tax rates
Social Security benefits	Taxed at three different levels, depending on outside income; marriage penalty applies
<b>Small Business</b>	
Rates	Typically taxed at individual rates
Recordkeeping	Numerous specialized tax accounting rules for items of income and deductions
Investment	Accelerated depreciation; special small business expensing rules allow write-off of \$102,000 in 2005 (but cut by ¼ in 2008)
<b>Large Business</b>	
Rates	Eight brackets: 15%, 25%, 34%, 39%, 34%, 35%, 38%, 35%
Investment	Accelerated depreciation under antiquated rules
Interest paid	Deductible
Interest received	Taxable
International tax system	Worldwide system with deferral of business profits and foreign tax credits
Corporate AMT	Applies second tax system to business income

## How the Tax Code Would Change

Provisions	Simplified Income Tax Plan	Growth and Investment Tax Plan
<b>Households and Families</b>		
Tax Rates	Four tax brackets: 15%, 25%, 30%, 33%	Three tax brackets: 15%, 25%, 30%
Alternative minimum tax	Repealed	
Personal exemption	Replaced with Family Credit available to all taxpayers: \$3,300 credit for married couple, \$2,800 credit for unmarried with child, \$1,650 credit for singles, \$1,150 credit for dependent taxpayer; additional \$1,500 credit for each child and \$500 credit for each other dependent	
Standard deduction		
Child tax credit		
Earned income tax credit	Replaced with Work Credit (and coordinated with the Family Credit); maximum credit for working family with one child: \$3,570; with two or more children, \$5,800	
Marriage penalty	Reduced. All tax brackets, Family Credits, and taxation of Social Security benefits for couples are double those of individuals	
<b>Other Major Credits and Deductions</b>		
Home mortgage interest	Home Credit equal to 15% of mortgage interest paid; available to all taxpayers; mortgage limited to average regional price of housing (limits ranging from about \$227,000 to \$412,000)	
Charitable giving	Deduction available to all taxpayers (who give more than 1% of income); rules to address valuation abuses	
Health insurance	All taxpayers may purchase health insurance with pre-tax dollars, up to the amount of the average premium (estimated to be \$5,000 for an individual and \$11,500 for a family).	
Education	Taxpayers can claim Family Credit for some full-time students; simplified savings plans	
State and local taxes	Not deductible	
<b>Individual Savings and Retirement</b>		
Defined contribution plans	Consolidated into Save at Work plans that have simple rules; AutoSave features point workers in a pro-saving direction	
Defined benefit plans	No change	
Retirement savings plans	Replaced with Save for Retirement Accounts (\$10,000 annual limit) – available to all taxpayers	
Education savings plans	Replaced with Save for Family Accounts (\$10,000 annual limit); would cover education, medical, new home costs, and retirement saving needs; available to all taxpayers; refundable Saver's Credit available to low-income taxpayers	
Health savings plans		
Dividends received	Exclude 100% of dividends of U.S. companies paid out of domestic earnings	Taxed at 15% rate
Capital gains received	Exclude 75% of corporate capital gains from U.S. companies (tax rate would vary from 3.75% to 8.25%)	Taxed at 15% rate
Interest received (other than tax exempt municipal bonds)	Taxed at regular income tax rates	Taxed at 15% rate
Social Security benefits	Replaces three-tiered structure with simple deduction. Married taxpayers with less than \$44,000 in income (\$22,000 if single) pay no tax on Social Security benefits; fixes marriage penalty; indexed for inflation	
<b>Small Business</b>		
Rates	Taxed at individual rates (top rate has been lowered to 33%)	Sole proprietorships taxed at individual rates (top rate lowered to 30%); Other small businesses taxed at 30%
Recordkeeping	Simplified cash-basis accounting	Business cash flow tax
Investment	Expensing (exception for land and buildings under the Simplified Income Tax Plan)	
<b>Large Business</b>		
Rates	31.5%	30%
Investment	Simplified accelerated depreciation	Expensing for all new investment
Interest paid	No change	Not deductible (except for financial institutions)
Interest received	No change	Not taxable (except for financial institutions)
International tax system	Territorial tax system	Destination-basis (border tax adjustments)
Corporate AMT	Repealed	