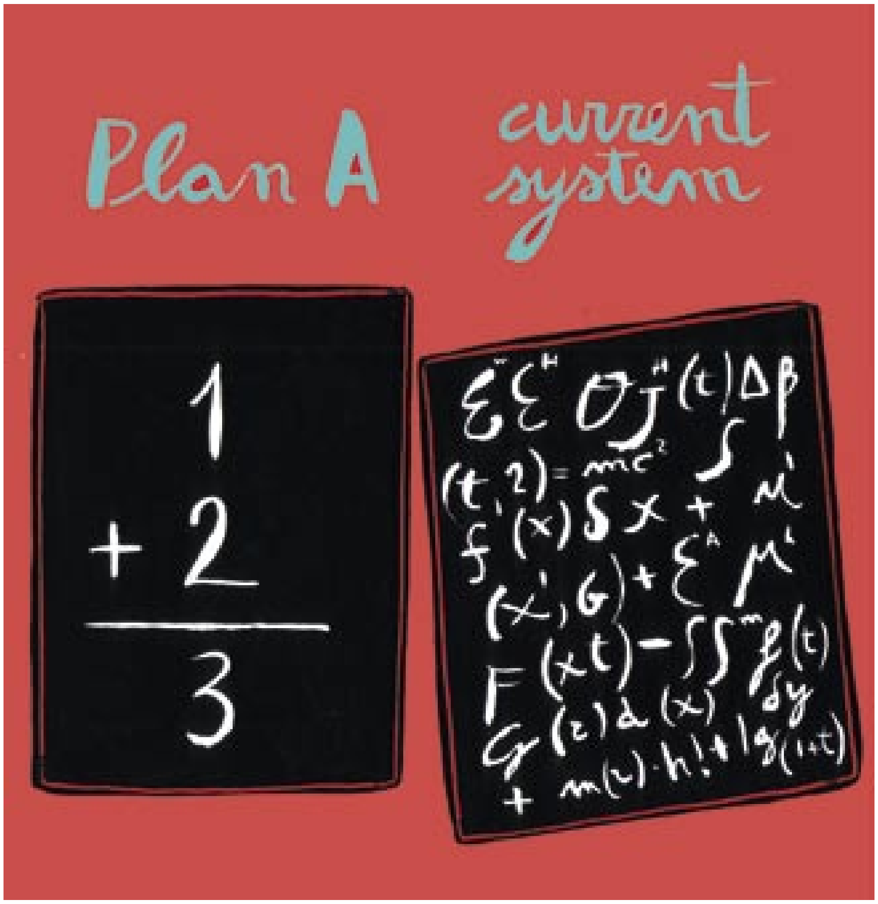
Chapter Six
The Simplified Income Tax Plan



Courtesy of Marina Sagona

The President directed the Panel to submit at least one option using the current income tax system as a starting point for reform. The Panel developed the Simplified Income Tax Plan to meet this objective. This chapter describes the Simplified Income Tax Plan and the impact it would have on taxpayers and the economy. It begins with an explanation of the provisions of the plan, and how they would simplify the tax system for individuals and businesses. Next, it summarizes the effect of the plan on issues of tax fairness, such as tax burden and distribution. Finally, this chapter closes with a discussion of the expected impact on the economy, including improved economic output and reduced compliance and administrative costs.

The Simplified Income Tax Plan would simplify the process of filing taxes and would make it easier to predict tax consequences when planning for the future. It would consolidate and streamline a number of major features of our current code – exemptions, deductions, and credits – that are subject to different definitions, limits, and eligibility rules. It would make the tax benefits for home ownership, charitable giving, and health coverage available to more taxpayers, simpler to calculate, and more efficient. It would repeal the AMT. It would lower tax rates, ensuring that individuals would not pay more than one-third of their income in federal income tax. And it would nearly eliminate taxes paid by individuals on income from corporate investments that are taxed in the United States.

Table 6.1 Simplified Income Tax Plan for Households	
Households and Families	
Tax rates	Four tax brackets: 15%, 25%, 30%, 33%
Alternative Minimum Tax	Repealed
Personal exemption Standard deduction Child tax credit	Replaced with Family Credit available to all taxpayers: $3,300 credit for married couples, $2,800 credit for unmarried taxpayers with child, $1,650 credit for unmarried taxpayers, $1,150 credit for dependent taxpayers; additional $1,500 credit for each child and $500 credit for each other dependent
Earned income tax credit	Replaced with Work Credit (and coordinated with the Family Credit); maximum credit for working family with one child is $3,570; with two or more children is $5,800
Marriage penalty	Reduced; tax brackets and most other tax parameters for couples are double those of individuals
Other Major Credits and Deductions	
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)
State and local taxes	Not deductible
Education	Taxpayers can claim Family Credit for some full-time students; simplified savings plans
Individual Savings and Retirement	
Defined contribution plans	Consolidated into Save at Work plans that have simple rules and use current-law 401(k) contribution limits; 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 Health 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
Dividends received	Exclude 100% of dividends of U.S. companies paid out of domestic earnings
Capital gains received	Exclude 75% of corporate capital gains from U.S. companies (tax rate would vary from 3.75% to 8.25%)
Interest received (other than tax exempt municipal bonds)	Taxed at regular income tax rates
Social Security benefits	Replaces three-tiered structure with a 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

The Simplified Income Tax Plan includes a comprehensive proposal to replace the maze of rules for saving for retirement, education, and health care with a simple structure that would allow most Americans to save tax-free. The savings proposal would consolidate the numerous savings-related provisions in our current code into three simple savings plans – Save at Work, Save for Retirement, and Save for Family accounts. Low-income taxpayers would receive a match for retirement savings contributions through a refundable credit. The savings package also would ensure that income earned outside these savings accounts would be taxed the same as other income by providing for more uniform tax treatment of financial income.

For businesses, the Simplified Income Tax Plan is designed to simplify tax filing and provide a more even tax treatment of business activities for businesses of all sizes. For small businesses, the Simplified Income Tax Plan would substantially simplify taxes by allowing them to use an accounting methodology that reflects the way most entrepreneurs manage and conduct their businesses. Ninety-five percent of all businesses – those with receipts under $1 million – would report their business income based on what goes into and out of their checking account: business receipts minus business cash expenses (other than purchases of land and buildings). Medium-sized businesses – those with more than $1 million but less than $10 million in receipts – would report on the same cash basis as small businesses, but would be required to depreciate rather than expense the purchase of new assets and, in some cases, maintain inventories.

Table 6.2. Simplified Income Tax Plan for Businesses

Small Business	
Tax rates	Taxed at individual rates (top rate has been lowered to 33%)
Recordkeeping	Simplified cash-basis accounting
Investment	Expensing (exception for land and buildings)
Large Business	
Tax rate	31.5%
Investment	Simplified accelerated depreciation
Interest paid	No change
Interest received	Taxable
International tax system	Territorial tax system
Corporate AMT	Repealed

Under the Simplified Income Tax Plan, large businesses would be taxed at a single rate of 31.5 percent, significantly lower than the 35 percent rate that currently applies to most corporate income. The Simplified Income Tax Plan would provide simpler rules for business investment and eliminate many of the special tax preferences in the current code. Indeed, over 40 special provisions would be eliminated. It would also eliminate the double tax on corporate profits earned in the United States. Finally, it would provide a simpler and more efficient international tax system to reduce complexity and help American businesses of all sizes compete globally.

The Simplified Income Tax Plan also would greatly reduce compliance costs and the time and money spent doing taxes. As explained in more detail later in this chapter, the tax returns that would be filed under the Simplified Income Tax Plan would be much simpler and more straightforward. Most taxpayers would file a one-page tax return that could even fit on the front and back of a postcard. Some taxpayers would have to file additional forms or schedules, but those would be much simpler than the maze of paperwork that many taxpayers face under our current system. Because taxes would be easier to compute and file, cheating and other forms of noncompliance would be more difficult.

The Simplified Income Tax Plan would be as progressive as the current income tax. Under the Simplified Income Tax Plan, most taxpayers would pay about the same in taxes as they are expected to pay under current law. Some specific taxpayers may pay a bit more or a bit less, but most taxpayers would find that their actual tax bill is about the same. The difference is that all taxpayers would face significantly less hassle and uncertainty.

Finally, several aspects of the Simplified Income Tax Plan would promote economic growth. First, the plan would provide simplified and expanded opportunities for tax-free saving. Second, the double tax on corporate profits would be nearly eliminated. Third, there would be simplified accounting and improved investment incentives for millions of small businesses. Lastly, there would be lower marginal tax rates on individuals and businesses.

How it Works: Streamlining the Tax Process for All Taxpayers

A Simpler Tax System for Families

Under our current tax code, many families struggle with complex forms as they seek to pay their taxes accurately. Under the new system, almost half of all taxpayers would be able to file their entire tax return on a single page. The Simplified Income Tax Plan would make the process far more streamlined and simpler to understand, and would allow a family to compute their taxes after following a few easy steps:

1. Compute income from wages, interest, and dividends by copying amounts from annual forms sent to the taxpayer by employers and payers, such as W-2 or 1099 forms.

2. Compute tax by looking up the tax liability that corresponds to income in a table. Almost three-quarters of all households will pay tax on their income at the lowest tax rate.

3. Compute the value of the taxpayer's Family Credit based on family type and size; subtract that value from the tax due to find out the amount owed or to be refunded.

There are exceptions to this relatively simple process; but only three would affect substantial numbers of taxpayers, and these would not require complex calculations. These provisions cover newly designed ways to provide tax benefits for home ownership, charitable giving, and health insurance coverage. As described in Chapter Five, the Panel recommends restructuring these tax benefits to make them simpler and fairer. For the Home Credit and charitable deduction, taxpayers would be sent forms by mortgage lenders and charities, and many taxpayers would do little more than copy the amounts from the forms onto their tax returns. Tax benefits for health insurance coverage also would be available to all taxpayers through a new deduction for health insurance. The majority of workers would not have to deal with claiming the deduction on their returns because tax-free health insurance received on the job would already be excluded from taxable wages reported to them by their employers.

Two newly designed provisions would apply only to lower-income taxpayers. Lower-income workers would be eligible to receive the refundable Work Credit described in Chapter Five, and lower-income savers would be eligible to receive the new refundable Saver's Credit, which is described below. These refundable credits would be targeted to taxpayers who have little or no federal income tax liability.

In addition, the Simplified Income Tax Plan would provide a much simpler way to measure the taxable amount of Social Security benefits. Married taxpayers who have less than $44,000 in income and single taxpayers with less than $22,000 in income would not pay tax on their Social Security benefits – about 60 percent of Social Security recipients would fall below these thresholds. As described in Chapter Five, taxpayers with income above the thresholds would include between 50 and 85 percent of their benefits in their taxable income depending on their income level – but unlike the current system, that computation would be straightforward. In addition, the new rules for calculating tax on Social Security benefits would eliminate the marriage penalties and the automatic, inflation-induced tax increases that our current code imposes.

Tax would be computed using four marginal tax rates – 15, 25, 30, and 33 percent – instead of the six rates that exist under current law. As summarized in the Table 6.3, the rate brackets for married taxpayers would be twice the amounts for unmarried taxpayers, which would reduce marriage penalties.

Table 6.3. Tax Rates Under the Simplified Income Tax Plan (2006)

Tax Rate	Married	Unmarried
15%	Up to $78,000	Up to $39,000
25%	$78,001 - $150,000	$39,001 - $75,000
28%	$150,001 - $200,000	$75,001 - $100,000
33%	$200,001 or more	$100,001 or more

Under the Simplified Income Tax Plan, the most complicated fixtures of our current system would be eliminated. Almost every tax benefit currently available to taxpayers comes with strings attached – the benefits are reduced when taxpayers reach a specified income level. Rules that target benefits to a limited number of taxpayers through phase-outs create tremendous complexity. Almost no two benefits are phased out the same way: Phase-outs use different threshold amounts (the amount of income at which benefits begin to fade), phase-out rates (the speed at which benefits disappear), and definitions of "income." These differing rules effectively cause taxpayers to compute their income multiple ways to find out how much of the tax benefits they lose. Under the Simplified Income Tax Plan, most taxpayers would not have to worry about making numerous, complex calculations to determine whether they are eligible for a particular tax preference or applying other complicated rules designed to restrict who can claim a tax benefit. The Simplified Income Tax Plan eliminates almost all of these phase-outs.

One of the most conspicuous complexities in our current system is the AMT. As discussed previously, the AMT is a parallel tax structure that requires taxpayers to recompute their tax liability using a new definition of income, different exemption amounts, different deductions and credits, and separate tax rates. The AMT takes back tax benefits that have previously been given to taxpayers through a complicated and deceptive mechanism. The AMT also makes it difficult for taxpayers to predict their tax liability in advance. If not repealed, millions more middle-class Americans will face a tax increase each year, as well as additional complexity and compliance costs. Under the Simplified Income Tax Plan, taxpayers would only be required to make *one* straightforward set of computations to determine their share of the cost of government. The Simplified Income Tax Plan would not rely on a backstop or second set of rules like the AMT.

Simpler and more straightforward rules would result in simpler tax returns and forms. The new Form 1040-Simple that would be used under the Simplified Income Tax Plan is easy to understand and involves calculations that are intuitive. As shown in Figure 6.1, the Form 1040-Simple would be no longer than one page. It would be a tremendous simplification as compared to the current Form 1040.

Figure 6.1. Form 1040-Simple

1040-SIMPLE **U.S. Individual Income Tax Return** **200X** (99)

For the year Jan. 1–Dec. 31, 200X, or other tax year beginning , 200X, ending , 20 — OMB No. 1545-XXXX

LABEL HERE

Your first name and initial	Last name	Your social security number
If married, spouse's first name and initial	Last name	Spouse's social security number
Home address (number and street, city, town or post office, state, and ZIP code). If you have a P.O. box or a foreign address, see page xx.		**Important!** You **must** enter your SSN(s) above.

1	Wages, salaries, tips, etc. Attach Form(s) W-2		1
2	Business income or (loss). Attach Schedule C, C-EZ, E, or F	+	2
3	Taxable interest and dividends	+	3
4	Gain or (loss) on stock. Attach Schedule D	+	4
5	Other gains or (losses). Attach Form 4797	+	5
6	Taxable distributions (retirement and savings)	+	6
7	Social security benefits	+	7
8	Other income. List type and amount ▶	+	8
9	Add lines 1 through 8	**Total income =**	9
10	Charitable contributions		10
11	Multiply line 9 by 1% (.01)	−	11
12	Subtract line 11 from line 10. If zero or less, enter -0-		12
13	Social security benefits deduction (see page xx)	+	13
14	Health insurance deduction	+	14
15	Add lines 12 through 14	−	15
16	Subtract line 15 from line 9. If zero or less, enter -0-	**Taxable income =**	16
17	Figure your tax (see page xx)	**Tax =**	17
18	Home credit (see page xx)	−	18
19	Subtract line 18 from line 17. If zero or less, enter -0-		19
20	Family credit from Schedule A, line 6, on back	−	20
21	Subtract line 20 from line 19. If zero or less, enter -0-		21
22	Self-employment tax	+	22
23	Other taxes and foreign tax credit. Attach Schedule O	+	23
24	Add lines 21 through 23. If zero or less, enter -0-	**Total tax =**	24
25	Federal income tax withheld		25
26	Work credit	+	26
27	Savers credit. Attach Form XXXX	+	27
28	Estimated tax and other payments	+	28
29	Add lines 25 through 28	**Total payments =**	29
30	If line 29 is more than line 24, subtract line 24 from line 29. If you want to use direct deposit, attach Form XXXX	**Amount overpaid =**	30
31	Amount of line 30 you want applied to your 200Y estimated tax		31
32	If line 24 is more than line 29, subtract line 29 from line 24	**Amount you owe =**	32

Sign Here
Married? See page xx.
Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature	Date	Your occupation	**If married but not filing with spouse, check here** ▶ ☐
Spouse's signature. If filing with spouse, **both** must sign.	Date	Spouse's occupation	Daytime phone number ( )

Paid Preparer's Use Only

Preparer's signature ▶	Date	Check if self-employed ☐	Preparer's SSN or PTIN
Firm's name (or yours if self-employed), address, and ZIP code ▶		EIN	
		Phone no.	( )

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page xx. Cat. No. 00000X **1040-SIMPLE** (200X)

For the approximately 38 percent of taxpayers who have children and other dependents, the Family Credit would be claimed on new Schedule A, which would assist taxpayers in making the straightforward computation. Computation of the refundable Work Credit would follow from the simple Family Credit computation on Schedule A. Taxpayers could even indicate their desire for the IRS to calculate the Work Credit for them by checking a box on new Schedule A. In total, 75 percent of current law filers would file, at most, the Form 1040-Simple and Schedule A.

The proposed tax forms take into account both the Panel's reform proposals and a number of other refinements that would reduce compliance burdens and streamline return processing. The Panel recognizes that some of these refinements reflect a departure from the way the IRS currently constructs and processes Form 1040.

This simplification would have a real impact on millions of Americans. The Simplified Income Tax Plan would reduce the time individuals spend doing their taxes and the records they have to keep. The Simplified Income Tax Plan also would reduce taxpayers' out of pocket costs for help with tax preparation and allow more taxpayers to prepare their own tax returns if they so choose. More importantly, under the Simplified Income Tax Plan, taxpayers would have a better understanding of how their taxes are computed.

Perhaps more valuable would be the greater confidence a simplified system would engender in our tax code. Taxpayers could file their taxes knowing they had determined their tax liabilities correctly. Taxpayers would feel more confident that they had not overlooked tax benefits available to them and that others are paying their fair share. The simpler and more transparent tax system also would be less susceptible to tax avoidance.

The greater transparency under the Simplified Income Tax Plan also would allow taxpayers to make better and more efficient economic decisions. Planning for the future – how much to save, for example – would no longer be complicated by the tax code's current set of elaborate rules. In addition, there would be fewer unpleasant surprises each April because taxpayers would not be caught off guard by phase-outs and the AMT that force them to pay more taxes than anticipated.

A Comprehensive Proposal To Remove Impediments to Saving

As described in Chapter Five, the current tax system discourages saving by imposing a higher tax on those who choose to save than those who spend. The Simplified Income Tax Plan includes a comprehensive package of savings proposals designed to allow Americans to save in a simple and efficient manner. The savings proposal consists of three parts. First, it would replace the current tax code's plethora of savings incentives with a unified system of expanded savings opportunities. Second, it would provide a refundable credit as an incentive for lower-income taxpayers to save. Third, it would introduce a more consistent treatment of savings held outside of tax-preferred accounts. The Panel believes that all components of this package should be considered together, and would not necessarily recommend adoption of some components without the others.

Flexible, Convenient, and Straightforward Savings Opportunities

The first component of the Simplified Income Tax Plan's savings proposals would combine the tax code's panoply of savings incentives and accounts into three simple and flexible opportunities: (1) Save at Work plans; (2) Save for Retirement accounts; and (3) Save for Family accounts. The Save at Work plans would incorporate changes to the way plans are administered, referred to as "AutoSave," that are designed to point workers in the direction of savings. The creation of these three opportunities would allow most Americans to save for their future financial needs, such as education, health costs, a new home, or retirement, free of tax. They would also largely eliminate the need for taxpayers to hire tax professionals to help them navigate the tax code's multitude of savings incentives. Americans would be able to make investment decisions based more on their preferred investment strategy, rather than the effects that certain tax-preferred investment vehicles have on their tax liability.

Save at Work

For millions of Americans, employer-provided retirement plans have been an integral part of retirement security. Over 90 million workers utilize some type of tax-preferred retirement savings plan at work. The benefits of employer-sponsored retirement savings accounts are not evenly distributed among the population, however. Taxpayers whose employer offers a retirement plan pay less tax on their income than those whose employers do not. In addition, employees who work for employers that offer tax-free matching contributions receive more favorable treatment than those whose employers do not offer a match.

The rules covering tax-preferred retirement savings are among the most complex in the tax code and may be a barrier to additional retirement saving by workers. Current law provides a number of different plans, including 401(k), SIMPLE 401(k), Thrift, 403(b), governmental 457(b), SARSEP, and SIMPLE IRA plans, that offer different kinds and amount of benefits to employees and are subject to different rules and standards. This variation and complexity creates high administrative and compliance costs. Those costs often prove to be a deterrent to employer sponsorship of retirement plans, making such tax-preferred savings unavailable to many workers. Only about 53 percent of private employers offer a defined contribution retirement plan to their workers. Administrative costs are a particular problem for small firms – less than 25 percent sponsor any retirement plan.

Small employers, which employ about 40 percent of American workers, can choose to offer either a 401(k) or SIMPLE IRA plan to employees, but each provides different rules governing employee eligibility, contribution amounts, catch-up amounts, and employer matching limits, among other features as summarized in Table 6.4. These different rules create significant obstacles for small employers because they find it difficult to determine which plan best fits the needs of their employees at the lowest cost.

Table 6.4. Example of Variation in Small Employer Retirement Plans

	401(k) Plan	SIMPLE IRA Plan
Pre-tax Contribution Amount	$14,000 in 2005	$10,000 in 2005
Catch-Up Amounts	$4,000 in 2005	$2,000 in 2005
Employer Matching	May be matching and/or nonelective	*Either* a full match on elective contributions up to 3% of pay or 2% nonelective contribution
Nonelective Contributions	Matching not limited to 3% and match may be less than full	Nonelective contributions limited to 2% of pay
Discrimination Testing	Yes	No
Vesting	Vesting schedule may be added	Full vesting of employer contribution
Top Heavy Contributions	May be required	Not required
Plan Loans	Permitted	Not permitted
Other Plans	May adopt other qualified plans	May not sponsor any other SIMPLE plan or qualified plan
Pooling of Plan Assets	May pool §401(k) contributions into a single trust invested by trustee	Individual assets within IRAs invested by employees
Eligibility	Eligibility may exclude employees with less than 1,000 hours of service	Eligibility must include employee who earns $5,000 or more during calendar year
ERISA Applicability	Protects benefits from creditors	Not applicable
Required Return	Form 5500 annual filing	No Form 5500 filing

The complexity of employer-sponsored retirement savings plans also affects employees. Account holders have to negotiate convoluted rules when changing jobs, for example. Given that job change is a feature of today's workforce, complexity in handling retirement savings disrupts workers' retirement savings patterns. It is not uncommon for a worker to have multiple 401(k) accounts spread out among past employers, each holding modest amounts. It is also not uncommon for separated workers to withdraw funds from a 401(k) plan, pay tax and an additional penalty, and spend what is left – instead of moving the funds into a new tax-preferred savings vehicle. The most recent studies suggest as of 1996, a sizable majority of workers who receive a lump-sum distribution of $5,000 or less from their former employer's retirement plan do not roll it over to another qualified plan or IRA, reducing the funds set aside to support the employee's future retirement.

The employer-provided Save at Work retirement plan would combine 401(k), SIMPLE 401(k), Thrift, 403(b), governmental 457(b), SARSEP, and SIMPLE IRA plans into a single type of plan that could be easily established by any employer. To encourage employers to make the Save at Work accounts available to their employees, a single set of administrative rules would be established. Save at Work plans would be less expensive for employers to administer, reducing compliance costs. In addition, the AutoSave features described below would change the administrative rules to encourage greater savings by workers. Save at Work plans would follow the existing contribution limits and rules for 401(k) plans, but the plan qualification rules would be greatly simplified.

Under current law, there are a number of complicated rules that ensure that highly compensated employees do not enjoy undue benefits from tax-deferred saving plans. These rules, known as "nondiscrimination requirements" generally apply a set of tests that ensure that highly compensated employees do not receive disproportionately high benefits relative to other employees. To simplify administration, Save at Work plans would apply a single test to ensure that employee contributions are not skewed towards highly compensated employees. In addition, an alternative rule would be provided to allow employers to avoid nondiscrimination testing altogether if the Save at Work plan is designed to provide consistent employer contributions to each plan participant, regardless of their compensation.

The Save at Work option also would include rules for small businesses to help reduce costs and encourage them to offer plans. Small employers with 10 or fewer employees could contribute to a Save at Work account largely controlled by the employee and similar to current-law SIMPLE IRAs. Like current-law SIMPLE IRAs, small business owners would not be required to file annual returns for these accounts and would not be subject to the same legal liability rules that apply to larger employer-sponsored plans.

Box 6.1. Eliminating Impediments to Saving Through Better Retirement Plan Design

Employer-provided retirement plans are designed to eliminate impediments to saving by reducing the tax on returns to savings. But studies have found that the return on savings is not the only factor that influences savings decisions: The structure of retirement savings plans and the way employers present them to employees affects their decisions to save.

Currently, participation in most employer-sponsored plans is dependent on the worker actively choosing to participate. Until recently, most believed that the voluntary aspects of employer-sponsored retirement savings had little to do with participation. In fact, a number of recent studies show the exact opposite result.

One study, focusing on firms that automatically enrolled their employees in the savings program unless the employee actively chose not to participate found significant increases in employee participation and contribution levels. In some cases, participation rates doubled to more than 90 percent. Employees also tended to adopt the default contribution amount and asset allocations, which invested employee contributions in balanced and diversified investment funds.

In another study, employees were given the option to commit a share of future salary increases to savings. Nearly 80 percent of employees who were offered the plan chose to participate and savings rates for participants more than tripled in just 28 months.

The study also found that default rules for disbursement when employees leave their jobs influence decisions to continue saving. If cash disbursement of retirement balances is the default option, employees tend to accept cash instead of putting the funds back into a tax-free savings account. On the other hand, employees whose default option was to automatically move the funds into an IRA or other retirement plan continued to save these funds.

AutoSave

The Save at Work plan would be accompanied by a number of features, referred to as AutoSave, that are designed to point workers in the direction of sound saving and investment decisions. Firms would be permitted, but not required, to include AutoSave as part of their retirement plan structure. The Panel's recommendation would remove restrictions that may currently discourage employers from implementing AutoSave. The AutoSave program would incorporate the following features:

- Automatic Enrollment in Save at Work – Employees would automatically become participants in their employer's Save at Work plan unless they actively choose not to participate.
- Automatic Growth in Save at Work Contributions – The employee contribution percentage would automatically increase over time – either through scheduled periodic increases or increases conditioned on pay raises over time – to boost the proportion of earnings set aside and total accumulated retirement savings.
- Automatic Investment of Save at Work Contributions – Employee contributions would be invested in balanced, diversified alternatives with low fees, such as broad index or life-cycle funds, unless the employee elects different investment alternatives.

- Automatic Rollover – Upon leaving a job, an employee's Save at Work plan balance would be retained in the existing plan or would be automatically transferred to a Save at Work account with their new employer, or to a rollover Save for Retirement account. Automatic rollover would ensure that amounts put aside for retirement continue to grow.

None of the AutoSave features would be mandatory and employees would be able to opt out of AutoSave at any time. Furthermore, employers would choose which default to use. The AutoSave features do not dictate choices, but merely point workers in a pro-saving direction when they fail to indicate their saving preferences. Provisions to ensure that employees retain control over enrollment and investment decisions would be incorporated. AutoSave plans would be required to provide participants with advance notice and an adequate opportunity to make their own, alternative choices before proceeding with the default option.

The Panel recommends that the following provisions be adopted as part of its AutoSave proposal. First, current law should be clarified to confirm that federal laws permitting automatic payroll deductions for retirement plans supersede any state laws that might prohibit this practice. Second, fiduciary liability protection against investment losses would be extended to sponsors of Save at Work plans that incorporate AutoSave features to the same extent provided by current law to all plans in which the employee exercises control over the investment of plan assets. Third, AutoSave plans would be entitled to discrimination testing that is less stringent than current law. Finally, to demonstrate leadership in this area, the Panel also recommends that the federal government adopt Auto-Save for its Thrift Savings Plan.

Save for Retirement

Save for Retirement accounts would allow taxpayers to supplement their Save at Work retirement savings by putting up to an additional $10,000 (or the total amount of earnings, if less) in tax-free accounts. The annual contribution amount would be indexed annually for inflation. No income limits would apply to Save for Retirement accounts.

The Save for Retirement accounts would replace existing IRAs, Roth IRAs, Nondeductible IRAs, deferred executive compensation plans, and tax-free "inside buildup" of the cash value of life insurance and annuities. Contributions would be made with after-tax dollars like current law Roth IRAs and earnings would grow tax-free.

Roth IRAs would be automatically converted to Save for Retirement accounts. Existing traditional IRAs (including those to which nondeductible contributions were made) could be converted into a Save for Retirement account by subjecting the value of those accounts to taxes once, similar to a current-law conversion of a traditional IRA account to a Roth IRA account. No income limits would restrict conversions. Similarly, upon separation, Save at Work plans could be rolled directly from an employer plan into a Save for Retirement account by paying income tax on the rollover amount. Existing traditional IRAs not converted into a Save for

Retirement account would continue to exist, but new contributions would have to be made to Save for Retirement accounts.

The Save for Retirement accounts are intended to supplement, not replace, retirement savings incentives provided through Save at Work accounts. The Save for Retirement accounts are proposed as part of a savings package that includes the Save at Work and AutoSave proposals, which are designed to ensure that the cost to employers of sponsoring a plan would be low and that more workers participate in employer-sponsored retirement plans.

To increase the likelihood that money set aside for retirement would not be spent early, Save for Retirement accounts would restrict distributions. Tax-free distributions from Save for Retirement accounts could be made only after age 58, or in the event of death or disability. Earlier distributions would be treated as taxable income and would be subject to an additional 10 percent tax, similar to the penalty paid on early withdrawals from Roth IRAs under current law. No minimum distribution rules would apply.

Under current law, there are exceptions for early withdrawal for education, first-time home buyer expenses, and medical expenses. These exceptions would no longer be necessary under the Simplified Income Tax Plan because Save for Family accounts, described below, would provide a separate vehicle to save for these important family needs.

Save for Family

The Simplified Income Tax Plan would provide flexible Save for Family accounts that could be used by taxpayers for retirement, health, education and training, or a down payment on a home. Save for Family accounts would allow every taxpayer to save $10,000 each year for these major expenditures, and would replace existing education and medical accounts, including Coverdell Education Savings Accounts, Section 529 Qualified Tuition Plans, Health Savings Accounts, Archer Medical Savings Accounts, and employer-provided Flexible Spending Accounts. In addition, Save for Family accounts could be used to supplement retirement savings.

All Americans, regardless of income, age, family structure, or marital status, could have a Save for Family account. Contributions would be made on an after-tax basis, and like current-law Roth IRAs, earnings would grow tax-free. Existing education and health savings plans could be converted to Save for Family accounts. Existing accounts that are not converted would continue, but all new contributions would be made to Save for Family accounts.

Tax-free withdrawals from Save for Family accounts could be made at any time to pay qualified expenditures for health or medical costs, education or training expenses, and purchases of a primary residence. As with Save for Retirement accounts, funds would be available tax-free at any time to taxpayers who are 58 or older.

To provide taxpayers even greater flexibility and to reduce record-keeping burdens, taxpayers would be able to withdraw up to $1,000 tax-free each year from Save for

Family accounts for any reason. Distributions in excess of $1,000 that are not for qualified expenditures would be treated as taxable income and would be subject to an additional 10 percent tax, similar to the penalty paid on early withdrawals from Roth IRAs under current law. No minimum required distribution rules would apply.

Figure 6.2. Summary of Simplification Created by New Save for Retirement and Save for Family Accounts

Description	Contribution Limit
Retirement Accounts	
IRAs[1,2]	$4,000 ($5,000 in 2008)[1]
Roth IRAs[1]	$4,000 ($5,000 in 2008)[1]
Health Incentives	
Health Savings Accounts (HSAs)[2]	$2,600 single/$5,150 family
Archer MSAs[2] (small businesses and self-employed)	75 percent of deductible for high deductible health plan
Flexible Spending Arrangements[2]	Unlimited (but portion may be forfeited if not used within prescribed time periods)
Education Savings Incentives	
Coverdell Savings Accounts	$2,000 (per student)
Qualified Tuition Programs (529s)	Effectively unlimited
Savings Bonds	Interest excludible up to qualified higher education expenses[1]
Other Tax Preferred Savings	
Life Insurance	Unlimited
Executive Deferred Compensation	Unlimited

Retirement Accounts → **Save for Retirement Accounts** ($10,000 annual contribution limit)

Health Incentives and Education Savings Incentives → **Save for Family Accounts** ($10,000 annual contribution limit)

[1] Contribution limit may phase out based on income.
[2] Contributions made to these accounts are excluded from income.

The New Refundable Saver's Credit

The Simplified Income Tax Plan savings proposals are designed to increase the likelihood that taxpayers will save more and to help establish a habit of saving and familiarity with the financial markets. As noted in Chapter Three, the progressivity of our current income tax relieves many lower-income Americans from paying any tax. The tax-free features of the Save at Work, Save for Retirement, and Save for Family accounts therefore would provide little, if any, additional tax benefit if these taxpayers save for their future. The second component of the Simplified Income Tax Plan's savings proposal would provide a subsidy for lower-income taxpayers to save.

Under current law, taxpayers with low to moderate incomes are eligible to receive the credit for qualified savings contributions (sometimes referred to as the "saver's credit"). The saver's credit provides a credit for 10, 20, or 50 percent of contributions of up to $2,000 made to an Individual Retirement Account (IRA) or an employer-sponsored defined contribution plan. The credit is phased out as the taxpayer earns more.

This credit is scheduled to expire after 2006. In addition, it has several design flaws that make it less effective than it could be in encouraging low-income taxpayers to save. Because the credit is nonrefundable, lower-income taxpayers who do not have tax liability receive no benefit from the credit. The combination of nonrefundability and income phase-outs as taxpayers earn more means that many taxpayers are unable to receive the full amount of the credit. The maximum credit of 50 percent is available to married couples with adjusted gross income (AGI) up to $30,000, head of household filers with AGI up to $22,500, and single filers with AGI up to $15,000, but quickly phases down to 10 percent once the taxpayer earns income above these thresholds. Head of household and single taxpayers are unable to receive the maximum $1,000 credit because their tax liability over the range where the 50 percent credit is applicable is always below $1,000. The complexity of the credit, its limited benefit to the targeted taxpayer group, and a lack of awareness of the credit have all contributed to its underutilization.

Recent studies suggest that lower-income taxpayers are responsive when given clear incentives to contribute to retirement accounts. These studies suggest that the presence of a meaningful match that is presented at the time of tax preparation can have a sizeable impact on the percentage of lower-income taxpayers who save and the amounts saved.

The Simplified Income Tax Plan would replace the current law credit with a new refundable Saver's Credit that would be available to more lower-income taxpayers. The maximum annual contribution eligible for the credit would be $2,000 and the credit rate would be 25 percent, making the maximum credit amount $500. This 25 percent credit would effectively provide an implicit government match rate of 33 percent: a $2,000 contribution reduces the taxpayer's income tax liability by $500, so the taxpayer's net contribution of $1,500 results in an account balance of $2,000.

The amount of the new Saver's Credit is calculated on a per-person basis. Although eligibility for the new Saver's Credit would be gradually reduced as taxpayers earn more than $30,000 if married and $15,000 if single, it would be fully refundable. The credit would phase-out smoothly at a rate of 5 percent: each additional $100 of earnings would reduce the credit amount by $5. The credit would be completely phased out at income levels of $40,000 for married couples and $25,000 for single taxpayers. To help encourage new savings and prevent taxpayers from merely shifting savings from one tax-preferred account to another, the credit would be required to be deposited into a Save for Retirement or a restricted Save for Family account. The restricted Save for Family account would not permit annual $1,000 unrestricted withdrawals. If the taxpayer has not qualified for a match in five years, the funds in the restricted Save for Family account could be transferred to a regular, unrestricted Save for Family account.

It is also important that the taxpayer would not, by reason of depositing savings that qualify for the Saver's Credit, lose eligibility for other means-tested programs, such as food stamps, temporary assistance for needy families, or Pell Grants. Thus, the Panel recommends that these assets be ignored for purposes of determining whether the taxpayer is eligible for a means-tested federal assistance program.

Leveling the Playing Field for Savings

An important element of the savings proposals included in the Simplified Income Tax Plan would provide a more neutral treatment for financial income earned outside of Save for Retirement, Save for Work, or Save for Family accounts. Currently, there are no annual limits on the tax benefits for certain deferred compensation arrangements and increases in the cash-value of annuities and life insurance. The Panel recommends that new rules be put in place to treat these arrangements like other investments.

Some life insurance policies and annuities allow for nearly unlimited tax-free savings. Currently, there is no taxable income until the policy is cashed in, even though the policyholder is receiving the benefit of increases or "inside build-up" in the value of the policy or annuity. In addition, withdrawals from policies are taxed favorably.

Under the Simplified Income Tax Plan, the increase in value in those policies would be treated as current income, and therefore would be subject to tax on an annual basis, just like a savings account. As with other financial investments, such as stocks or bonds, whole-life insurance policies and deferred annuities could be purchased through tax-deferred Save for Retirement and Save for Family accounts, subject to the same dollar limits. Life insurance that cannot be cashed out and annuities that provide regular, periodic payouts of substantially equal amounts until the death of the holder (known as life annuities) would not be taxed on an inside build-up, the same treatment as under current law.

The Simplified Income Tax Plan also would eliminate the ability of some taxpayers to save tax-free through the use of executive deferred compensation plans. These plans allow executives to elect to defer a portion of their compensation in order to receive an amount later that has grown tax-free. Recently enacted legislation tightened the rules applicable to deferred executive compensation, but retained a number of exceptions that allow tax-free growth on deferred wages. The Simplified Income Tax Plan would require all amounts deferred under a nonqualified deferred compensation plan to be included in income to the extent these amounts are not subject to a substantial risk of forfeiture and were not previously included in income.

Annuities, life insurance arrangements, and deferred compensation plans that currently are in existence would continue to be taxed under current-law rules.

Currently, interest earned on tax-exempt bonds is not taxed. Providing an incentive for investment in public infrastructure is seen as sensible public policy that is widely valued. Similar to preferences for home ownership, charitable giving, and health coverage, the Panel chose to maintain current law treatment of state and local tax-exempt bonds for individual investors. The Panel recommends, however, that because of the flexibility businesses have to deduct interest, the exclusion from business income for state and local tax-exempt bond interest be eliminated. Although current law disallows interest paid by businesses to buy or carry tax-exempt bonds, the rule is difficult to administer and easy to avoid.

As under current law, individual investors would be able to deduct the amount of interest incurred to generate taxable investment income. The deduction for investment interest would be limited to the amount of taxable investment income reported by a taxpayer.

Taxing Corporate Earnings Once

The Simplified Income Tax Plan also would improve the environment for business investment by reducing the double taxation of corporate income earned in the United States. In our current system, business income is taxed twice – once when earned by the corporation and a second time when shareholders receive dividend distributions out of profits or realize capital gains from the sale of stock. The Simplified Income Tax Plan would allow shareholders to exclude from income the value of dividends received from corporations that are paid out of profits on which tax is paid in the United States.

Under the Simplified Income Tax Plan, corporations would notify shareholders of the portion of dividends that would be subject to tax – this would be based on the proportion of income not subject to U.S. taxation during the prior year. Shareholders would pay tax only on the reported proportion of dividends not based on income taxed in the United States during the prior year. For example, if in the prior year a firm reported taxable income of $800 in the United States out of total worldwide income of $1,000, shareholders would be taxed only on 20 percent ($200 divided by $1,000) of dividends received during the following year. Requiring corporations to publicly report to their shareholders and the IRS the proportion of profits that were taxed in the United States also would make the tax system more transparent by directly informing shareholders how much of their income is taxed in the United States.

The Panel considered, but rejected, extending the exclusion for corporate dividends to amounts paid by U.S. corporations out of income earned abroad. Under the territorial system recommended as part of the Simplified Income Tax Plan, earnings from active foreign operations of U.S. corporations would be excluded from U.S. tax. A dividend exclusion for foreign earnings of U.S. corporations would require raising revenue elsewhere, thereby causing U.S. taxpayers to subsidize foreign operations of U.S. corporations. In addition, dividends received by U.S. shareholders from foreign corporations would not receive an exclusion. The Panel considered extending the exclusion for dividends paid from U.S. corporations to dividends paid from foreign corporations, but concluded that it would not be possible to implement a workable plan to determine the portion of dividends paid out of profits of foreign corporations on which U.S. tax had been paid.

Of course, dividends are not the only way shareholders benefit from corporate earnings. Earnings that are not distributed to shareholders as dividends, but are retained by corporations and reinvested in new projects, increase the value of the corporation's stock. Shareholders realize this increase in value as capital gains when they sell their shares. To reduce double taxation of corporate earnings retained by U.S. corporations, the Simplified Income Tax Plan would exclude 75 percent of capital gains received by individuals on sales of U.S. corporations if the individual held the stock for more than one year. This treatment would lower the capital gains rate on sales of corporate stock to a maximum of 8.25 percent. For example, if a shareholder recognizes $100 of capital gain on the sale of stock, only 25 percent, or $25, would be subject to tax at ordinary rates. A taxpayer in the top 33 percent tax bracket would pay $8.25, or 8.25 percent, in tax, while a taxpayer in the lowest 15 percent tax bracket would pay $3.75, or 3.75 percent, in tax.

The Panel considered more complicated regimes that would more precisely track the amount and timing of dividends and capital gains that should be exempt from shareholder-level tax based on the amount of income on which U.S. tax was paid at the business level. These regimes would require shareholders to track increases in the basis of their stock on an annual basis to more accurately level the playing field between dividend distributions and retained earnings. The Panel rejected these more complicated regimes in favor of the 100 percent dividend exclusion and the 75 percent exclusion of capital gains on stock sales because these approaches provide simpler ways of reducing the double tax on earnings of U.S. corporations. The treatment represents an area where the Panel made a tradeoff in favor of simplicity over more precise calculations.

Taken together, the exclusion from income for domestic dividends and 75 percent of capital gains from U.S. corporate stock sales would substantially reduce the tax rate on investment in America's companies. It also would introduce greater efficiency in the way American investors deploy their capital and choose between corporate and non corporate investments. It would likely result in increased investment in corporate equity. Additional information regarding the treatment of corporate dividends and capital gains can be found in the Appendix.

Capital Gains

The sale of corporate stock is just one way individuals can earn capital gains. Individuals also realize capital gains when they sell other kinds of assets. Under current law, capital gains of both corporate and non-corporate investments are taxed at a maximum rate of 15 percent (the rate is 5 percent for taxpayers in lower tax brackets). By providing a special rate for all capital gains, the current tax code fails to fully eliminate the double tax on corporate retained earnings, while providing a generous tax break on other kinds of gains.

The Simplified Income Tax Plan would tax all gains, other than those on the sale of stock of U.S. corporations, at the taxpayer's regular tax rates. The Simplified Income Tax Plan would therefore raise the tax rate on some capital gains for higher-income individuals, while lowering the rate for all investors in corporate stock. This treatment would greatly simplify reporting of income from capital gains and the separate provisions described above would achieve the objective of reducing the double taxation of corporate retained earnings. Taxing capital gains at the same tax rate that applies to other income also would eliminate the need for a host of complex rules for the recapture of tax on the sales of assets by small businesses that take advantage of the new simplified and expanded expensing of investments described below.

One type of capital gain that receives special treatment under our current tax system is the gain on the sale of housing. Under current law, taxpayers may exclude a substantial amount of the gains on the sale of their primary residences from income (the exclusion amount is up to $500,000 if the taxpayer is married and up to $250,000 if single) if the home was owned and used as a principal residence for two or more of the preceding five years. Gains in excess of this amount are taxed at the capital gains rate, which is up to 15 percent under current law. Taxing capital income at the same rate as other income may mean that some taxpayers would pay a higher tax rate on capital gains from selling their homes than they do under current law. To help ensure that there is not an increase on the overall taxation of owner-occupied housing, the Panel recommends that the current law exclusion be increased to $600,000 ($300,000 for singles), an amount roughly equal to the current-law exclusion if it had been indexed for inflation since its enactment in 1997. As described in Chapter Five, the Panel recommends that the exclusion would apply only if a home was used as a principal residence for at least three of the preceding five years, instead of two of the preceding five years under current law. The $600,000 figure would be indexed annually for inflation. This proposal would ensure that capital gains on the sale of a home would be free from taxation for a great majority of American home sellers.

A Simpler Tax System for Businesses

The tax imposed on a business under current law turns on a number of factors, including the legal form of the business, the type of business activity, and the type of investment a business makes. The result is a tax system for businesses that is overly complex and inefficient. The Simplified Income Tax Plan would simplify the tax system for all businesses, remove subsidies for favored industries and activities, and replace the current system with one that taxes business income more uniformly and lowers the overall tax burden.

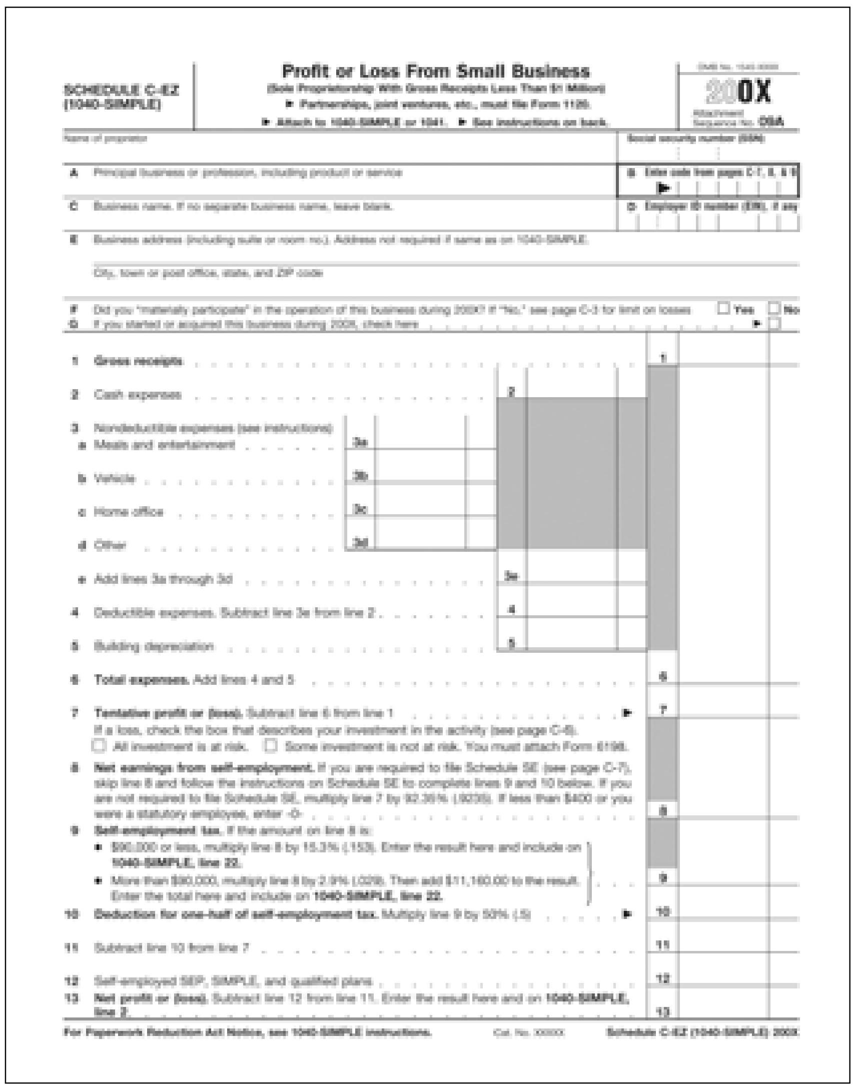
Small Business Rules Designed for Small Businesses

As described in Chapter Five, small business owners bear disproportionately higher compliance costs as a result of the complexity of our tax system. Under the Simplified Income Tax Plan, businesses with less than $1 million in receipts would no longer be required to maintain their books and records using the multitude of complex accounting rules found in our tax code. This would provide greater simplicity for more than 22 million small businesses, which account for more than 95 percent of all businesses. Under the Simplified Income Tax Plan, noncorporate small businesses would report income based on cash receipts less cash business expenses. Simplified cash accounting would be extended to almost all items of income and deductions, except for purchases of land and buildings.

This expanded cash accounting would make tax filing extremely straightforward for most small businesses. They would simply use their existing records as a basis for establishing their income and expenses. By comparison, today's rules require many small businesses to separately track and compute depreciation, amortization schedules, inventory, capitalized expenditures, and other items that require special accounting for taxes. In addition, abolishing the AMT would eliminate another set of complex tax computations. Figure 6.3 shows the new simple form that millions of sole proprietors would use to report their business income.

As described in Chapter Five, small-business owners would have greater flexibility to immediately write-off purchases of new assets, such as new tools, software, and equipment – extending and expanding current-law rules that

Figure 6.3. New Schedule C under the Simplified Income Tax Plan



SCHEDULE C-EZ (1040-SIMPLE)

Profit or Loss From Small Business

(Sole Proprietorship With Gross Receipts Less Than $1 Million)

► Partnerships, joint ventures, etc., must file Form 1120.

► Attach to 1040-SIMPLE or 1041. ► See instructions on back.

200X

Attachment Sequence No. 09A

Name of proprietor | Social security number (SSN)

A Principal business or profession, including product or service | B Enter code from pages C-7, 8, & 9 ►

C Business name. If no separate business name, leave blank. | D Employer ID number (EIN), if any

E Business address (including suite or room no.). Address not required if same as on 1040-SIMPLE.

City, town or post office, state, and ZIP code

F Did you "materially participate" in the operation of this business during 200X? If "No," see page C-3 for limit on losses ☐ Yes ☐ No

G If you started or acquired this business during 200X, check here ► ☐

1 **Gross receipts** . . . 1

2 Cash expenses . . . 2

3 Nondeductible expenses (see instructions)

a Meals and entertainment . . . 3a

b Vehicle . . . 3b

c Home office . . . 3c

d Other . . . 3d

e Add lines 3a through 3d . . . 3e

4 Deductible expenses. Subtract line 3e from line 2 . . . 4

5 Building depreciation . . . 5

6 **Total expenses.** Add lines 4 and 5 . . . 6

7 **Tentative profit or (loss).** Subtract line 6 from line 1 . . . ► 7

If a loss, check the box that describes your investment in the activity (see page C-6).

☐ All investment is at risk. ☐ Some investment is not at risk. You must attach Form 6198.

8 **Net earnings from self-employment.** If you are required to file Schedule SE (see page C-7), skip line 8 and follow the instructions on Schedule SE to complete lines 9 and 10 below. If you are not required to file Schedule SE, multiply line 7 by 92.35% (.9235). If less than $400 or you were a statutory employee, enter -0- . . . 8

9 **Self-employment tax.** If the amount on line 8 is:

- $90,000 or less, multiply line 8 by 15.3% (.153). Enter the result here and include on **1040-SIMPLE, line 22.**
- More than $90,000, multiply line 8 by 2.9% (.029). Then add $11,160.00 to the result. Enter the total here and include on **1040-SIMPLE, line 22.** . . . 9

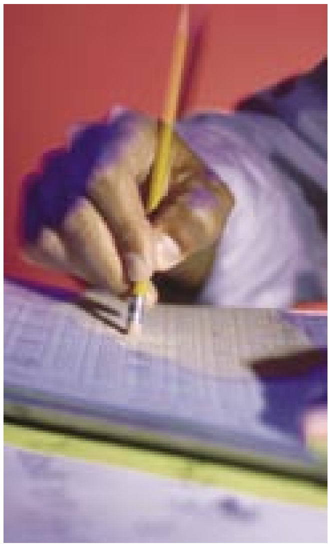
10 **Deduction for one-half of self-employment tax.** Multiply line 9 by 50% (.5) . . . ► 10

11 Subtract line 10 from line 7 . . . 11

12 Self-employed SEP, SIMPLE, and qualified plans . . . 12

13 **Net profit or (loss).** Subtract line 12 from line 11. Enter the result here and on **1040-SIMPLE, line 2.** . . . 13

For Paperwork Reduction Act Notice, see 1040-SIMPLE instructions. Cat. No. XXXXX **Schedule C-EZ (1040-SIMPLE) 200X**



give small business an incentive to purchase productivity-enhancing assets. Similarly, these small businesses would no longer be required to make difficult determinations about whether a particular expenditure can be immediately deducted or must be capitalized and amortized. The current-law treatment of land as a nondeductible expense and the depreciation of buildings and structures would continue to apply.

Medium-sized businesses – those with receipts of more than $1 million, but less than $10 million – would also be allowed to use simplified and expanded cash accounting. These medium-sized businesses would use the cash method for small business described above, but would be required to depreciate the cost of equipment and other capital expenditures (in addition to land and buildings). The Simplified Income Tax Plan also would make permanent administrative practice that requires only medium-sized businesses in inventory-intensive industries to use inventory methods for physical inventories.

For purposes of classifying a business as small, medium-sized, or large, gross receipts would be measured using the average over the prior three years. A business that crosses a particular gross receipts threshold would continue to be treated as a medium-sized or large business, even if its receipts later fall below the applicable gross receipts threshold.

To improve recordkeeping and compliance, the Simplified Income Tax Plan would require that small and medium-sized businesses use designated business bank accounts into which they would deposit all receipts and from which they would make business expenditures. Businesses would be prohibited from making personal expenditures out of, or from commingling personal and business funds in, these segregated business bank accounts. To aid small businesses in filing their returns and to improve compliance, banks would be required to provide small businesses with an annual summary of account inflows and outflows. This summary would be reported directly to the IRS by the financial institution maintaining the account. Similarly, the Simplified Income Tax Plan would require that issuers of debit and credit cards report to businesses and the IRS payments for credit and debit card purchases of their cardholders. Although taxpayers who fail to deposit cash receipts into segregated accounts would still present a compliance issue, simpler accounting rules and more detailed information reporting would make such willful evasion easier to detect.

The Panel also recommends that the tax treatment of small business entities be simplified. Under current law, owners of sole proprietorships, LLCs and partnerships, and S corporations report business income from these entities on their tax returns. Although these three separate regimes are designed to provide a single level of tax, there are a number of differences between them that make choosing a legal business form and tax compliance unnecessarily complex. In light of the recommendations that would provide for a single level of tax on profits of large businesses earned in the United States, the Panel recommends that the rules applicable to pass-through entities be simplified and streamlined. For example, greater uniformity among the rules for contributions, allocations of income, distributions, and liquidations would eliminate confusion and simplify choice of entity considerations. The Panel also recommends that the current-law rule that treats an unincorporated business that is jointly owned by a married couple as a partnership be modified to permit the couple to treat the business as a sole proprietorship and report business income on Schedule C instead of a separate partnership tax return.

One Set of Rules for Large Businesses

The Simplified Income Tax Plan contains rules for larger businesses that, like the rules for small and medium-sized businesses, are designed to provide a more uniform and consistent treatment of business activity. Gone from the tax code would be most of the special preferences and rates that often apply to such large businesses. This would result in a system that taxes large business entities with more than $10 million of receipts more uniformly and at a lower 31.5 percent tax rate. Business entities with less than $10 million in receipts would be free to report income and to be taxed as a corporation if they so chose; if they did so, their owners would obtain the benefits of the 100 percent exclusion for domestic dividends and the 75 percent exclusion of capital gains on the sale of their corporate stock.

Large business entities would be taxed at the entity level like corporations. Owners of these entities would not be subject to tax when they receive distributions of income earned in the United States and would exclude 75 percent of the capital gains on the sale of an interest in these entities. For large businesses that currently are taxed as flow-through entities, such as partnerships, LLCs, and S-corporations, domestic earnings would be subject to tax at the business level. Passive investment vehicles, such as regulated investment companies (RICs) and real estate investment trusts (REITs), would continue to be treated the same as under current law. Distributions and capital gains would be subject to the rules applicable to corporations.

Currently, there are only about 150,000 active U.S. businesses that have more than $10 million in receipts. Requiring all large entities, including partnerships, to abide by the same business tax rules would provide fewer opportunities for tax shelters and less exploitation of loopholes. For example, a consistent treatment of income from large businesses would shrink opportunities to use a partnership structure to avoid taxes. Many recent tax shelters were designed to exploit the complicated partnership rules. The uniform treatment of large businesses under the Simplified Income Tax Plan also would greatly simplify the individual income tax returns of their owners, who now must cope with complex distributions of various categories of business income and expenses that are reported to them on complicated partnership and S corporation forms.

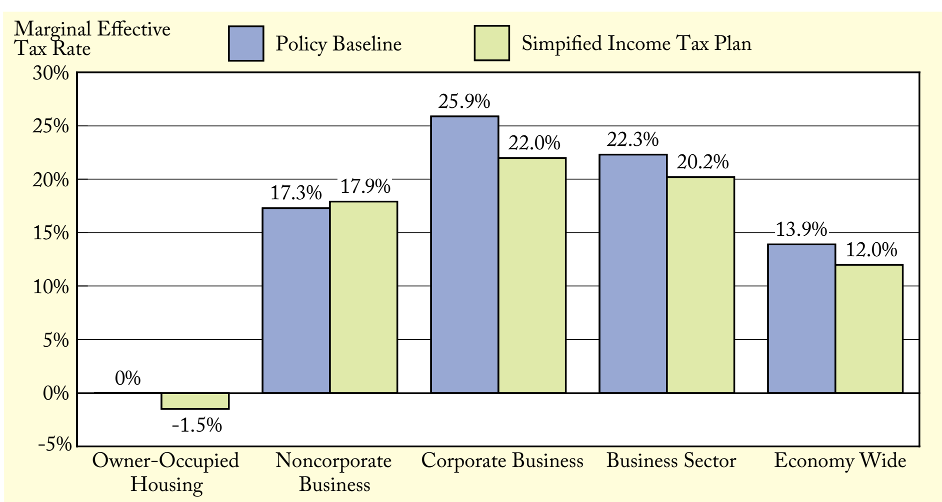
Over the years, numerous special preferences for business activities have been added to the tax code. Some of these preferences are substantial in size and affect a significant percentage of businesses, while others are much smaller and affect only a few businesses. Each item on the long list of tax preferences requires complex rules and regulations to define who is entitled to get these preferences. These rules are an enormous source of controversy and confusion for taxpayers and the IRS. In addition, these preferences have the effect of raising the rates for all businesses.

Like the individual income tax provisions, the Simplified Income Tax Plan begins with a clean tax base for large businesses by eliminating all tax preferences other than accelerated depreciation. Over 40 business tax breaks would be eliminated, including the research and experimentation credit, the rehabilitation investment credit, and the newly-enacted deduction for domestic production activities. To level the playing field between large businesses that pay tax at the entity level and small business owners who pay tax on business income on their individual returns, the deduction for state and local income taxes would be eliminated for large businesses under the Simplified Income Tax Plan.

This clean tax base would permit the business tax rate to be reduced from 35 to 31.5 percent – a 10 percent across-the-board reduction – while enormously simplifying the tax code. Eliminating special preferences that many large businesses use to reduce or avoid paying tax also would reduce the need to more closely track a business's taxable income for purposes of the 100 percent exclusion of dividends paid out of domestic earnings.

The tax treatment of investment by businesses also would be significantly improved. Currently, our tax system favors a strategy of financing corporate growth by issuing debt rather than by issuing stock. This is because distributions out of corporate profits are taxed twice, while interest on debt is deductible. The result is a corporate sector that disproportionately uses debt to finance future growth, retains earnings rather than distributing them as dividends, and favors unincorporated entities over corporations. The single-rate, business-level tax paid by all large business entities coupled with the proposal to nearly eliminate the tax on domestic earnings of large business entities at the individual level would reduce the tax burden on business investment and provide a more even treatment across types of business financing. As illustrated in Figure 6.4, there will be a lower and more even tax burden on the returns to investment.

Figure 6.4. Comparison of Effective Tax Rates on Different Types of Investment



Note: The tax rates for the policy baseline assume, among other things, that the 2001 and 2003 tax cuts will be made permanent and that the proposals contained in the President's Budget to create retirement savings accounts and lifetime savings accounts (each with a $5,000 limit) would be enacted.
Source: Department of the Treasury, Office of Tax Analysis.

The Panel also evaluated a proposal to tax large entities based on net income reported on financial statements instead of requiring a separate calculation of income for tax purposes. Although the Panel has not included that proposal as part of the Simplified Income Tax Plan, the Panel recommends that it be studied further.

A Simplified Cost Recovery System

Under current law, taxpayers are allowed to take depreciation deductions for new investments under the Modified Accelerated Cost Recovery System, or MACRS. Under MACRS, each asset is assigned a recovery period (the number of years over which depreciation allowances are spread), a recovery method (how depreciation allowances are allocated over the recovery period), and an applicable convention that establishes when property is deemed to have been placed in service during the year. Under the asset classification systems that date back to 1962 and earlier, assets are assigned to one of nine specific recovery periods. Recovery methods range from straight line, which provides even depreciation allowances over the recovery period, to double declining balance, which provides more generous deductions in the early years.

Under MACRS, most investments in equipment are assigned a recovery period that depends on the taxpayer's industry. Equipment is assigned to one of seven recovery periods, ranging from three years to 25 years, but most are assigned to the five or seven-year recovery periods. Investments in buildings are recovered on a straight-line basis over 27.5 years for residential buildings or 39 years for nonresidential buildings.

Under the Simplified Income Tax Plan, all businesses would benefit from simplified rules for recovering the cost of new assets. As described above, small businesses would be able to take an immediate deduction for the cost of new tools, equipment, and other assets. These businesses would not have to worry about complicated asset classifications, asset class lives, depreciation methods, or depreciation tables, except for purchases of buildings.

A simplified cost recovery system would be adopted to reduce the compliance hassles associated with the tax treatment of business investment. The new simplified depreciation system would replace the nine different asset class lives, three different recovery methods, and three different applicable conventions with a simple system involving only four asset categories. This system would provide roughly the same cost recovery deductions as current law, but would greatly simplify the process. It would eliminate much of the accounting and recordkeeping burden imposed by our current system. It also would eliminate many of the inter-asset distortions created by the antiquated classification of assets in our current system. For example, there would no longer be different recovery periods for similar assets just because they are used in different industries.

Under the simplified depreciation system, taxpayers would increase the balance in each property account by the amount of new purchases and be allowed a uniform allowance each year. Depreciation would be computed by multiplying the account's average balance by the depreciation rate applicable to the specific asset category. As summarized in Table 6.5, there would be only four categories of assets.

Table 6.5. Asset Categories Under the Simplified Depreciation System

	Category I	Category II	Category III	Category IV
Type of Assets	Assets used in the agricultural, mining, manufacturing, transportation, trade, and service sectors	Assets used for energy production, a few other relatively long-lived utility properties, and most land improvements	Residential buildings	Non-residential buildings and other long-lived real property
Annual Recovery Percentage	30 percent	7.5 percent	4 percent	3 percent

Medium-size businesses (and small businesses that depreciate buildings and structures) would be allowed to use a much simpler accounts-based system under which the amount of new assets would simply be added to the existing balance in each asset account. Unlike current law, separate accounts for assets placed in service in each year would not be required. The new depreciation system also would provide a more simple treatment of asset dispositions by not requiring adjustment of the account upon sale, retirement or other disposition of an asset. Depreciation would be allowed for the account balance and, if all assets in a category were disposed of, the remaining adjusted basis in an account would be deducted. Any proceeds received from an asset disposition would be included fully in the taxpayer's gross income. These rules would relieve businesses from detailed tracking of individual assets for tax purposes.

Large businesses would continue to track assets as they do under current law, but would benefit from the simpler process of categorizing assets into one of four asset classes and claiming depreciation deductions based on the simplified method.

Simplifying the Taxation of International Business

The Simplified Income Tax Plan would update our international tax regime by adopting a system that is common to many industrial countries. As explained in Chapter Five, our tax system taxes all income of U.S. corporations regardless of where it is earned and provides a limited tax credit for income taxes paid to foreign governments. Many of our trading partners use "territorial" tax systems that exempt some (or all) of business earnings generated by foreign operations from home country taxation. France and the Netherlands, for example, exempt foreign dividends. Canada, on the other hand, exempts foreign dividends from countries with which it has tax treaties from home taxation. Canada effectively administers a territorial system because it has tax treaties with many countries.

To understand the tax implications of territorial and worldwide systems, consider a simple example. A French multinational company and a U.S. multinational company both have subsidiaries with active business operations in another country, Country X, that imposes a 20 percent tax on corporate income. The U.S. corporate income tax rate is 35 percent. Assume that both companies earn $100 from their operations in Country X and immediately send the profits home as a dividend.

Both the U.S and French subsidiaries pay $20 of tax to Country X on their $100 of earnings. However, the U.S. company faces a "repatriation tax" on the dividend, but the French company does not. The U.S. tax bill of $35 on the $100 of foreign earnings is reduced to $15 because the company receives a credit of $20 for the taxes already paid to Country X by its subsidiary. This means that the U.S. multinational pays a total of $35 in tax: $20 to Country X and $15 to the United States. The French multinational, on the other hand, pays only $20 in tax to Country X. The French company faces a lower tax rate on investments in Country X than the U.S. company because France has a territorial tax system.

Unfortunately, reality is not as simple as this example portrays it. As explained in Chapter Five, the U.S. multinational does not pay U.S. tax on its subsidiary's earnings in Country X until the earnings are repatriated to the United States. The repatriation tax is elective and, as a result, distorts business decisions. If the U.S. multinational redeploys earnings abroad by reinvesting the $80 in an active business, for example, it may avoid the U.S. tax on the earnings. To do so, the U.S. company may forego more attractive investments in the United States or may have to fund investments at home through costly borrowing that would be avoided if there were no repatriation tax on the foreign earnings. Tax planners can devise elaborate strategies to avoid the repatriation tax, but the strategies employed may themselves be costly and wasteful to the economy.

For some firms, arranging corporate affairs to avoid the repatriation tax involves costly and distortionary activity that would not take place except for tax considerations. As explained in Chapter Five, the combination of deferral and the foreign tax credit creates a situation in which the tax rate imposed on investment abroad differs among U.S. multinationals. For example, a multinational that can defer repatriation indefinitely (or avoid the repatriation tax at no cost) pays no repatriation tax. A multinational that is unable to structure operations to avoid the repatriation tax faces the U.S. tax rate.

Under our current tax system, it is also possible for companies to face tax rates on marginal investments abroad that are lower than host country rates. For example, consider a U.S. multinational that finances additional investment in Country X through U.S. borrowing. If the multinational is able to indefinitely defer tax on earnings in Country X (or avoid any repatriation tax through tax planning) it will face a lower than 20 percent rate on its investment. This is because the U.S. company gets a deduction at the U.S. tax rate for interest payments with no corresponding taxation of income at the U.S. rate. Although territorial tax systems are designed to impose no home country tax on active foreign earnings, the goal of these systems is not to subsidize foreign investment. For this reason, provisions that allocate expenses associated with exempt foreign income against that income (or tax some otherwise exempt foreign income as a proxy for allocating those expenses) are necessary.

The Simplified Income Tax Plan would adopt a straightforward territorial method for taxing active foreign income. Active business income earned abroad in foreign affiliates (branches and controlled foreign subsidiaries) would be taxed on a territorial basis. Under this system, dividends paid by a foreign affiliate out of active foreign earnings would not be subject to corporate level tax in the United States. Payments from a foreign affiliate that are deductible abroad, however, such as royalties and interest would generally be taxed in the United States. Reasonable rules would be imposed to make sure that expenses incurred in the United States to generate exempt foreign income would not be deductible against taxable income in the United States. Because insuring that related entities charge each other "arm's length" prices for goods and services is even more important in a territorial system than under current law, additional resources would need to be devoted to examining these transfer prices. As is common in territorial systems around the world, income generated by foreign assets – such as financial income – that can be easily relocated to take advantage of the tax rules would continue to be taxed in the United States as it is earned. For example, if the U.S. company in our example was to invest the $100 of foreign profits in Country X in bonds instead of in an active business, the interest earned on the bonds would be subject to immediate U.S. taxation (with a credit for any taxes paid to Country X).

Such a tax system would more closely reflect the international tax rules used by many of our major trading partners. It would level the playing field among U.S. multinationals investing abroad. It would allow U.S. multinationals to compete with multinationals from countries using a territorial approach without having to bear the planning costs that are necessary under today's system. In addition, it would make it easier for American companies to repatriate income earned in foreign nations tax-free and reduce the degree to which tax considerations distort their business decisions. Finally, commentators from both industry and academia have concluded that a carefully designed territorial-type system can lead to simplification gains.

Research on the consequences of adopting a territorial system for the United States suggests that this reform could lead to both efficiency and simplification gains. Economists have found that the financial decisions of corporate managers are extremely sensitive to the tax on repatriations – lower U.S. taxes on dividend repatriations lead to higher dividend payments and vice-versa. This correlation implies that repatriation taxes reduce aggregate dividend payouts and generate an efficiency loss that would disappear if active foreign source income were exempt from U.S. tax. Corporate managers would be able to arrange corporate affairs and financial policies to meet objectives other than tax avoidance if they were freed from worrying about how to time repatriations of foreign income to reduce U.S. taxes.

At first glance, one might assume that exempting active foreign source income from U.S. taxation would lead to a substantial reallocation of U.S. investment and jobs worldwide. A careful study of how location incentives for U.S. multinational corporations may change under a territorial system similar to the one proposed for the Simplified Income Tax Plan provides different results. Researchers found no definitive evidence that location incentives would be significantly changed, which suggests that the territorial system the Panel has proposed would not drive U.S. jobs and capital abroad relative to the current system. This result is not surprising. As explained in Chapter Five, the U.S. international tax system has both worldwide and territorial features. For some firms, the U.S. international tax system produces tax results that are as good or even better than those that would apply under a territorial system. Exempting active foreign-source income repatriated as a dividend from U.S. tax provides no additional incentive to invest abroad if, in response to the current tax system, firms have already arranged their affairs to avoid the repatriation tax. Instead, exempting dividends allows firms to productively use resources that were inefficiently employed under current law. The Simplified Income Tax Plan would produce no less revenue from multinational corporations than the current system, but would be less complex and more uniform in its application.

Additional information regarding the Panel's proposals for a new system of international taxation under the Simplified Income Tax Plan can be found in the Appendix.

Strengthening Rules to Prevent International Tax Avoidance

The Simplified Income Tax Plan also would modify the definition of business subject to U.S. tax to ensure businesses that enjoy the benefit of doing business in the U.S. pay their fair share. Under current law, residency is based on the place a business entity is organized. This rule makes an artificial distinction that allows certain foreign entities to avoid U.S. taxation even though they are economically similar to entities organized in the United States. This rule may give businesses an incentive to establish legal place of residency outside the United States to avoid paying tax on some foreign income. Several large U.S. companies have used a similar technique to avoid taxes under our current system. Recently enacted legislation created rules to prevent existing corporations from moving offshore, but does not prevent newly organized entities from taking advantage of the rules.

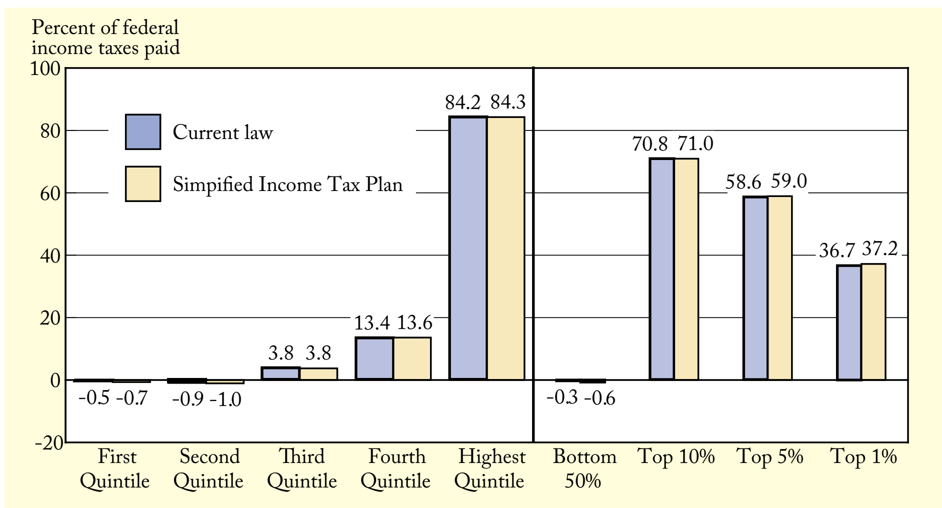
To prevent this tax-motivated ploy, the Simplified Income Tax Plan would provide a comprehensive rule that treats a business as a resident of the U.S. (and subject to U.S. tax) if the United States is the business's place of legal residency or if the United States is the business's place of "primary management and control." The new two-pronged residency test would ensure that businesses whose day-to-day operations are managed in the United States cannot avoid taxes simply by receiving mail and holding a few board meetings each year at an island resort.

A Progressive Tax System

As discussed in Chapter Four, the Panel agreed to design tax reform options that would not materially alter the current progressive distribution of the federal individual and corporate income tax burden. The following estimates provided by the Treasury Department demonstrate that the Simplified Income Tax Plan meets those guidelines. While there are some minor differences, the overall distribution closely tracks current law.

Figures 6.5 and 6.6 show the results for 2006. Figure 6.5 breaks the population into fifths – or quintiles – according to their cash income. The figure also shows the taxes paid by the fifty percent of the population with the lowest incomes, and those in the top 10, 5, and 1 percent of the income distribution. Figure 6.6 presents similar information, but instead of assigning households to percentiles of the income distribution, it shows the distribution of taxes by taxpayer income levels. The figure presents income levels ranging from zero to $15,000 of income to $200,000 and over of income.

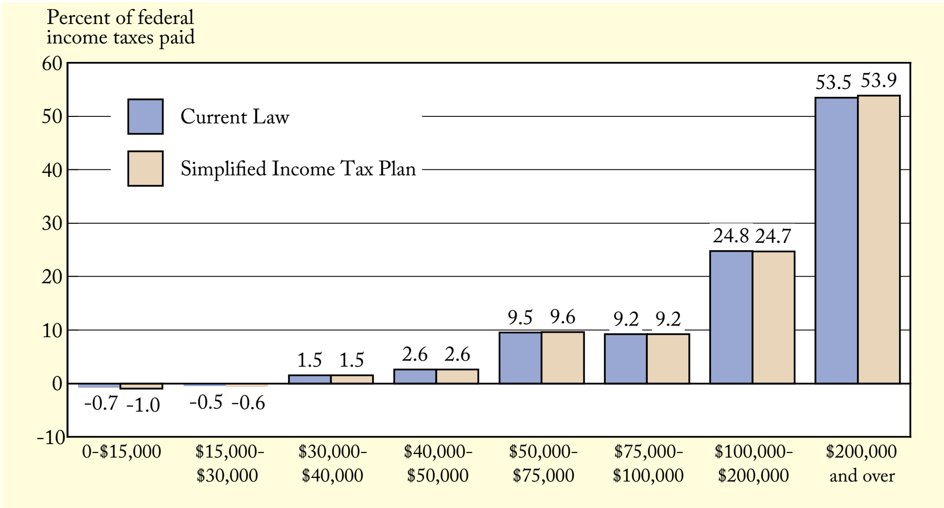
Figure 6.5. Distribution of Federal Income Tax Burden Under Current Law and the Simplified Income Tax by Income Percentile (2006 Law)



Note: Estimates of 2006 law at 2006 cash income levels. Quintiles begin at cash income of; Second $12,910; Third $27,461; Fourth $45,345; Highest $84,124; Top 10% $123,076; Top 5% $169,521; Top 1% $407,907; Bottom 50% below $36,738.

Source: Department of the Treasury, Office of Tax Analysis.

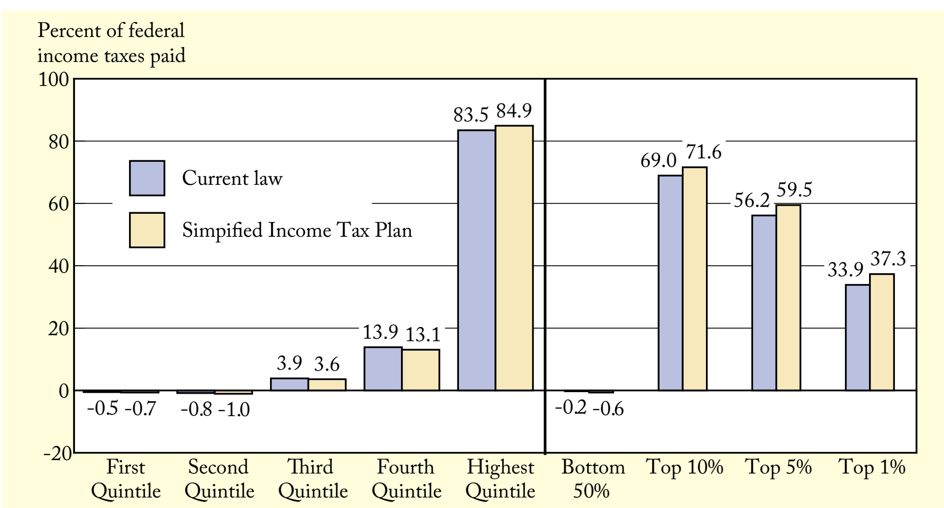
Figure 6.6. Distribution of Federal Income Tax Burden Under Current Law and the Simplified Income Tax Plan by Income Level (2006 Law)



Note: Estimates of 2006 law at 2006 cash income levels.
Source: Department of the Treasury, Office of Tax Analysis.

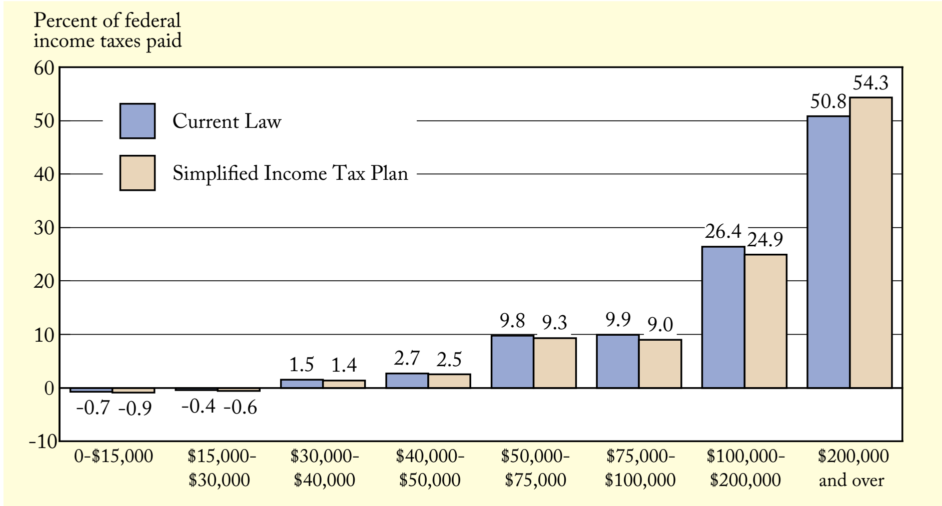
To provide additional information about the effect of the Simplified Income Tax Plan, the Panel asked the Treasury Department to provide a distribution of the Simplified Income Tax Plan for 2015, the last year of the budget window. Figures 6.7 and 6.8 compare the effect of the Simplified Income Tax Plan and current law in 2015, while holding constant the level and pre-tax distribution of income.

Figure 6.7. Distribution of Federal Income Tax Burden Under Current Law and the Simplified IncomeTax Plan by Income Percentile (2015 Law)



Note: Estimates of 2015 law at 2006 cash income levels. Quintiles begin at cash income of; Second $12,910; Third $27,461; Fourth $45,345; Highest $84,124; Top 10% $123,076; Top 5% $169,521; Top 1% $407,907; Bottom 50% below $36,738.
Source: Department of the Treasury, Office of Tax Analysis.

Figure 6.8. Distribution of Federal Income Tax Burden Under Current Law and the Simplified Income Tax by Income Level (2015 Law)

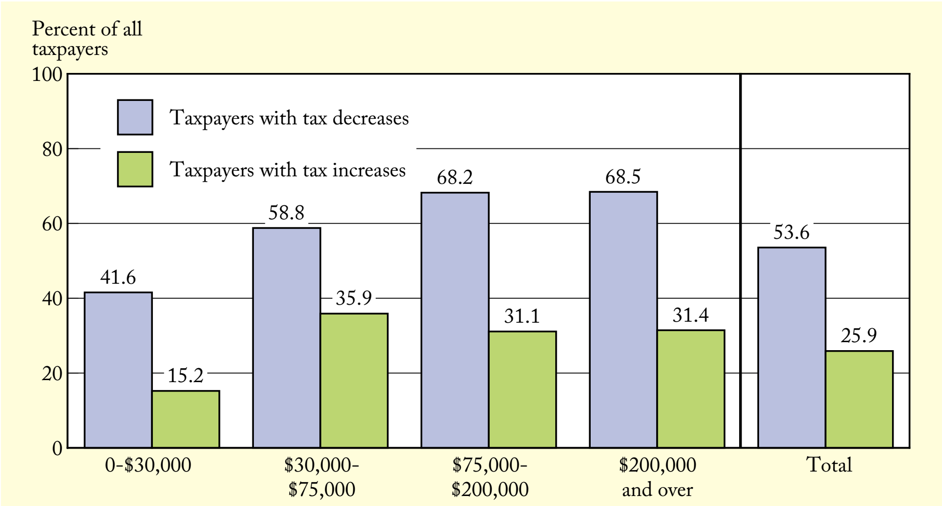


Note: Estimates of 2015 law at 2006 cash income levels.
Source: Department of the Treasury, Office of Tax Analysis.

The Treasury Department has also provided two additional sets of distribution tables that are explained and displayed in the Appendix. One table describes the tax burden under the Simplified Income Tax Plan for the entire ten-year budget period. The other shows the tax burden if the corporate income tax is distributed 50 percent to owners of capital and 50 percent to labor, rather than solely to owners of capital income.

Another way to evaluate the distributional effects of a tax reform proposal is to consider the number of taxpayers who would face higher or lower taxes under the proposal. The constraint of revenue neutrality implies that any tax relief provided to one taxpayer must be financed with higher taxes on somebody else. Looked at solely from the perspective of one's tax bill, the Simplified Income Tax Plan is certain to generate both "winners" and "losers." The Panel recognizes that this comparison is inevitable, but at the same time urges taxpayers to recognize other benefits of tax reform. Greater simplicity in the tax system would allow taxpayers to save time and preparation fees, and would inspire confidence that the tax system is straightforward and fair, and not providing hidden loopholes to others. Greater economic growth should also benefit all Americans.

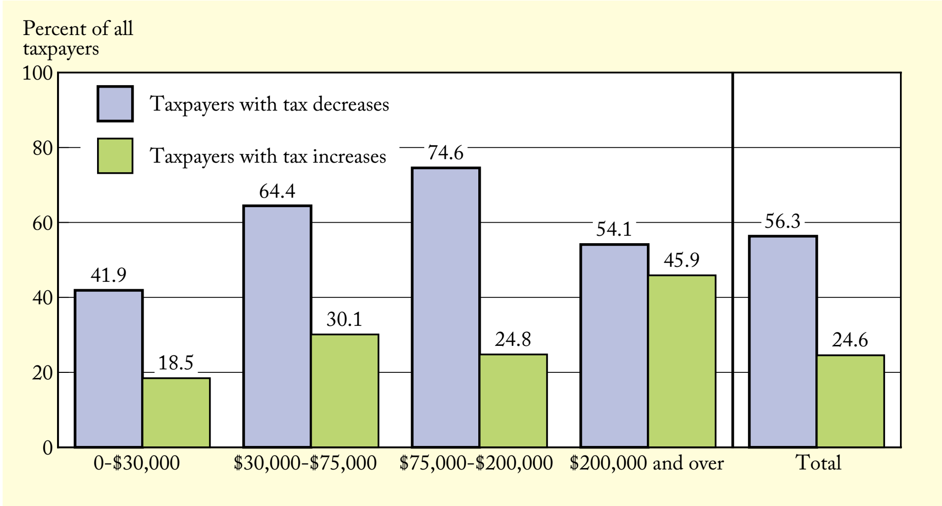
Figure 6.9. Percentage of Taxpayers with Decreases and Increases in Tax Liability Under the Simplified Income Tax Plan (2006 Income Levels)



Note: Estimates of 2006 law at 2006 cash income levels. Figure does not show the percentage of taxpayers who have neither an increase nor a decrease in tax liability.
Source: Department of the Treasury, Office of Tax Analysis.

Figures 6.9 and 6.10 demonstrate that in each income class, many more taxpayers would receive a tax cut than a tax increase. Overall, under the Simplified Income Tax Plan, there are more than twice as many taxpayers who would pay less in taxes.

Figure 6.10. Percentage of Taxpayers with Decreases and Increases in Tax Liability Under the Simplified Income Tax Plan (2015 Income Levels)



Note: Estimates of 2015 law at 2006 cash income levels. Figure does not show the percentage of taxpayers who have neither an increase nor a decrease in tax liability.
Source: Department of the Treasury, Office of Tax Analysis.

All of the above distributional information looks at the aggregate effects on groups of taxpayers. While this is informative, the Panel understands that many taxpayers would like to have a greater level of specificity and would like to know what would happen to their personal tax bill. To provide some information of that type, the Panel has developed an array of hypothetical taxpayers and calculated their taxes under the Simplified Income Tax Plan.

Before analyzing the results, it is important to describe how the Panel chose these examples. The Panel asked the IRS to construct a set of stylized taxpayers with different family structures, ages, incomes, and deductions. The IRS created these model taxpayers using data on actual taxpayers, divided into singles, married joint filers, and heads of households, and further sorted by whether or not the household head is over the age of 65. Within each of these taxpayer categories, households were ranked according to their adjusted gross income. This ranking was carried out using tax return data from 2003. Dollar figures were inflated to 2006 levels.

The Panel asked the IRS to consider the characteristics of taxpayers at the bottom 25th percentile, median, top 25th percentile, and top 5th percentile of the income distribution, with particular emphasis on the composition of income and the use of various deductions. In determining the attributes of a stylized 25th percentile taxpayer, for example, the Panel asked the IRS to use data on taxpayers with incomes between the 24th and 26th percentiles. Averages of the amount of wage and salary income, the amount of capital income flows such as interest, dividends, and capital gains, and, in the case of itemizers, the amount of various deductions were calculated for each of the stylized taxpayers. In addition, the Panel asked the Treasury Department to estimate values of itemized deductions for taxpayers who did not itemize, and included these estimates in the averages. Although these stylized taxpayers may not correspond to actual taxpayers due to the averaging procedure for income and itemized deductions, they nevertheless provide an illustrative way to compare different tax systems.

Table 6.6 presents a set of Treasury Department calculations for how the Simplified Income Tax Plan would affect hypothetical taxpayers for 2006. These examples demonstrate an essential point, which is that looking at elements of the Simplified Income Tax Plan in isolation can result in very misleading conclusions. The plan is a carefully crafted combination of numerous individual provisions intended to achieve substantial improvements in the tax system while minimizing the changes in total tax liabilities experienced by individual taxpayers. While some elements of the plan, considered in isolation, may increase the taxes paid by some taxpayers, other elements will have offsetting effects. Rather than focusing on the effects of individual provisions, the focus should be on the overall changes in tax liability that would result from the Simplified Income Tax Plan in its entirety.

Table 6.6. Examples of Taxpayers Under the Simplified Income Tax Plan in 2006 (in dollars)

	Taxpayer Characteristics and Placement in Income Distribution	Income	Salaries and Wages	Taxable Interest	Dividends	Capital Gain	Itemized Deductions				Income Tax under 2006 Law at 2006 Levels		
							State and Local Taxes	Mortgage Interest	Charitable Contributions	Misc (before 2% floor)	Current Law	Simplified Income Tax	Percentage Change in Tax Liability
Single Taxpayers Younger Than 65													
1	Bottom 25th	12,300	12,300						369		385	158	-59.0%
2	50th	24,300	24,300						729		2,003	1,922	-4.0%
3	Top 25th	41,000	40,700	200	100				1,230		4,758	4,542	-4.6%
4	Top 5%	82,800	80,500	800	700	800	4,000	6,400	2,000	2,200	13,541	14,336	5.9%
Heads of Household Younger Than 65 (bottom 25th and 50th percentile households have two child dependents; top 25th and top 5% household has one child dependent)													
5	Bottom 25th	14,000	14,000						420		-4,941	-5,488	-11.1%
6	50th	23,100	23,100						693		-4,225	-4,242	-0.4%
7	Top 25th	37,200	36,700	200	100	200			1,116		1,960	1,202	-38.7%
8	Top 5%	71,800	71,300	300	100	100	2,900	8,300	2,400	2,500	7,042	8,112	15.2%
Married Filing Jointly Younger Than 65 (all have two child dependents)													
9	Bottom 25th	39,300	38,600	300	200	200			1,179		-282	-833	-195.9%
10	50th	66,200	65,300	400	300	200	2,300	8,200	2,400	2,100	3,307	2,286	-30.9%
11	Top 25th	99,600	97,800	600	600	600	4,100	9,400	2,700	2,200	9,340	9,129	-2.3%
12	Top 5%	207,300	196,200	2,300	2,700	6,100	10,000	14,400	5,400	2,800	40,417	37,162	-8.1%
Single Taxpayers (and Surviving Spouses) Age 65 and Over*													
13	50th	24,800	0	3,200	1,600	100			555		1,919	1,983	3.3%
14	Top 25th	42,800	0	4,000	3,200	200			1,130		5,731	5,820	1.6%
Married Filing Jointly Age 65 and Over**													
15	50th	51,000	0	3,000	1,300	500			1,125		2,772	2,363	-14.7%
16	Top 25th	77,500	0	5,400	3,600	1,000			2,230		9,635	8,822	-8.4%

Note:
* The 50th percentile taxpayer has gross Social Security benefits of $6,300 and taxable pensions, annuities, and IRA distributions equal to $13,600. The top 25th percentile taxpayer has gross Social Security benefits of $12,000 and taxable pensions, annuities, and IRA distributions equal to $23,400.
** The 50th percentile taxpayer has gross Social Security benefits of $18,400 and taxable pensions, annuities, and IRA distributions equal to $27,800. The top 25th percentile taxpayer has gross Social Security benefits of $21,000 and taxable pensions, annuities, and IRA distributions equal to $46,500.
See text for further explanation of sample taxpayers.
Source: Department of the Treasury, Office of Tax Analysis.

For 2006, a prototypical married couple under age 65 at the median income level of $66,200 would expect to pay $3,307 under current law. Under the Simplified Income Tax Plan, that couple would pay $2,286 in taxes, which would be a decrease of almost 31 percent. A prototypical married couple under age 65 earning about $100,000 would expect to pay $9,340 in taxes in 2006. Under the Simplified Income Tax Plan, that couple would pay $9,129, a decrease of about 2 percent.

Similarly, for 2006, a single taxpayer under age 65 at the median income level of about $24,000 would receive a tax cut of 4 percent. The tax bill of a head of household taxpayer at the median income of about $23,000 would remain roughly the same. Single taxpayers and heads of households who are at the 95th percentile of income would face a tax increase under the Simplified Income Tax Plan.

The Panel also felt that it would be instructive to see how the plan affected taxpayers living in high tax and low tax states. Accordingly, the Panel asked the IRS to vary the amount of state and local taxes paid by each of the taxpayer groups under age 65. The Treasury Department then calculated how tax liabilities would change for those taxpayers who would have itemized and claimed state and local tax deductions under current law for "high" and "low" values of state and local tax deductions. The "high" value is the cut-off level for the top 10 percent of state and local taxes claimed in 2003 (inflated to 2006 levels) and the "low" value is the cut-off level for the bottom 25th percent. These figures are shown below for each group of taxpayers in Table 6.7.

The examples in Table 6.7 show that because of the interaction between the alternative minimum tax and other provisions, there was no difference in the treatment of the stylized married couple earning about $100,000 or in the treatment of the married couple earning about $207,000. In other words, regardless of whether those couples lived in high-tax or low-tax states, they still came out ahead in the Simplified Income Tax Plan. The stylized couple earning about $66,000 living in a low-tax state receives a tax cut of $1,081 while the same couple living in a high-tax state receives a tax cut of $781. Both of these taxpayers would pay the same tax level under the Simplified Income Tax Plan, regardless in which state they reside. For single taxpayers and head of households who itemized under current law, there would be a larger tax increase in taxes for those taxpayers who are living in high-tax states. This is due to the fact taxpayers in high-tax states currently pay less tax than taxpayers in the low-tax states. Under the Simplified Income Tax Plan, taxpayers with similar income and characteristics face the same tax bill.

Table 6.7. Examples of Taxpayers Living in "High" and "Low" Tax States Under Current Law and Simplified Income Tax Plan

Taxpayer Characteristics and Placement in Income Distribution	Income	State and Local Tax Deduction	Income Tax under 2006 Law at 2006 Levels		
			Current Law	Simplified Income Tax	Percentage Change in Tax Liability
Single Taxpayers Younger Than 65					
Top 5% in "low-tax" state	82,800	3,500	13,666	14,336	4.9%
Top 5% in "high-tax" state	82,800	6,400	12,941	14,336	10.8%
Heads of Household Younger Than 65 (bottom 25th and 50th percentile households have two child dependents; top 25th and top 5% household has one child dependent)					
Top 5% in "low-tax" state	71,800	2,400	7,167	8,112	13.2%
Top 5% in "high-tax" state	71,800	4,800	6,567	8,112	23.5%
Married Filing Jointly Younger Than 65 (all have two child dependents)					
50th in "low-tax" state	66,200	1,900	3,367	2,286	-32.1%
50th in "high-tax" state	66,200	3,900	3,067	2,286	-25.5%
Top 25th in "low-tax" state	99,600	3,600	9,340	9,129	-2.3%
Top 25th in "high-tax" state	99,600	6,900	9,340	9,129	-2.3%
Top 5% in "low-tax" state	207,300	8,300	40,417	37,162	-8.1%
Top 5% in "high-tax" state	207,300	16,300	40,417	37,162	-8.1%

Notes: Taxpayers have same characteristics as those in Table 6.6 with the exception of state and local taxes. See text for further explanation of sample taxpayers.
Source: Department of the Treasury, Office of Tax Analysis.

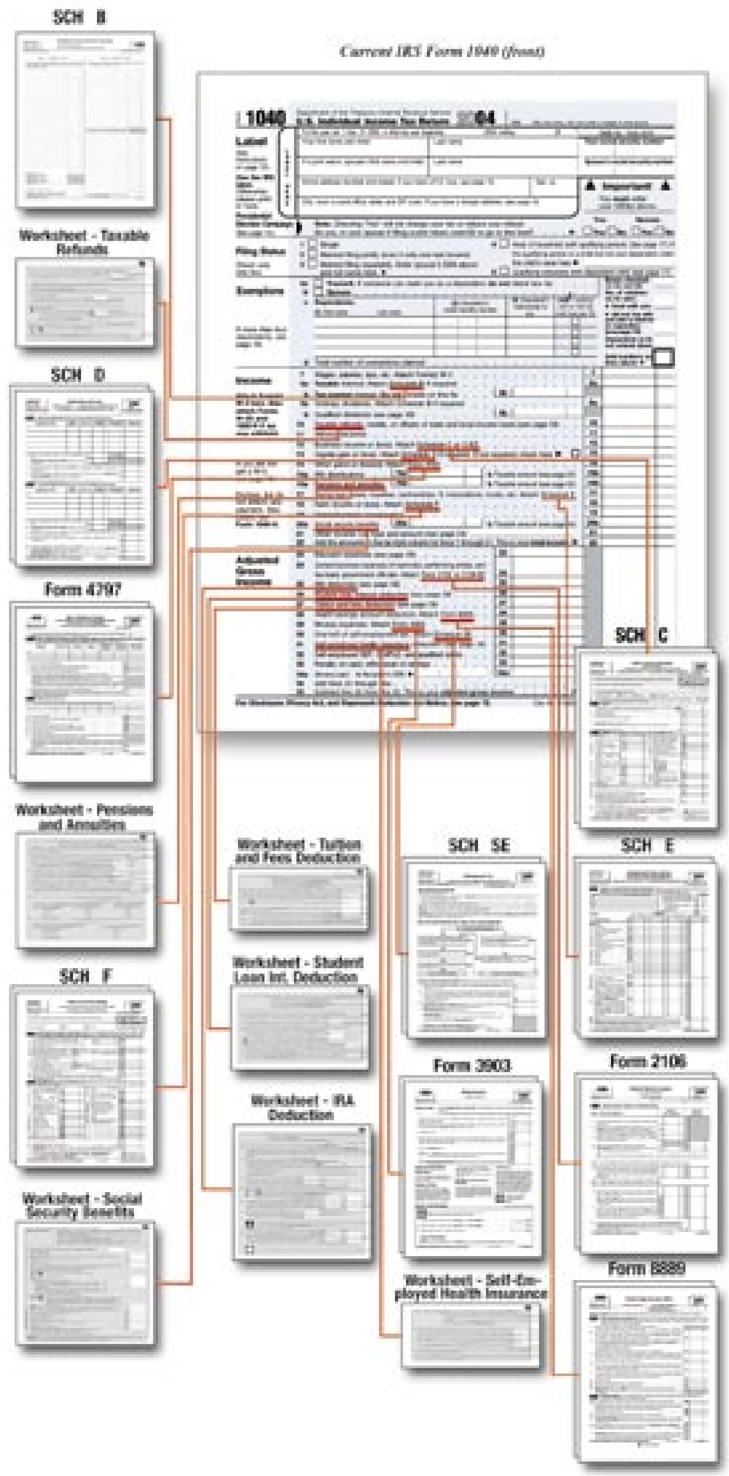
Improved Transparency and Lower Compliance Costs

An obvious benefit of this system would be a simple and straightforward process for computing taxes dramatically cutting the time spent keeping records and filling out forms.

Figures 6.11 and 6.12 demonstrate how much simpler the tax filing process would be. Figure 6.11 shows the current, two-page Form 1040 with over 50 forms, schedules, and worksheets that are frequently used to compute taxes. Figure 6.11 shows the tax return that would be used under the Simplified Income Tax Plan – not only is the form easier to use, but only a fraction of the forms would be required to compute tax owed.

Making taxes of individuals and businesses easier to compute and report would also make our tax system fairer and more transparent. The IRS would be able to process returns and enforce the tax laws more efficiently, thus freeing up resources that could be better used to reduce the gap that exists between taxes owed and taxes paid.

Figure 6.11. Current IRS Form 1040 with Related Schedules, Forms, and Worksheets



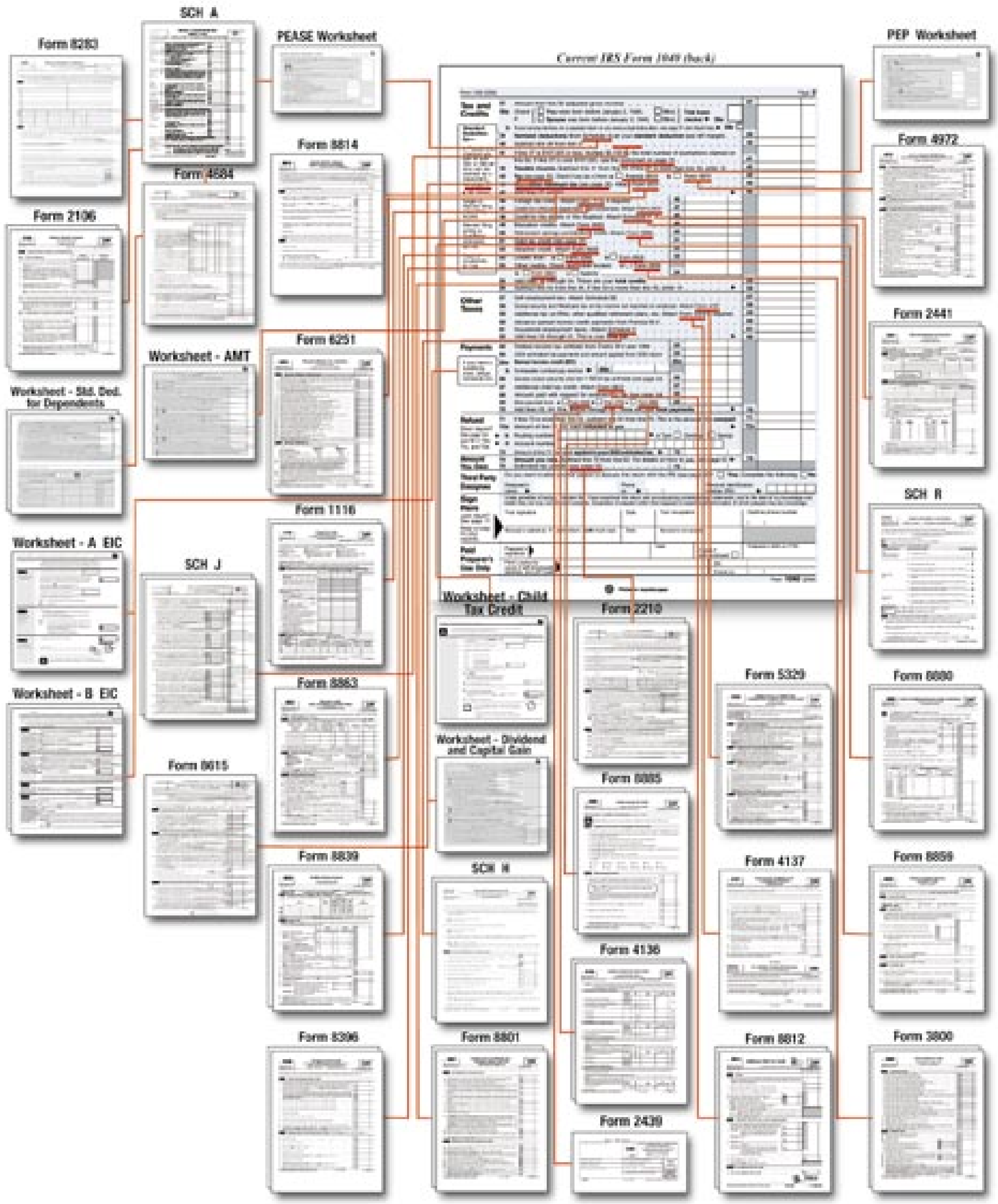
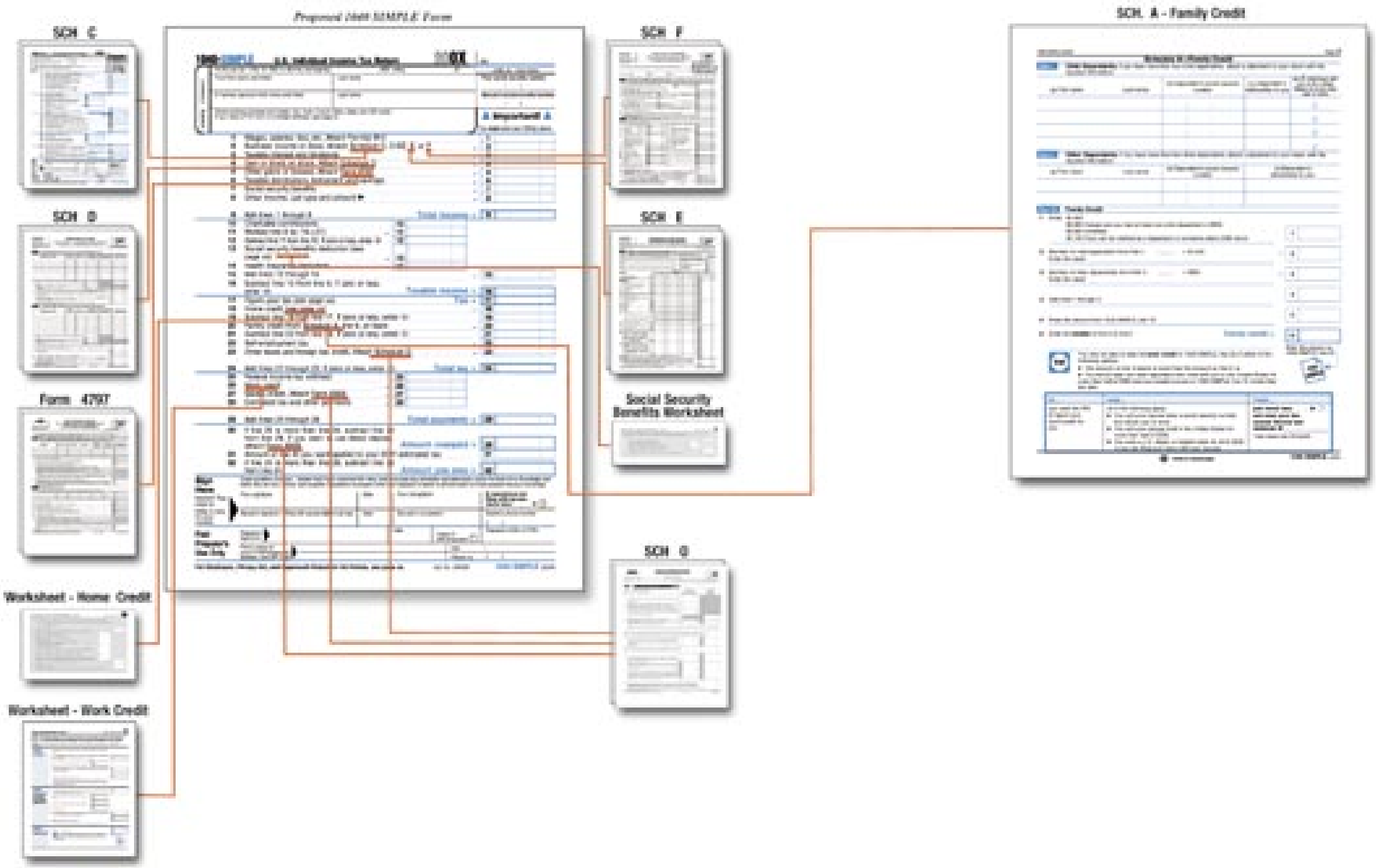

Current IRS Form 1040 (back)
Form 8283
SCH A
PEASE Worksheet
PEP Worksheet
Form 4972
Form 2106
Form 4684
Form 8814
Form 2441
Worksheet - AMT
Form 6251
Worksheet - Std. Ded. for Dependents
Form 1116
SCH R
Worksheet - A EIC
SCH J
Worksheet - Child Tax Credit
Form 2210
Worksheet - B EIC
Form 8863
Form 5329
Form 8880
Worksheet - Dividend and Capital Gain
Form 8615
Form 8885
Form 8839
SCH H
Form 4137
Form 8859
Form 4136
Form 8396
Form 8801
Form 8812
Form 3800
Form 2439

Figure 6.12. Form 1040 SIMPLE with Related Schedules, Forms, and Worksheets



Revenue Neutrality

The Treasury Department advises the Panel that the Simplified Income Tax Plan would be revenue neutral. The plan would collect the same amount of tax revenue as the current law baseline from both individual income taxes and corporate income taxes over the ten-year period.

As noted in Chapter Four, the Panel's baseline for determining revenue neutrality includes the full effects of the AMT. Some members of the Panel believe that it is more likely that lawmakers will extend the current-law provision, often referred to as the AMT "patch," that provides a higher exemption amount, and possibly index this higher amount for inflation. If the Panel did not need to account for the cost of the patch, estimated to be $886 billion, tax rates could be lowered by five percent. In such a scenario, the top rate would have been reduced from 33 percent to 31.5 percent.

A More Pro-Growth Tax System

The Simplified Income Tax Plan would provide a number of long-term economic benefits. First, it would use a cleaner tax base and would eliminate the need for the AMT, which represents a long-term tax hike for tens of millions of Americans. Second, the system would offer lower tax rates, which by definition improve the conditions for economic growth and job creation. In addition, the Save at Work, Save for Retirement, and Save for Family accounts would encourage more taxpayers to save, which would support greater individual wealth and ownership, as well as an increase in the capital stock.

The Simplified Income Tax Plan also would provide a more uniform method for calculating the taxation of business investment, and would lower the cost of that investment. The removal of the double tax on corporate earnings would represent a significant reduction in the taxation of business investment. In addition, the Simplified Income Tax Plan would reduce the top tax rate on corporations from 35 percent to 31.5 percent. And the new territorial-based international tax system would be simpler for corporations to navigate, and would reduce some of the distortions and wasteful tax planning in the current system.

Estimates from the Treasury Department macroeconomic models described in the Appendix indicate that the Simplified Income Tax Plan could increase output (national income) by up to 0.5 percent over the budget window, by up to 1 percent over 20 years, and by up to 1.2 percent over the long run. The Treasury Department models also suggest that the Plan could have a significant impact on the growth of the capital stock (the economy's accumulation of wealth). The estimates for an increase in the capital stock range from 0.1 percent to 0.4 percent over the budget window, from 0.3 percent to 1.4 percent over 20 years, and from 0.9 percent to 2.3 percent over the long run.