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Tax Reform: An Overview of Proposals in the 110th Congress

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Tax Reform: An Overview of Proposals in the 110th Congress

Summary

Tax reform promises to be a major issue in the 110th Congress. This report examines three main categories of tax reform: fundamental tax reform, tax reform based on the elimination of the individual alternative minimum tax, and Treasury's proposals for reforming the corporate income tax.

Most proposals for fundamental tax reform involve the concept of replacing our current income tax system with some form of a consumption tax, usually with a single or "flat tax" rate, whereas other proposals would significantly broaden the income tax base and lower tax rates. Proponents of these tax revisions often maintain that they would simplify the tax system, make the government less intrusive, and create an environment more conducive to saving. Critics express concern about the distributional consequences and transitional costs of a dramatic change in the tax system. Most observers believe that the problems and complexities of our current tax system are not primarily related to the number of tax rates but rather stem from difficulties associated with measuring the tax base. For those fundamental tax reform proposals involving shifting to a consumption tax, one or more of the following four major types of broad-based consumption taxes are included in these congressional tax proposals: the value-added tax (VAT), the retail sales tax, the consumed-income tax, and the flat tax based on a proposal formulated by Robert E. Hall and Alvin Rabushka of the Hoover Institution.

As of January 30, 2008, in the 110th Congress, nine bills for fundamental tax reform have been introduced: Representative John Linder's proposal (H.R. 25), Representative Michael Burgess's proposal (H.R. 1040), Representative Phil English's proposal (H.R. 4159), Representative Chaka Fattah's proposal (H.R. 2130), Senator Saxby Chambliss's proposal (S. 1025), Senator Richard C. Shelby's proposal (S. 1040), Senator Arlen Specter's proposal (S. 1081), Senator Ron Wyden's proposal (S. 1111), and Senator Sam Brownback's proposal (S. 2518). These bills are described in this report. Two other bills relevant to fundamental tax reform have been introduced in the 110th Congress: H.R. 510 and S. 747. Although these two bills are similar and have the same title, "Tax Code Termination Act," there are significant differences in their contents.

In the 110th Congress, numerous bills have been introduced that would eliminate the individual alternative minimum tax (ATM) and require major changes in the tax code. Arguably, one of the more significant bills, *Tax Reduction and Reform Act of 2007* (H.R. 3970), was introduced by House Ways and Means Committee Chair Charles B. Rangel. A temporary patch for the AMT was passed in the first session of the 110th Congress, but AMT reform will be debated in the second session.

Two major reports released by the Treasury examine sweeping proposals for reform of the business income tax system. These reports may be the basis for legislation in the second session of the 110th Congress.

This report will be updated as issues develop and new legislation is introduced.

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Introduction

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Most proposals for fundamental tax reform involve the concept of replacing our current income tax system with some form of a consumption tax, usually with a single or "flat tax" rate, whereas other proposals would significantly broaden the income tax base and lower tax rates. Proponents of these tax revisions are concerned about the administrative and compliance costs of the current income tax system. Proponents also believe that the current income tax system discourages saving, reduces economic growth, causes economic distortions, and worsens the nation's balance of trade. Critics question whether most of these proposals will improve macroeconomic performance, express concern about equity issues, and maintain that transitional costs will be prohibitive. Most observers believe that the problems and complexities of our current tax system are not primarily related to the number of tax rates but rather stem from difficulties associated with measuring the tax base.

In the 110th Congress, numerous bill have been introduced that would eliminate the individual alternative minimum tax (AMT) and require major changes in the tax code. Arguably the most significant bill was introduced by House Ways and Means Committee Chair Charles B. Rangel, *The Tax Reduction and Reform Act of 2007*, (H.R. 3970). A temporary patch for the AMT was passed in the first session of the 110th Congress, but the issue of AMT reform will be debated in the second session.

Two major reports released by the Treasury examine proposals for reform of the business income tax system. These reports may be the basis for legislation in the second session of the 110th Congress.

Fundamental Tax Reform

Most proposals for fundamental tax reform would change the tax base from income to consumption. Consequently, the initial sections of this report examine topics concerning broad-based consumption taxation.

The Relationship Between Income and Consumption

Although our current tax structure is primarily an income tax, it actually contains elements of both an income- and a consumption-based tax. For example, the current tax system includes in its tax base wages, interest, dividends, and capital gains, all of which are consistent with an income tax. At the same time, however, the current tax system excludes some savings, such as pension and Individual Retirement Account contributions, which is consistent with a tax using a consumption base.

The easiest way to understand the differences between the income and consumption tax bases is to define and understand the economic concept of income. In its broadest sense, income is a measure of the command over resources that an individual acquires during a given time period. Conceptually, individuals can exercise two options with regard to their income: they can consume it or they can save it. This theoretical relationship between income, consumption, and saving allows a very useful accounting identity to be established: income, by definition, must equal consumption plus saving. It follows that a tax that has a measure of comprehensive income applies to both consumption and savings. A consumption tax, however, applies to income minus saving.

A consumption tax can be levied at the individual level in a form very similar to the current system. An individual would add up all income in the same way as he or she does now under the income tax but then would subtract out net savings (saving minus borrowing). The result of these calculations would be the consumption base on which tax is assessed. Equivalently, a consumption tax can also be collected at the retail level in the form of a sales tax or at each stage of the production process in the form of a value-added tax (VAT).

Regardless of the form or point where a consumption tax is collected, it is ultimately paid by the individual doing the consuming. It should be noted that consumption, in the economy as a whole, is smaller than income. Thus, to raise equal amounts of revenue in a given year, tax rates on a comprehensive consumption base would have to be higher than the tax rates on a comprehensive income base.

What Should Be Taxed?

Should the tax base be income or consumption? Is one inherently superior to the other? How do they stack up in terms of simplicity, fairness, and efficiency — the three standards by which tax systems are generally assessed? There appears to be insufficient theoretical or empirical evidence to conclude that a consumption-based tax is inherently superior to an income-based tax or vice versa.

One issue associated with the choice of a tax base is equity — how the tax burden will be distributed across income classes and different types of taxpayers. For example, a tax is "progressive" if tax paid as a percentage of income increases as income rises. Although some types of consumption taxes can be designed to achieve any desired level of progressivity with respect to consumption alone, their progressivity with respect to income could only be approximated. Also, a consumption tax would involve a redistribution of the tax burden by age group, with the young and old generally bearing more of the total tax burden than those in their prime earning years. And the transition from an income-based tax to a consumption-based tax would have the potential for creating windfall gains for some taxpayers and losses for others.

A definitive assessment cannot be made of the effects of taxing consumption on either economic efficiency or the aggregate level of savings. Although the current tax system's distortions of the relative attractiveness of present and future consumption (saving) would be eliminated, to raise the same amount of tax revenue, a consumption-based tax would require an increase in marginal tax rates (since consumption is smaller than income). This action, in turn, would increase the current system's distortion between the attractiveness of market (e.g., purchased products) and nonmarket activities (e.g., leisure). The net effect on overall economic efficiency cannot be ascertained theoretically. In addition, economic theory indicates a consumption tax would not necessarily produce an increase in saving. The increase in after-tax income might reduce saving, while the increase in the return to saving may increase it; the net result is uncertain.[1]

A positive aspect of a consumption-based tax is the ease with which the individual and corporate tax systems could be integrated. In addition, the problems introduced by separate provisions for capital gains, attempts to distinguish between real and nominal income, and depreciation procedures would essentially be eliminated. It is doubtful, however, that a consumption-based tax would have much effect on the complexities introduced into the system to promote specific social and economic goals. Many of the same factors that influenced the design of the current income tax system would exert the same influences on the final design of a consumption tax.

Whether one prefers income or consumption, one tax rate or multiple tax rates, a critical point to remember is that the benefits to be derived from tax revision would result from defining the tax base more comprehensively than it is under current law. A tax with a base that is comprehensively defined would prove more equitable and efficient than a tax with a less comprehensively defined base.

Types of Broad-Based Consumption Taxes

Four major types of broad-based consumption taxes are included in congressional tax proposals: the value-added tax (VAT), the retail sales tax, the consumed-income tax, and the flat tax based on a proposal formulated by Robert I. Hall and Alvin Rabushka of the Hoover Institution.[2]

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[1] For an analysis of this issue, see CRS Report RS22367, *Federal Tax Reform and Its Potential Effects on Saving*, by Gregg A. Esenwein.

[2] For an overview of the economic issues relevant to broad-based consumption taxation, see CRS Report RL32603, *The Flat Tax, Value-Added Tax, and National Retail Sales Tax:*

(continued...)

Value-Added Tax

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

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

Under the subtraction method, the firm calculates its value added by subtracting its cost of taxed inputs from its sales. Next, the firm determines its VAT liability by multiplying its value added by the VAT rate.[3] Under the addition method, the firm calculates its value added by adding all payments for untaxed inputs (e.g., wages and profits). Next, the firm multiplies its value added by the VAT rate to calculate VAT to be remitted to the government.

Retail Sales Tax

In contrast to a VAT, a retail sales tax is a consumption tax levied only at a single stage of production, the retail stage. The retailer collects a specific percentage markup in the retail price of a good or service, which is then remitted to the tax authorities.

Consumed-Income Tax

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

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[2] (...continued)
Overview of the Issues, by Gregg A. Esenwein and Jane G. Gravelle.

[3] For a comparison of the credit-invoice method and the subtraction method, see *Value-Added Tax: Methods of Calculation* (a general distribution memo), by James M. Bickley, available on request from the author.

Flat Tax (Hall/Rabushka Concept)

A flat tax could be levied based on the proposal formulated by Robert E. Hall and Alvin Rabushka of the Hoover Institution. Their proposal would have two components: a wage tax and a cash-flow tax on businesses. (A wage tax is a tax only on salaries and wages; a cash-flow tax is generally a tax on gross receipts minus all outlays.) It is essentially a modified VAT, with wages and pensions subtracted from the VAT base and taxed at the individual level. Under a standard VAT, a firm would not subtract its wage and pension contributions when calculating its tax base. Under this proposal, some wage income would not be included in the tax base because of exemptions. Under a standard VAT, all wage income would be included in the tax base.[4]

International Comparisons

There are two major distinctions between recent flat tax proposals for the United States that would change the tax base from income to consumption and the current tax systems of other developed nations. First, although the United States is the only developed nation without a broad-based consumption tax at the national level, other developed nations adopted broad-based consumption taxes as adjuncts to or replacements for other consumption taxes rather than as replacements for their income-based taxes. Most of the congressional proposals would replace our current income taxes with consumption taxes.

Second, all developed nations with VATs, except Japan, calculate their VATs using the credit-invoice method. In contrast, most of the current U.S. flat tax proposals, which include VAT components, use the subtraction method of calculation.

Other Types of Fundamental Tax Reform

Two other types of fundamental tax reform are income tax reform and a tax plan that gives taxpayers a choice of systems.

Income Tax Reform: Base Broadening

Income tax base broadening would involve eliminating most tax preferences, increasing the standard deduction and personal exemption allowances, and reducing tax rates. Proposals of Senator Wyden and Representative Emanuel are in this category.

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[4] For a comprehensive overview of this concept, see CRS Report 98-529, *Flat Tax: An Overview of the Hall-Rabushka Proposal*, by James M. Bickley.

Option of the Current or an Alternative Income Tax System

Proposals of Representative Burgess and Senator Brownback would give taxpayers the option of either paying taxes under the current income tax or paying a flat rate income tax.

Legislative Proposals for Fundamental Tax Reform

As of January 30, 2008, in the 110th Congress, nine bills for fundamental tax reform have been introduced. Representative John Linder's proposal (H.R. 25) and Senator Saxby Chambliss's proposal (S. 1025) would replace our current income-based tax system and estate/gift taxes with a national retail sales tax. Representative Michael Burgess's proposal (H.R. 1040) would allow taxpayers to select a flat tax, a modified VAT based on the concepts of Robert E. Hall and Alvin Rabushka, as an alternative to the current income tax system. Representative Phil English's proposal (H.R. 4159) would replace our corporate income tax with a subtraction-method VAT, replace our individual income tax with a consumed-income tax, and eliminate the estate and gift tax. Senator Richard C. Shelby's proposal (S. 1040) and Senator Arlen Specter's proposal (S. 1081) would replace individual and corporate income taxes and estate and gift taxes with a flat tax based on the Hall-Rabushka concept. Senator Ron Wyden's proposal (S. 1111) would reform the current income tax system by expanding the tax base and simplifying the tax code. Representative Chaka Fattah's proposal (H.R. 2130) would require the Treasury to conduct a study of the implementation of a transaction fee as a replacement for all existing federal taxes on individuals and corporations. Senator Sam Brownback's proposal (S. 2518) would simplify the individual income tax by allowing each taxpayer the option of paying a simple, low-rate tax on gross income less an individual tax credit. Although some of these plans were more detailed than others, none of the proposals had the level of detail that would be required to make a plan operational. Many difficult details and transitional considerations had yet to be addressed.

Representative John Linder's Proposal

H.R. 25. (A companion bill was introduced in the Senate, S. 1025.) **The Fair Tax Act of 2007** was introduced on January 4, 2007, and referred to the Committee on Ways and Means. This proposal would repeal the individual income tax, the corporate income tax, all payroll taxes, the self-employment tax, and the estate and gift taxes and levy a 23% (tax-inclusive) national retail sales tax as a replacement. Every family would receive a rebate of the sales tax on spending up to the federal poverty level (plus an extra amount to prevent any marriage penalty). The Social Security Administration would provide a monthly sales tax rebate to registered qualified families. The 23% national retail sales would not be levied on exports. The sales tax would be separately stated and charged. Social Security and Medicare benefits would remain the same with payroll tax revenue replaced by some of the revenue from the retail sales tax. States could elect to collect the national retail sales tax on behalf of the federal government in exchange for a fee. Taxpayer rights provisions are incorporated into the act.

Senator Saxby Chambliss's Proposal

S. 1025. (A companion bill, H.R. 25 was introduced in the House.) **The Fair Tax Act of 2007** was introduced on March 29, 2007, and referred to the Senate Finance Committee. This act would "promote freedom, fairness, and economic opportunity by repealing the income tax and other taxes, abolishing the Internal Revenue Service, and enacting a national sales tax to be administered primarily by the states." (See H.R. 25 on the preceding page for a description.)

Representative Michael C. Burgess's Proposal

H.R. 1040. Freedom Flat Tax Act was introduced February 14, 2007, and referred to the House Committee on Ways and Means. This proposal would allow taxpayers to select a flat tax as an alternative to the current income tax system. The flat tax was based on the concepts of the Hall-Rabushka flat tax proposal. The individual's selection of the flat tax would be irrevocable. In the first two years, the flat tax rate would be 19%, and in subsequent years it would fall to 17%. An individual engaged in a business activity may elect irrevocably, as an alternative to our current income tax system, to be taxed on business taxable income that equals gross sales less the cost of business inputs for business activity, wages, and retirement contributions. For the first two years, a 19% rate would apply to business taxable income, but after the first two years, this rate would decline to 17%. This act would become effective for tax year 2008. This act would repeal the estate and gift taxes.

Senator Richard C. Shelby's Proposal

S. 1040. Tax Simplification Act of 2007 was introduced on March 29, 2007, and referred to the Senate Finance Committee. This act is modeled after the proposal formulated in 1981 by Hall and Rabushka. This flat tax would levy a consumption tax as a replacement for the individual and corporate income taxes, and the estate and gift taxes.

This proposal has two components: a wage tax and a cash-flow tax on businesses. It is essentially a modified VAT, with wages and pensions subtracted from the VAT base and taxed at the individual level. Under this proposal, some wage income would not be included in the tax base because of deductions, while under a VAT all wage income would be included in the tax base.

Initially the individual wage tax would be levied at a 19% rate, but when the tax was fully phased in, this rate would decline to 17%. The individual wage tax would be levied on all wages, salaries, pensions, and unemployment compensation. In addition, government employees and employees of nonprofit organizations would have to add to their wage tax base the imputed value of their fringe benefits.

The individual wage tax would not be levied on Social Security receipts. Thus, the current partial taxation of Social Security payments to high-income households would be repealed. Social Security contributions would continue to be taxed; that is, they would not be deductible and would be made from after-tax income. Firms would pay the business tax on their Social Security contributions. Individuals would pay the wage tax on their Social Security contributions. The individual wage tax would have "standard deductions" that would equal the sum of the "basic standard deduction" and the "additional standard deduction."

The "basic standard deduction" would depend on filing status. For tax year 2007, the basic standard deduction would have been the following:

- $25,580 for a married couple filing jointly or a surviving spouse;
- $16,330 for a single head of household;
- $12,790 for a single person; and
- $12,790 for a married person filing a separate return.

The "additional standard deduction" would be an amount equal to $5,510 times the number of dependents of the taxpayer.

All deductions would be indexed for inflation using the consumer price index (CPI).

Initially businesses would pay a tax of 19% (declining to 17% when the tax was fully phased in after December 31, 2009) on the difference (if positive) between gross revenue and the sum of purchases from other firms, wage payments, and pension contributions. This business tax would cover corporations, partnerships, and sole proprietorships. Pension contributions would be deductible but there would be no deductions for fringe benefits. In addition, state and local taxes (including income taxes) and payroll taxes would not be deductible.

Activities of government entities and tax-exempt organizations would be exempt from the business tax.

If the business's aggregate deductions exceed gross revenue, then the excess of aggregate deductions can be carried forward to the next year and increased by a percentage equal to the three-month Treasury rate for the last month of the taxable year.

Any congressional action that raises taxes would require a three-fifths (supermajority) vote in both the Senate and the House of Representatives.

Senator Arlen Specter's Proposal

S. 1081. Flat Tax Act of 2007 was introduced on April 10, 2007, and referred to the Senate Finance Committee. This act is modeled after the Hall-Rabushka proposal, which was previously discussed. The Specter flat rate consumption tax would replace the federal individual and corporate income taxes and the federal estate and gift taxes.

This proposal has two components: a wage tax and a cash-flow tax on businesses. It is essentially a modified VAT, with wages, salaries, and pensions subtracted from the VAT base and taxed at the individual level.

The individual wage tax would be levied at a 20% rate on all wages, salaries, and pensions. In addition, government employees and employees of nonprofits would have to add to their wage base the imputed value of their fringe benefits. The individual wage tax would have "standard deductions" that would equal the sum of the "basic standard deduction" and the "additional standard deduction."

The "basic standard deduction" would depend on filing status. For tax year 2007, the basic standard deduction would have been the following:

- $25,000 for a joint return;
- $25,000 for a surviving spouse;
- $18,750 for a head of household;
- $12,500 for a married taxpayer filing separately; and
- $12,500 for a single taxpayer.

The "additional standard deduction" would be an amount equal to $6,250 times the number of dependents of the taxpayer. All deductions would be indexed for inflation.

Individuals would be allowed to deduct up to $3,125 ($1,562.50 in the case of a married individual filing a separate return) annually for charitable contributions. Individuals also would be allowed to deduct "qualified residence interest" on acquisition indebtedness not exceeding $125,000 ($75,000 in the case of a married individual filing a separate return).

The business tax would be levied at a 20% tax rate on gross revenue less the sum of purchases from other firms, wage payments, pension contributions, and the cost of personal and real property used in the business. Purchases from other firms would include capital goods. If the business's aggregate deductions exceed gross revenue, then the excess of aggregate deductions can be carried forward to the next year and increased by a percentage equal to the three-month Treasury rate for the last month of the taxable year.

This tax reform act would have become operational for taxable years beginning after December 31, 2007.

Senator Ron Wyden's Proposal

S. 1111. The Fair Flat Tax Act of 2005 was introduced on April 16, 2007, and referred to the Senate Finance Committee. This proposal would reform the current income tax base rather than changing to a consumption base. This act has three stated purposes: (1) to make the federal individual income tax system simpler, fairer, and more transparent; (2) to make the federal corporate income tax rate a flat 35% and eliminate special tax preferences that favor particular types of businesses or activities; and (3) to partially offset the federal budget deficit through the increased fiscal responsibility resulting from these reforms.

The progressive individual income tax would have three rates: 15%, 25%, and 35%. The individual income tax would provide a federal income tax credit for state and local income, sales, and property taxes. The individual income tax would provide for an earned income tax credit for childless taxpayers and a new earned income child credit; repeal the individual alternative minimum tax; increase the basic standard deduction and maintain itemized deductions for principal residence mortgage interest and charitable contributions; and reduce the number of exclusions, exemptions, deductions, and credits. All income including capital gains and dividends would be taxed equally. The corporate tax rate would be 35% of taxable income. The Secretary of the Treasury would be required to report "recommendations regarding the elimination of federal tax incentives which subsidize inefficiencies in the health care system."[5] When sufficient information is available, brokers would be required to report customers' basis in securities transactions. Penalties for promoting abusive tax shelters would be increased. The criminal monetary penalty limitation for the underpayment or overpayment of tax due to fraud would be increased. This act would sunset after tax year 2012.

Representative Chaka Fattah's Proposal

H.R. 2130. The Comprehensive Transform America Transaction Fee Act of 2007 was introduced on May 3, 2007, and referred to the House Committee on Ways and Means. This act would require the Secretary of the Treasury to conduct a study and produce a comprehensive analytical report on the implementation of a transaction fee as a replacement for all existing federal taxes on individuals and corporations. This transaction fee would apply to all non-cash transactions (including checks, credit cards, transfers of stocks, bonds, and other financial instruments) and all high-dollar cash transactions. The fee would not apply to cash transactions of less than $500, or salaries and wages paid by employers to employees, or transactions involving individual savings instruments through financial institutions. The fee would be double, or higher than, the standard transaction fee on cash withdrawals from financial institutions. The fee would be collected by the seller or financial institution servicing the transaction. The fee would be set at least at the level to replace revenues generated under the Internal Revenue Code. A higher fee could be levied to pay for one or more of the following: elimination of the national debt over 10 years, a federal revenue sharing program with the states to support 50% of the K-16 education costs, a plan to meet the promised levels of certain provisions listed under the National Security Intelligence Reform Act of 2004, a federal health care program providing insurance coverage for the estimated 45 million uninsured Americans, an increase in the military basic pay rate to a level comparable with that of federal civilian pay, a federal revenue sharing program supporting community and economic development investments in new markets (rural and urban areas) at a level equal to 10% of current federal tax revenues, a plan to increase the pay for National Guard and Reserve soldiers to that of active duty military for periods of extended deployments abroad, and a Social Security and Medicare solvency plan ensuring that revenues continue to exceed expected outlays. The Secretary of the Treasury would submit to Congress the results of the study in a comprehensive analytical report not later than one year after the enactment of this act.[6]

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[5] S. 1111, Fair Flat Tax Act of 2007, Section 204.

[6] For an analysis of the transaction tax, see CRS Report RL32266, *Transaction Tax: General Overview*, by Maxim Shvedov.

Representative Phil English's Proposal

H.R. 4159. The Simplified USA Tax Act of 2007 was introduced on November 13, 2007, and referred to the House Ways and Means Committee. The *corporate income tax* would be replaced by a cash-flow business tax (a subtraction-method VAT). The gross tax base (value-added) would equal gross receipts less purchases from other firms. The tentative tax would be determined by multiplying the value-added by the appropriate tax rate. A tax rate of 8% would apply to the first $150,000 of a business's value-added, and a tax rate of 12% would apply to all of the business's value-added over $150,000. A business tax rate of 12% would apply to all imports. A credit for the 7.65% employer-paid OASDHI payroll tax (commonly called FICA or the Social Security tax) would be subtracted from the tentative tax to calculate the business's tax liability for the year.

The *individual income tax* would be replaced by a tax on consumed-income. An individual's tax liability would be calculated by (1) calculating gross income, (2) subtracting exemptions and deductions, (3) applying a progressive rate structure to the difference, and (4) subtracting a credit for the 7.65% employee-paid OASDHI payroll tax payments. Gross income would equal wages and salaries plus interest, dividends, pension receipts, and amounts received from the sale of stock and other assets. Deductions would be allowed for charitable contributions, home mortgage interest, and higher education tuition. Deductions would also be allowed for retirement-oriented 401 (k) contributions and IRAs for lower-income families.

The Simplified USA Tax eliminates the double taxation of savings by allowing everyone to contribute after-tax income to a USA Roth IRA, which is a universal savings vehicle. After five years, accumulated principal and earnings on principal can be withdrawn on a tax-free basis at any time and for any purpose. The federal estate and gift tax would be repealed.

Senator Sam Brownback's Proposal

S. 2518. The Freedom to Choose Tax Reform Act of 2007 was introduced on December 18, 2007, and referred to the Senate Finance Committee. This act seeks to simplify the individual income tax by allowing eligible individual taxpayers the option of paying a simple, low-rate tax system on gross income less an individual tax credit. For tax year 2009, an individual could choose to pay a tax of 10% of gross income up to $102,000 and 23% of gross income over $102,000. The taxpayer, the taxpayer's spouse, and each dependent of the taxpayer would be allowed a credit of $1,000 against the tax. The gross income levels and credit would be indexed for inflation. A single individual taxpayer whose gross income exceeds $175,000 for the taxable year would not be eligible to choose the simplification option. Married couples would be eligible only if both select the option of paying the simplified tax and their gross income does not exceed $350,000. This act would be effective for tax year 2009.

Other Legislation about Fundamental Tax Reform

As of January 30, 2008, two other bills relevant to fundamental tax reform have been introduced in the 110th Congress: H.R. 510 and S. 747. Although these two bills are similar and have the same title, "Tax Code Termination Act," there are significant differences in their contents.

H.R. 510 (Representative Bob Goodlatte). Tax Code Termination Act was introduced on January 17, 2007, and referred to the House Committee on Ways and Means. After December 31, 2010, this act terminates the tax code except for self-employment taxes, Federal Insurance Contributions Act taxes, and Railroad Retirement taxes. This act declares that any new federal tax system should be a simple and fair system that (1) applies a low rate to all Americans, (2) provides tax relief for working Americans, (3) protects the rights of taxpayers and reduces tax collection abuses, (4) eliminates the bias against savings and investment, (5) promotes economic growth and job creation, and (6) does not penalize marriage or families. This act requires that the new federal tax system be approved by Congress not later than July 4, 2010.

S. 747 (Senator Johnny Isakson). Tax Code Termination Act was introduced on March 2, 2007, and referred to the Senate Finance Committee. This act establishes within the legislative branch a National Commission on Tax Reform and Simplification. This act directs the commission to (1) review the Internal Revenue Code of 1986 and its impact on the economy, families, and the workforce; (2) determine whether the current income tax system can be replaced by a more efficient and fair system of taxation; and (3) submit a report to Congress on the results of its review with recommendations for fundamental reform and simplification of the code. If a new federal tax system is not approved by July 4, 2010, then Congress would be required to vote to reauthorize the Internal Revenue Code of 1986.

Tax Reform to Eliminate the AMT

Already in the first session of the 110th Congress, numerous bills were introduced to eliminate the individual alternative minimum tax (AMT).[7] Some of these bills call for sweeping changes in the tax code.[8] In the first session of the 110th Congress, one of the more significant bills was introduced by House Ways and Means Committee Chair Charles B. Rangel, *The Tax Reduction and Reform Act of*

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[7] For an examination of the alternative minimum tax for individuals, see CRS Report RL30149, *The Alternative Minimum Tax for Individuals*, by Gregg A. Esenwein and Steven Maguire.

[8] For information about proposed AMT legislation, see CRS Report RS22563, *The Alternative Minimum Tax for Individuals: Legislative Initiatives in the 110th Congress*, by Gregg A. Esenwein and Steven Maguire.

2007 (H.R. 3970).[9] Although a temporary patch for the AMT was passed at the end of the first session of the 110th Congress, the issue of AMT reform remains and will likely be debated in the second session.

Reform of the Business Income Tax

Some tax reform proposals would lower the marginal corporate income tax rate and broaden the corporate income tax base.[10] Other tax reform proposals would replace the corporate income tax with some other form of taxation.

During the first session of the 110th Congress, the Treasury released two major studies concerning corporate tax reform: "Business Taxation and Global Competitiveness," and "Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century." These studies may be the basis for legislation in the second session of the 110th Congress.

Report on "Business Taxation and Global Competitiveness"

On July 23, 2007, the U.S. Department of the Treasury held a conference on "Business Taxation and Global Competitiveness." The Treasury released a background paper, which argued that

> The current business tax base includes an array of special provisions that reduce taxes for particular types of activities, industries, and businesses. These provisions take the form of exclusions from income, deductions allowed or enhanced from what otherwise would be allowed, preferential tax rates, income deferral, and tax credits. Some of these provisions are intended to ease tax compliance and administration, such as allowing cash accounting for small corporations, but others were intended by Congress to encourage particular types of activity. The premise underlying many of the special provisions is that they promote activities that have spillover effects, or address various externalities or market failures. Unwarranted tax subsidies may lead to the misallocation of capital, as they encourage investment decisions based on tax characteristics rather than economic fundamentals, and generally reduce economic growth.
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> Together, these provisions substantially narrow the corporate tax base, which requires that tax rates be higher in order to raise the same tax revenue. For example, it is estimated that these special corporate tax provisions narrow the corporate tax base by roughly 25 percent. If the tax base were broadened by removing these special provisions, the top corporate tax rate of 35 percent could

[9] For an overview of the bill, see CRS Report RL34249, *The Tax Reduction and Reform Act of 2007: An Overview*, by Jane G. Gravelle.

[10] For an analysis of some important issues concerning corporate tax reform, see CRS Report RL34229, *Corporate Tax Reform: Issues for Congress*, by Jane G. Gravelle and Thomas L. Hungerford.

> be reduced to 27 percent, or, as an alternative, about 40 percent of investment costs could be written off immediately (i.e., expensed) by all businesses.[11]

The Treasury states that the United States has the second highest statutory corporate tax rate among countries in the Organization for Economic Cooperation and Development (OECD, an organization consisting of most developed countries).[12] The Treasury maintains that broadening the corporate tax base and reducing the statutory corporate tax rate would improve the global competitive position of the United States.[13]

Report on Competitiveness of the U.S. Business Tax System

On December 20, 2007, the U.S. Treasury issued a report titled *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century*.[14] This report was a follow-up to the July 26th conference report. It stated,

> Three broad approaches for reforming the U.S. business tax system are outlined: (1) replacing business income taxes with a business activities tax (BAT), a type of consumption tax, (2) eliminating special business tax provisions coupled with either business tax rate reduction or faster write-off of business investment, potentially combined with the exemption of active foreign earnings, and (3) implementing specific changes that focus on important structural problems within our business tax system. Rather than present a particular recommendation, this report examines the strengths and weaknesses of the various approaches. The various policy ideas discussed in this report represent just some of the approaches that could be considered. This report does not advocate any specific recommendation nor does it call for or advance any legislative package or regulatory changes.[15]

The proposed business activities tax (BAT) is a subtraction-method value-added tax (VAT). Under this method, each firm in the economy calculates its value added by subtracting its cost of taxed inputs from its sales. Next, the firm determines its VAT liability by multiplying its value added by the VAT rate.[16]

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[11] U.S. Department of the Treasury, *Treasury Conference on Business Taxation and Global Competitiveness*, Background Paper, Washington, July 23, 2007, p. 7.

[12] Ibid., p. 35.

[13] Ibid., p. 1.

[14] U.S. Department of the Treasury, Office of Tax Policy, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century*, Dec. 20, 2007, 116 p.

[15] Ibid., p. ii of executive summary.

[16] For an explanation of a subtraction-method VAT, see CRS Report RL33619, *Value-Added Tax: A New U.S. Revenue Source?* by James M. Bickley.