



Tax Reform: An Overview of Proposals in the 112th Congress

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Summary

The President and leading members of Congress have stated that fundamental tax reform is a major policy objective for the 112th Congress. These policymakers have said that fundamental tax reform is needed in order to raise a large amount of additional revenue, which is necessary to reduce high forecast budget deficits and the sharply rising national debt. Congressional interest has been expressed in both a major overhaul of the U.S. tax system and the feasibility of levying a consumption tax. Some proponents of reform argue that the tax base should be broadened by reducing or eliminating many tax expenditures. Tax expenditures are revenue losses resulting from federal tax provisions that grant special tax relief designed to encourage certain kinds of behavior by taxpayers or to aid taxpayers in special circumstances. If tax expenditures are reduced substantially or a consumption tax is levied or both, then the marginal income tax rates could be reduced. An alternative to increasing tax revenues is cutting spending. Thus, members are faced with considering the best mix of tax increases and spending cuts in order to reduce deficits and slow the growth of the national debt.

Proposals for fundamental reform have been made in reports by the National Commission on Fiscal Responsibility and Reform (the “Commission”) and the Debt Reduction Task Force of the Bipartisan Policy Center. The proposals in these reports may influence the debate over fundamental tax reform. Both proposals recommended the elimination of most tax expenditures and the lowering of marginal corporate and individual income tax rates. In addition, the Debt Reduction Task Force recommended the levying of a 6.5% value-added tax. An evaluation of these and other proposals would consider the effects on equity, efficiency, and simplicity.

This report primarily covers fundamental tax reform. CRS reports are available online concerning the other three categories of tax reform: tax reform based on the elimination of the individual alternative minimum tax (AMT), proposals for reforming the corporate income tax, and proposals for reforming the U.S. taxation of international business.

A temporary individual AMT patch for 2010 and 2011 was included in the *Tax Relief, Unemployment Insurance Authorization, and Job Creation Act of 2010*, which became P.L. 111-312 on December 17, 2010. The patch increased the individual AMT exemption amounts. Some proponents of tax reform argue that the AMT should be repealed or a permanent patch should be passed. The repeal or passage of a permanent patch of the individual AMT would require a major increase in taxes to offset the large revenue loss.

Options for reforming the federal business income tax are under consideration. The concept of lowering the marginal corporate income tax rate and broadening the corporate income tax base has been advocated by some members of Congress. Other options for reform include corporate tax integration and the replacement of the income tax system with a consumption tax.

The current system of U.S. taxation of international business is complex and difficult to administer. Furthermore, critics argue that the current system is not sufficiently neutral, which results in economic inefficiency. Proposals to reform the system include the replacement of the current hybrid system with either a territorial tax system or a residence-based system.

This report will be updated in the event of significant legislative activity or policy proposals.

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Introduction

The President and leading members of Congress have stated that fundamental tax reform is a major policy objective for the 112th Congress. These policymakers have said that fundamental tax reform is needed in order to raise a large amount of additional revenue, which is necessary to reduce high forecast budget deficits and the sharply rising national debt. Congressional interest has been expressed in both a major overhaul of the U.S. tax system and the feasibility of levying a consumption tax over the existing tax system. Some proponents of reform argue that the tax base should be broadened by reducing or eliminating many tax expenditures. “Tax expenditures are revenue losses resulting from federal tax provisions that grant special tax relief designed to encourage certain kinds of behavior by taxpayers or to aid taxpayers in special circumstances.”¹ If tax expenditures are reduced substantially or a consumption tax is levied or both, then the marginal income tax rates could be reduced. An alternative to increasing tax revenues is cutting spending. Thus, members are faced with considering the best mix of tax increases and spending cuts in order to reduce deficits and slow the growth of the national debt.

In December 2010, The National Commission on Fiscal Responsibility and Reform (the “Commission”) issued a report titled *The Moment of Truth*, which proposed extensive broadening of both the individual income tax base and the corporate income tax base by eliminating all business tax expenditures and almost all individual tax expenditures.² Marginal individual and corporate income tax rates would be reduced, and the individual alternative minimum tax would be abolished. The taxation of foreign-source income would be changed by moving to a territorial system.³ On November 17, 2010, the Debt Reduction Task Force of the Bipartisan Policy Center issued a report titled *Restoring America’s Future*.⁴ This report also recommended that individual and corporate income tax bases be broadened by reducing or eliminating most tax expenditures. Marginal individual and corporate income tax rates would be lowered, and the individual alternative minimum tax would be eliminated. In addition, this report recommended that a 6.5% value-added tax be levied. The recommendations of these two reports may influence the tax reform debate in the 112th Congress.

In the 112th Congress, members of Congress are expected to introduce numerous bills containing incremental or marginal adjustments in the tax code in an attempt to redistribute income, reallocate resources, change individual behavior, etc. Proposed incremental or small tax adjustments are considered tax changes.⁵ In contrast, fundamental tax reform concerns a major proposed overhaul of the U.S. tax system, which affects the entire tax system or a major component of the system. This report primarily covers fundamental tax reform because CRS reports are available online concerning the other three categories of tax reform: tax reform based on the elimination of the individual alternative minimum tax (AMT), proposals for reforming the corporate income tax, and proposals for reforming the U.S. taxation of international business.⁶

¹ Senate Committee on the Budget, *Tax Expenditures: Compendium of Background Material on Individual Provisions*, Washington: U.S. Govt. Print. Off., December 2008, p. 2.

² The National Commission on Fiscal Responsibility and Reform, *The Moment of Truth*, December 2010, 65 p.

³ *Ibid.*, p. 33.

⁴ The Debt Reduction Task Force, Bipartisan Policy Center, *Restoring America’s Future*, November 17, 2010, 138 p.

⁵ Some of these proposed tax changes are examined in CRS reports.

⁶ Citations of these CRS reports are shown in footnotes in the sections covering these other categories of tax reform.

Fundamental Tax Reform Options

Two broad fundamental tax reform categories for addressing the severe deficit problem are base-broadening and levying a new tax. Some of the revenue from base-broadening and a new tax could be used to reduce marginal tax rates.

Base-Broadening

Some members of Congress have expressed concern about the large number and high cost of tax expenditures.⁷ Examples of tax expenditures are the deduction for mortgage interest on owner-occupied residences and the deduction for property taxes on owner-occupied residences. Many of these tax expenditures are seen as targets to be reduced or eliminated. Congress may want to consider whether the benefits of a particular tax expenditure exceed the costs of that tax expenditure. Arguably, the current tax reform debate deals with broadening the individual and corporate income tax bases and lowering marginal tax rates.

New Tax

Revenue from a new tax would allow the retention of more tax expenditures and lower reductions in other tax expenditures. Furthermore, revenue from a new tax could finance a larger reduction in marginal income tax rates and permit a smaller reduction in federal spending. Broad categories have received the most attention: consumption and environmental taxes.

Broad-Based Consumption Tax

In recent Congresses, three major types of broad-based consumption taxes have been included in congressional tax proposals: the value-added tax (VAT), the retail sales tax, and the flat tax. These possible broad-based consumption taxes have the potential of a robust revenue yield.

Value-Added Tax

A value-added tax is a tax on the value that a firm adds to a product at each stage of production. The value the firm adds 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 taxable 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.

⁷ For an analysis of tax expenditures, see CRS Report RL34622, *Tax Expenditures and the Federal Budget*, by Thomas L. Hungerford.

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

All developed nations, except Japan, use the credit-invoice method. Japan uses the subtraction method.

Retail Sales Tax

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 government.⁸ As of February 1, 2010, the Tax Foundation reports that 45 states had retail sales taxes.⁹

Flat Tax

A flat tax could be levied based on the proposal formulated by Robert E. Hall and Alvin Rabushka of the Hoover Institution.¹⁰ 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 the flat tax, 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.

Environmental Tax

Environmental taxes have been proposed to reduce pollution and raise revenue. The most frequently discussed energy tax is a *carbon tax* that would be levied on the volume of carbon emitted. This tax is frequently recommended by economists, but the Obama Administration is attempting to implement a cap and trade system. Another alternative energy tax would be higher *gasoline taxes*.

Framework of Evaluation

In evaluating any change in tax policy, the prevailing framework is to analyze the tax policy for equity, efficiency, and simplicity. Tradeoffs may exist between these three objectives. For

⁸ For a contrast between the VAT and the national sales tax, see CRS Report RL33438, *A Value-Added Tax Contrasted With a National Sales Tax*, by James M. Bickley.

⁹ *State Sales, Gasoline, Cigarette, and Alcohol Tax Rates by State, 2000-2010*, Tax Foundation. Available at <http://www.taxfoundation.org>, visited January 12, 2011.

¹⁰ For a comprehensive analysis of the flat tax, see CRS Report 98-529, *Flat Tax: An Overview of the Hall-Rabushka Proposal*, by James M. Bickley.

example, if greater income equality is desired, this may conflict with the goal of economic efficiency.

Equity

Economic theory maintains that it is not possible to make interpersonal comparisons of utility. Hence, whether a change in the distribution of income, with gainers and losers, is an improvement in the national welfare is a value judgment. The effects on different groups, however, can be measured and debated. Thus, the following questions can be examined.

How will different income groups be affected annually and over their lifetimes? Will taxpayers in similar circumstances pay approximately the same amount of taxes? What will be the effect on taxpayers in different age groups? Will there be distributional effects by region of the country? How will minority groups be affected? What will be the tax incidence on families versus single taxpayers?

Efficiency

Tax policy should promote economic efficiency; that is, a tax change should be as neutral as possible by minimizing economic distortions.¹¹ Low marginal tax rates tend to lessen distortions.

Many efficiency questions concern household decisions. What will be the effect of a tax change on households decisions to save versus consume? Will households' choices of leisure versus work be affected? Will household decisions about the composition of goods and services consumed be affected?

Other efficiency questions concern firms' decisions. What will be the effect on firms' decisions concerning the method of financing (debt or equity), choice among inputs, type of business organization (corporation, partnership, of sole proprietorship), and composition of output?

Simplicity

The greater the simplicity of the tax system, the lower will be the administrative and compliance costs. Thus, tax policy should eliminate any unnecessary complexity and promote transparency. Numerous questions concerning simplicity arise; among them are the following: How will a tax change affect federal administrative costs? Will the administrative costs of state and local governments change? How will compliance costs of households be affected? Will business compliance costs change?

¹¹ The loss in economic efficiency due to a tax is referred to by economists as the deadweight loss or excess burden of the tax.

Other Tax Reform Issues

Alternative Minimum Tax for Individuals

In 1969, Congress enacted the individual alternative minimum tax (AMT) to make sure that everyone paid at least a minimum of income taxes and still preserve the economic and social incentives in the tax code. The combined effects of inflation and the legislative reductions in the regular income tax have expanded the number of taxpayers subject to the AMT. Consequently, Congress has passed temporary increases in the basic exemption for the AMT to limit the number of taxpayers subject to the AMT. Most recently, an AMT patch for 2010 and 2011 was included in the *Tax Relief, Unemployment Insurance Authorization, and Job Creation Act of 2010*, which became P.L. 111-312 on December 17, 2010. Some proponents of tax reform argue that the AMT should be repealed or a permanent patch should be passed, but either reform would require a major increase in taxes to offset the large revenue loss.¹²

Business Taxation

Federal taxes on business income have differential effects.¹³ For example, non-corporate income is taxed less than corporate income, debt financing is an expense but equity financing is not, and depreciation rules favor machines and equipment over structures and inventory. These differential effects distort investment decisions, lessen economic efficiency, and lower economic welfare. Several options have been proposed to reform federal business taxation.¹⁴

First, comprehensive taxation of corporate income and lower tax rates would eliminate or reduce most major distortions. In the 112th Congress, the concept of lowering the marginal corporate income tax rate and broadening the corporate income tax base has been advocated by some members of Congress.

Second, corporate tax integration would eliminate the double taxation of corporate income by altering the general system of taxing corporate-source income. Integration could apply to both retained earnings and dividends and thus all corporate profits (“full integration”), or the treatment only of earnings that are distributed (“partial integration”).

Third, a broad-based consumption tax could be levied that would replace individual and corporate income taxes.

¹² For an examination of the alternative minimum tax for individuals, see CRS Report RL30149, *The Alternative Minimum Tax for Individuals*, by Steven Maguire.

¹³ For an overview of the reform of federal business taxation, see CRS Report RL33171, *Federal Business Taxation: The Current System, Its Effects, and Options for Reform*, by Donald J. Marples. For an overview of corporate tax reform issues, see CRS Report RL34229, *Corporate Tax Reform: Issues for Congress*, by Jane G. Gravelle and Thomas L. Hungerford.

¹⁴ For a comprehensive analysis of these options, see CRS Report RL33171, *Federal Business Taxation: The Current System, Its Effects, and Options for Reform*, by Donald J. Marples.

International Taxation

The rapid growth of the foreign trade sector in the U.S. economy and the expansion of international flows of capital have increased the importance of appropriate U.S. international tax practices.¹⁵ The two alternative principles on which countries can base their international tax systems are residence and territory.

Under a residence system, a country taxes its own residents (or domestically chartered “resident” corporations) on their worldwide income, regardless of its geographic source. Under a territorial system, a country taxes only income that is earned within its own borders. Currently, the United States has a hybrid system with elements of both a residence system and a territorial system. The United States taxes both income of foreign firms earned within its borders as well as the worldwide income of its U.S.-chartered firms. U.S. taxes, however, do not apply to the foreign income of U.S.-owned corporations chartered abroad. A U.S. firm can indefinitely defer U.S. tax on its foreign income if it conducts its foreign operations through a foreign-chartered subsidiary corporation; U.S. taxes do not apply as long as the foreign subsidiary’s income is reinvested overseas. With some exceptions, U.S. taxes apply only when the income is remitted to the U.S.-resident parent as dividends or other intra-firm payments. While the United States taxes worldwide income on either a current or deferred basis, it also allows a foreign tax credit for foreign taxes paid on a dollar-for-dollar basis against U.S. taxes in order to avoid the double-taxation of income.¹⁶

The current system is complex and difficult to administer. Furthermore, critics argue that the current system is not sufficiently neutral, which results in economic inefficiency. The system provides a tax incentive to invest in countries with low tax rates and a disincentive to invest in countries with high tax rates. Proposals to reform the U.S. international tax system include the replacement of the current hybrid system with either a territorial tax system or a residence-based system.¹⁷

Legislative Outlook for the 112th Congress

In the 111th Congress, numerous bills were introduced to reform the tax system. Two of those bills may be particularly relevant to the debate over tax reform in the 112th Congress. Representative Paul D. Ryan’s proposal has received widespread interest because it is seen as a comprehensive plan to address America’s long-term fiscal issues. Representative Ryan is chair of the House Budget Committee for the 112th Congress and served as a member of the National Commission on Fiscal Responsibility and Reform.

Senator Ron Wyden’s proposal has also been widely discussed. His proposal would broaden the tax base and lower marginal tax rates. The co-chairs of the Commission (Erskine Bowles and former Senator Alan Simpson) issued a draft document in November 2010. Their comprehensive

¹⁵ This section of this report summarizes some basic concepts in CRS Report RL34115, *Reform of U.S. International Taxation: Alternatives*, by Jane G. Gravelle. Some excerpts are stated from this report.

¹⁶ *Ibid.*, p. 2.

¹⁷ *Ibid.*, pp. 12-16.

tax reform option 2 was a “Wyden-Gregg Style Reform.”¹⁸ This option was not included in the final Commission report.

Representative Paul D. Ryan’s Proposal

H.R. 4529 (111th Congress). The **Roadmap for America’s Future Act of 2010** was introduced January 1, 2010, and referred to the House Committee on Ways and Means, House Budget Committee, and four other committees. This bill is a comprehensive plan to address America’s long-term economic and fiscal issues. Major components of the plan include health care reform, Medicare/Medicaid reform, Social Security reform, tax reform, job training reforms, and budget process reforms. Tax reform includes the elimination of the alternative minimum tax, a choice between the current income tax and a simplified income tax, the elimination of the estate and gift taxes, and the replacement of the corporate income tax with a value-added tax.¹⁹

The simplified income tax would have a broad base and two marginal tax rates (10% and 25%). A tax rate of 10% would apply to adjusted gross income up to \$100,000 for joint filers, and \$50,000 for single filers. A tax rate of 25% would apply to taxable income above \$100,000 for joint filers and \$50,000 for single filers. Under the simplified income tax system, the standard deduction would be \$25,000 for joint filers and \$12,500 for single filers, and the personal exemption would be \$3,500. Thus, for a family of four, the first \$39,000 of income would not be taxable.²⁰ Interest, dividends, and capital gains would not be taxed.

The current corporate income tax would be replaced with a subtraction-method value-added tax referred to as a Business Consumption Tax (BCT). The BCT would be levied at a rate of 8.5% and have a broad base. Temporary “transition relief” provisions would be included in order to facilitate the change from the corporate income tax.

Senator Ron Wyden’s Proposal

S. 3018 (111th Congress). The **Bipartisan Tax Fairness and Simplification Act of 2010** was introduced on February 23, 2010, and referred to the Senate Finance Committee. This proposal would reform the current income tax base rather than changing to a consumption base. This bill 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 24%, repeal the corporate alternative minimum tax, 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 alternative minimum tax would be eliminated. The standard deduction would almost triple. While most deductions would be eliminated, the bill would include deductions for mortgage interest and charitable contributions. The bill would permanently extend the enhancements of the child tax credit, the earned income tax credit, and the dependent care credit.

¹⁸ *Co-Chairs’ Proposal*, Draft Document, November 2010, p. 27.

¹⁹ For a comprehensive explanation of this proposed legislation, see *A Roadmap for America’s Future*, available at <http://www.roadmap.republicans.budget.house.gov/>.

²⁰ A family of four assumes a married couple plus two dependent children.

The bill would consolidate the three existing types of IRAs into a new retirement savings account, and a new lifetime savings account. A married couple would be able to contribute up to \$14,000 per year to tax-favored retirement and savings accounts. The corporate tax rate would be 24% of taxable income. The corporate tax base would be broadened by the elimination of numerous tax credits, deductions, and exclusions from income. The growth of small businesses would be encouraged by allowing businesses with gross annual receipts of up to \$1 million to permanently expense all equipment and inventory costs in a single year. The bill includes numerous provisions to improve tax compliance.

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