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## Presidential Panel Urges Sweeping Tax Changes for Businesses, Individuals

*Written by Drew Lyon*

### Overview

Chairman Connie Mack and Vice Chairman John Breaux yesterday presented the long-awaited report of the President's Advisory Panel on Federal Tax Reform to Treasury Secretary John Snow. Secretary Snow indicated that the Treasury Department hoped to develop its own tax reform recommendations by the end of the year, in time for a rollout in the President's State of the Union address next January, should the Administration choose that course.

The panel report, exceeding 270 pages, argues the case for tax reform, provides fairly detailed descriptions of two differing options that the panel unanimously recommends, and briefly outlines other consumption tax alternatives not agreed to by the panel.

The panel's task as assigned by President Bush was to produce revenue-neutral reform options that would simplify the tax system while making it more conducive to economic growth and maintaining the general distribution of tax burdens.

Overall, the panel's recommendations would revamp the tax code considerably -- creating both winners and losers at the corporate and individual levels -- while modestly reducing tax rates relative to those currently in place. Although no revenue tables were included in the report, the two options endorsed by the panel were estimated to be revenue-neutral in their entirety and are believed also to be neutral between the individual and corporate sectors. The panel measured revenue neutrality relative to the Administration's budget, which extends the major sunset provisions of the 2001 and 2003 acts.

### Arguments for Tax Reform

Many observers agree the U.S. tax system is in need of an overhaul. The panel report notes that compliance costs of the income tax system are estimated at \$140 billion per year, or approximately one percent of total U.S. economic output. Distortions and inefficiencies created by the tax system reduce output by several percentage points more.

Problems with the current tax code for individuals stand out. Under current law, if the temporary individual alternative minimum tax (AMT) relief provision is permitted to sunset at the end of this year, the number of AMT taxpayers would rise to 20 million in 2006 and to more than 50 million by 2015. The estimated \$1.2 trillion, 10-year cost of repealing the individual AMT complicated the panel's task of revenue-neutral reform. Other scheduled sunsets include expiration of the 15-percent tax rate on dividends and capital gains after 2008 and expiration of the 2001/2003 individual tax cuts after 2010.

Business taxes do not reflect the tax rules of many trading partners of the United States. U.S. corporations face the highest combined federal and state income tax rates among developed countries. The panel report notes that many U.S. trading partners exempt active income earned abroad, whereas the United States taxes this income upon repatriation.

## **Panel Recommendations**

The panel recommends two reform options: a Simplified Income Tax and a Growth and Investment Tax Plan. **An overview of key provisions follows, with additional detail in the accompanying side-by-side table attached below.**

### ***Simplified Income Tax***

#### **Individual Provisions**

Rates and deductions. -- Under the Simplified Income Tax, four brackets of 15, 25, 30, and 33 percent would replace the current tax rate schedule for individuals. The individual AMT would be repealed. Itemized deductions, including the deduction for state and local taxes, would be repealed. Mortgage interest expense on the taxpayer's principal residence would be eligible for a 15-percent credit (transition rules would phase in a cap on the loan amount on which home mortgage interest would be eligible for the credit, in addition to phasing out the deduction). Charitable deductions would be permitted for all individual taxpayers to the extent contributions exceed one percent of income.

Savings and incentives. -- Savings generally would be treated more favorably than under current law. Dividends of U.S. corporations paid out of U.S. taxable income would be 100-percent excluded from taxation. Capital gains on U.S. corporate stock would be 75-percent excluded, resulting in effective tax rates ranging from 3.75 percent to 8.25 percent. Generous new tax-free savings accounts would replace the current mix of IRAs, HSAs, 529 plans, and other special accounts. Employer-sponsored defined contribution plans would be simplified and provide for automatic enrollment. No other income deferrals through executive compensation arrangements or tax-free inside build-up through whole life insurance policies and annuities would be permitted.

#### **Business Provisions**

Rates and preferences. -- For businesses, the corporate rate would be reduced from 35 to 31.5 percent, a 10-percent reduction. The corporate AMT would be repealed. All tax preferences – more than 40 business provisions – other than accelerated depreciation would be repealed, including the research tax credit and the recently enacted deduction for domestic production activities (sec. 199). The deduction for state and local taxes would be denied to businesses, and municipal bond interest would be subject to tax.

Depreciation. -- The panel proposes simplified depreciation rules for new investments by grouping property into one of four new asset categories. Property in each category would be depreciated by multiplying an annual recovery percentage against the remaining balance in the account. Under this method, property would remain in an account until disposed of or sold, unlike

the fixed recovery periods under current law. The four depreciation categories and recovery periods are:

Category I: For assets used in agriculture, mining, manufacturing, transportation, trade, and service sectors, a 30-percent annual recovery percentage would apply. At an 8-percent nominal discount rate, the present value of depreciation allowances using this method would be between that of property recovered under current law over 5 and 7 years, using the 200-percent declining balance method.

Category II: For assets used in energy production, relatively long-lived utility property, and most land improvements, a 7.5-percent annual recovery percentage would apply. At an 8-percent nominal discount rate, the present value of depreciation allowances using this method would be slightly less than that of property recovered under current law over 20 years, using the 150-percent declining balance method.

Category III: For residential buildings, a 4-percent annual recovery percentage would apply. At an 8-percent nominal discount rate, the present value of depreciation allowances using this method would be slightly smaller than that of property recovered under current law over 27.5 years, using the straight-line method.

Category IV: For non-residential buildings and other long-lived real property, a 3-percent annual recovery percentage would apply. At an 8-percent nominal discount rate, the present value of depreciation allowances using this method would be slightly smaller than that of property recovered under current law over 39 years, using the straight-line method.

Although this proposed depreciation system would require fewer classification decisions to be made in determining the proper recovery period of an asset, the grouping of many disparate assets in the same recovery category necessarily would disadvantage short-lived assets relative to long-lived assets placed in the same category.

International. -- The Simplified Income Tax would adopt a territorial tax principle. Under this approach, active income earned abroad by U.S.-based multinational corporations would not be subject to U.S. tax when repatriated. All distributions following the effective date would be eligible for this exemption, without regard to whether the distributions were paid out of pre- or post-effective date earnings. Receipt of foreign source rents, royalties, and passive income would continue to be subject to U.S. tax, with a credit for foreign taxes. Expenses allocated to foreign source income would not be deductible.

The panel proposes to allocate interest on a worldwide basis following the rules enacted in the 2004 Jobs Act. General and administrative expenses would be allocated to the extent not otherwise recovered through intercompany payments. Research expenses would not be allocated, since these would be compensated for through foreign royalty payments. Note: While the panel report does not describe the revenue effects of this particular form of territorial taxation, a related simplification proposal made by the staff of the Joint Committee on Taxation was estimated to increase tax revenues by more than \$50 billion over 10 years.

### ***Growth and Investment Tax Plan***

#### **Individual Provisions**

The Growth and Investment Tax Plan largely follows the Simplified Income Tax modifications for individuals, but with three rate brackets for wages (15, 25, and 30 percent) and a 15-percent rate for all investment income, including dividends, interest, and capital gains earned outside of the special tax-free savings accounts.

## **Business Provisions**

In general. -- At the business level, tax would be assessed on cash flow at a 30-percent tax rate. All capital investments would be expensed. Interest payments would not be deductible, and investment income earned by a business would be excluded from taxation (different rules would be provided for financial service companies).

International. -- International tax rules would be modified under this option. As under the Simplified Income Tax, active foreign earnings of U.S. multinationals would not be subject to tax upon repatriation. In addition, since investment income generally would not be subject to taxation at the business level, passive foreign income would not be subject to tax.

Further, the panel proposes that this tax be border-adjustable, like a value-added tax. Border adjustments would be achieved by excluding from tax income earned from exports. Under this principle, royalties received from abroad also would be excluded from U.S. taxation. In addition, tax would be imposed on imports by not allowing a deduction for the cost of imports.

Transition rules. -- The panel recommends a series of transition rules for the Growth and Investment Plan. First, depreciation deductions on existing assets would be phased out based on the following schedule:

Year 1: 80 percent of depreciation on prior investments would be permitted;  
Year 2: 60 percent of depreciation on prior investments would be permitted;  
Year 3: 40 percent of depreciation on prior investments would be permitted;  
Year 4: 20 percent of depreciation on prior investments would be permitted;  
Year 5: No depreciation on prior investments would be permitted.

Second, interest deductions on pre-existing debt would be phased out based on a similar schedule:

Year 1: 80 percent of interest on pre-existing debt could be deducted;  
Year 2: 60 percent of interest on pre-existing debt could be deducted;  
Year 3: 40 percent of interest on pre-existing debt could be deducted;  
Year 4: 20 percent of interest on pre-existing debt could be deducted;  
Year 5: No interest on pre-existing debt could be deducted.

Third, border adjustments would be phased in over a four-year schedule:

Year 1: 90 percent of export income up to a base period amount would be subject to tax, and 90 percent of import expense up to a base period amount would be deductible;  
Year 2: 60 percent of export income up to a base period amount would be subject to tax, and 60 percent of import expense up to a base period amount would be deductible;  
Year 3: 30 percent of export income up to a base period amount would be subject to tax, and 30 percent of import expense up to a base period amount would be deductible;  
Year 4: Border adjustments fully phased in.

## **Overall Economic Effects**

As estimated by Treasury, the Simplified Income Tax would increase national income by about 0.5 percent after 10 years and 1 percent after 20 years. The long-run capital stock would increase by 1 to 2 percent. At 2006 income levels, about two-thirds of taxpayers with incomes over \$75,000 would have reduced tax liability under the proposal relative to current law, while

one-third would have increased tax liability. Effective tax rates on new corporate investment would decline modestly under the proposal.

Under the Growth and Investment Tax Plan, Treasury estimates national income would increase by about 1.8 percent after 10 years and 3.6 percent after 20 years. The long-run capital stock would increase by 5 to 20 percent. At 2006 income levels, slightly less than two-thirds of taxpayers with incomes over \$75,000 would have reduced tax liability under the proposal relative to current law, while one-third would have increased tax liability. The effective tax rate on new corporate investment would be reduced significantly from about 26 percent under current law to 7 percent under the proposal.

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