Tax Reform: An Overview of Proposals in the 111th Congress

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Summary

Tax reform is of congressional interest in the 111th Congress. 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. Most proposals for fundamental tax reform involve the concept of replacing the current income tax system with some form of a consumption tax, usually with a single or "flat tax" rate. 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. 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 March 17, 2010, the following bills for fundamental tax reform have been introduced: Representative David Dreier's proposal (H.R. 99), Representative John Linder's proposal (H.R. 25), Senator Saxby Chambliss's proposal (S. 296), and Senator Arlen Specter's proposal (S. 741), Representative Michael C. Burgess's proposal (H.R. 1040), Senator Lamar Alexander's proposal (S. 963), Senator Richard C. Shelby's proposal (S. 932), Representative Paul D. Ryan's proposal (H.R. 4529), Senator Jim DeMint's proposal (S. 1240), Senator Ron Wyden's proposal (S. 3018), and Representative Chaka Fattah's proposal (H.R. 4646). Companion bills are H.R. 25/S. 296 and H.R. 1040/S. 963.

A temporary patch for 2009 for the individual alternative minimum tax (AMT) was included in *American Recovery and Reinvestment Tax Act of 2009* (P.L. 111-5). The patch increased the individual AMT exemption amount and allowed personal credits against the AMT. The FY2010 budget resolution conference report (S.Con.Res. 13) provides for three years of relief from the AMT, through 2012, without the need for any revenue offset.

In the 111th Congress, 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, including Representative Charles B. Rangel, Chairman of the House Ways and Means Committee. 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. In the FY2011 Budget, the Obama Administration proposed numerous changes in the U.S. international tax system that would raise revenue through "reforms" and closing "loopholes."

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

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Introduction

Tax reform has been of congressional interest in the 111th Congress. Members of Congress have introduced numerous bills containing incremental or marginal adjustments in the tax code in an attempt to redistribute income, reallocate resources, change individual behavior, etc.[1] Proposed incremental or small tax adjustments are considered tax changes.[2] In contrast, 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.[3]

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. 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.

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[1] As of March 17, 2010, a word search in the Legislative Information System (LIS) using the term "tax" under the category "Title, Summary, Subjects, etc." resulted in a listing of 1,379 bills. For the entire 110th Congress, the same search yielded 2,012 bills. Nearly all of these proposed taxes were incremental or marginal changes in the tax code.

[2] Some of these proposed tax changes are examined in CRS reports.

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

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. Later in this report, other fundamental tax reform proposals are discussed.

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 (IRA) 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 is done 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. But, currently in the United States, the low savings rate would result in the tax rate on consumption being only slightly higher than the tax rate on income.

Proposals to shift from an income tax to a consumption tax differ in their treatment of the estate and gift tax. Some proposals would eliminate the estate and gift tax while others would not affect it.

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, who have a higher savings rate, since savings are not subject to a consumption tax. Whether or not this intergenerational transfer is "fair" is a subjective decision. 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).[4] These higher marginal tax rates, in turn, would increase the current system's distortion between the attractiveness of market (e.g., purchased products) and nonmarket activities (e.g., leisure).[5] 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.[6]

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 in the current system 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 could exert the same influences on the final design of a consumption tax.

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[4] Currently, in the United States, the personal savings rate is low. Consequently, the marginal tax rate on consumption would have to be only slightly higher than the marginal tax rate on income.

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

[6] For an analysis of effects of tax policy on saving, see CRS Report RL33482, *Saving Incentives: What May Work, What May Not*, by Thomas L. Hungerford.

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

In prior Congresses, four major types of broad-based consumption taxes have been 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 E. Hall and Alvin Rabushka (H-R) of the Hoover Institution.[7] As of March 17, 2010, in the 111th Congress bills have been introduced that would levy a VAT, a retail sales tax, or a flat tax.

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.[8] 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.

[7] 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: Overview of the Issues*, by Jane G. Gravelle.

[8] 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.

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 consumed-income and paying the tax obligation.

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.[9]

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.

[9] 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.

Other Types of Fundamental Tax Reform

Two other types of fundamental tax reform are (1) reforming the current income tax by broadening the tax base and lowering tax rates and (2) a tax plan that gives taxpayers a choice between the current income tax system and a simplified income tax.

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. Proponents argue that this approach would reduce economic distortions and thus increase economic efficiency.

Option of the Current or an Alternative Income Tax System

Taxpayers could be given the option of either paying the current income tax or paying an alternative income tax. In the 111th Congress, as of March 17, 2010, three bills has been introduced that gives taxpayers this option.

Legislative Proposals for Fundamental Tax Reform

As of March 17, 2010, in the 111th Congress, the following bills for fundamental tax reform have been introduced.

Representative David Dreier's Proposal

H.R. 99. The **Fair and Simple Tax Act of 2009** was introduced on January 6, 2009, and referred to the House Ways and Means Committee. This bill would establish an alternative determination of tax liability for individuals. A "simplified taxable income" would be taxed at the rates of 10% on the first $40,000, 15% on the income over $40,000 but under $150,000, and 30% on the income over $150,000. Simplified taxable income would equal gross income less the sum of deductions for personal exemptions, the deduction allowed for the acquisition of indebtedness with respect to the principal residence, the deduction allowed for state and local income taxes, the deduction allowed for charitable giving, and the deduction allowed for medical expenses. The estate and gift taxes would be repealed. The alternative minimum tax exemption amounts would be indexed for inflation. The maximum corporate income tax rate would be reduced to 25%. The 15% rate on dividends and capital gains of individuals would be reduced to 10%. The basis for assets for purposes of determining capital gain or loss would be indexed for inflation. This bill would create tax-free accounts for retirement savings, lifetime savings, and lifetime skills. Examples of qualified life skills include assessments of skill levels, development of an individual employment plan, career planning, occupational skills training, on-the-job training, and entrepreneurial training. This bill would repeal the adjusted gross income threshold in the medical care deduction for individuals under age 65 who have no employer health coverage. This bill would make the research credit permanent. This bill would repeal Title IX of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) relating to sunset of provisions. This bill would repeal Section 107 of the Jobs and Growth Tax Relief Reconciliation Act of 2003 relating to application of EGTRRA sunset to this title.

Representative John Linder/Senator Saxby Chambliss Proposal

H.R. 25. The **Fair Tax Act of 2009**, was introduced on January 6, 2009, by Representative Linder and referred to the Committee on Ways and Means. A companion bill, **S. 296**, the **Fair Tax Act of 2009,** was introduced on January 22, 2009, by Senator Chambliss and referred to the Senate Finance Committee. 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. The tax-inclusive retail sales tax would equal 23% of the sum of the sales price of an item and the amount of the retail sales tax. Every family would receive a rebate of the sales tax on spending amounts 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. The sales tax would sunset at the end of a seven-year period beginning on the enactment of this act if the Sixteenth Amendment is not repealed. This amendment provided Congress with the “power to lay and collect taxes on incomes.... ”

Senator Arlen Specter’s Proposal

S. 741. The **Flat Tax Act of 2009** was introduced on March 30, 2009, 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 2010, 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 for each dependent of the taxpayer. All deductions would be indexed for inflation.

Filers of a joint return would be allowed to deduct up to $3,125 ($1,562.50 in the case of a married individual filing a separate return or a single filer) annually for charitable contributions. Filers of a joint return would also 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 or a single filer).

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 legislation would have become operational for taxable years beginning after December 31, 2009.

Representative Michael C. Burgess/Senator Lamar Alexander Proposal

H.R. 1040. The **Freedom Flat Tax Act**, was introduced on February 12, 2009, by Representative Burgess and referred to the House Committee on Ways and Means. A companion bill, **S. 963**, the **Optional One Page Flat Tax Act**, was introduced on May 4, 2009, by Senator Lamar Alexander and referred to the Senate Finance Committee.

This proposal would authorize an individual or a person engaged in business activity to make an irrevocable election to be subject to a flat tax (in lieu of the existing tax provisions). The flat tax was based on the concepts of the Hall-Rabushka flat tax proposal. Each act would also repeal the estate and gift taxes.

For individuals not engaged in business activity who select the flat tax, their initial tax rate would be 19%, but after two years this rate would decline to 17%. The individual flat tax would be levied on all wages, salaries, retirement distributions, and unemployment compensation.

The flat 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:

- $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
- $12,790 for a married person filing a separate return

The "additional standard deduction" would be an amount equal to $5,510 for each dependent of the taxpayer. All deductions would be indexed for inflation using the consumer price index (CPI).

For individuals engaged in business activity who select the flat tax, their initial tax rate would be 19% (declining to 17% when the tax was fully phased in two years after enactment) on the difference between the gross revenue of the business and the sum of its purchases from other firms, wage payments, and pension contributions.

Any congressional action that raises the flat tax rate or reduces the amount of the standard deduction would require a three-fifths (supermajority) vote in both the Senate and the House of Representatives. The effective date of the flat tax would be calendar year 2010.

Senator Richard C. Shelby's Proposal

S. 932. The **Simplified, Manageable, and Responsible Tax Act** was introduced on April 30, 2009, and referred to the Senate Finance Committee. This act is modeled after the proposal formulated in 1981 by Hall and Rabushka. This proposal, which is a 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 value-added tax (VAT), with wages and pension contributions 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.

The individual wage tax would be levied at a 17% rate. The individual wage tax would be levied on all wages, salaries, pension distributions, 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, because activities of government entities and tax-exempt organizations would be exempt from the business tax. Private sector employers pay a cash-flow tax (or business tax) on fringe benefits paid to employees.

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 2010, the basic standard deduction would have been the following:

- $26,180 for a married couple filing jointly or a surviving spouse
- $16,710 for a single head of household
- $13,090 for a single person
- $13,090 for a married person filing a separate return

The "additional standard deduction" would be an amount equal to $5,640 for each dependent of the taxpayer. All deductions would be indexed for inflation using the consumer price index (CPI).

Businesses would pay a tax of 17% 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.

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.

Representative Paul D. Ryan's Proposal

H.R. 4529. 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 similar to S. 1240. 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.[10]

The simplified income tax would have a broad base and only 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.[11] 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 Jim DeMint's Proposal

S. 1240. The **Roadmap for America's Future Act of 2009** was introduced on June 11, 2009, and referred to the Senate Committee on Finance. This bill is similar to H.R. 4529, but it has no job training reforms. 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, 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.

[10] For a comprehensive explanation of this proposed legislation, see *A Roadmap for America's Future*, available at http://www.roadmap.republicans.budget.house.gov/.

[11] A family of four assumes a married couple plus two dependent children.

Senator Ron Wyden's Proposal

S. 3018. 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. 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.

Representative Chaka Fattah's Proposal

H.R. 4646. The **Debt Free America Act** was introduced on February 23, 2010, and referred to the Committee on Ways and Means and three other committees. This act would impose a transaction fee of 1% on the entire amount of specified intermediate and final transactions. Revenue raised from this fee would be sufficient to eliminate the national debt during a seven year period and phase out the income tax on individuals. The term *specified transaction* "means any transaction that uses a payment instrument, including any check, cash, credit card, transfer of stock, bonds, or other financial instrument." The fees would be collected by the seller or financial institution servicing the transaction and would be paid to the U.S. Treasury. The bill would establish a Bipartisan Task Force for Responsible Fiscal Action, which would identify factors affecting the long-term fiscal imbalance, analyze potential courses of action, and provide recommendations and legislative language to improve the long-term fiscal imbalance.

Other Legislation about Fundamental Tax Reform

As of March 17, 2010, in the 111th Congress, three other bills relevant to fundamental tax reform have been introduced: H.R. 982, H.R. 1703, and S. 3047.

H.R. 982. (Sponsor: Representative Bob Goodlatte). The **Tax Code Termination Act** was introduced on February 11, 2009, and referred to the House Committee on Ways and Means. After December 31, 2012, this bill proposes to terminate the tax code except for self-employment taxes, Federal Insurance Contributions Act taxes, and Railroad Retirement taxes. This proposal 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 bill would require that the new federal tax system be approved by Congress not later than July 4, 2012.

H.R. 1703. (Sponsor: Representative Chaka Fattah). The **Comprehensive Transform America Transaction Fee Act of 2009** was introduced on March 25, 2009, and referred to the House Committee on Ways and Means. This bill 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 46 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.[12]

S. 3047 (Sponsor: Senator Johnny Isakson). The **Tax Code Termination Act** was introduced on February 25, 2010, and referred to the Senate Finance Committee. This bill would establish within the legislative branch a National Commission on Tax Reform and Simplification. This commission would (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, 2013, then Congress would be required to vote to reauthorize the Internal Revenue Code of 1986.

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

Proposals Regarding the AMT

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. To offset a large revenue loss from the repeal of the individual AMT would require a major increase in taxes.

President Barack Obama did not propose the elimination of the individual AMT in his FY2010 Budget. In the 111th Congress, a temporary patch for 2009 for the alternative minimum tax (AMT) was included in *American Recovery and Reinvestment Tax Act of 2009* (P.L. 111-5). The patch increased the individual AMT exemption amount and allowed personal credits against the AMT. The FY2010 budget resolution conference report (S.Con.Res. 13) provides for three years of relief from the AMT, through 2012, without the need for any revenue offset.[13]

Reform of Federal Business Taxation

Federal taxes on business income have differential effects.[14] 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.[15]

First, comprehensive taxation of corporate income and lower tax rates would eliminate or reduce most major distortions. In the 111th 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, including Representative Charles B. Rangel, Chairman of the House Ways and Means Committee.

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, as previously discussed, a broad-based consumption tax could be levied that would replace individual and corporate income taxes. Types of consumption taxes include the national retail sales tax, the consumed-income tax, the value-added tax, and the "flat tax" (a modified VAT).

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

[14] 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.

[15] 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, pp. 14-20.

Reform of U.S. 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.[16] 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.[17]

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.[18]

In the FY2011 Budget, the Obama Administration proposed numerous changes in the U.S. international tax system that would raise revenue through "reforms" and closing "loopholes."[19] Proposed reforms include changes in the foreign tax credit and changes in transfer pricing. Proposals to close loopholes include increased withholding and requiring more third-party information reporting.

[16] 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.

[17] Ibid, p. 2.

[18] Ibid., pp. 12-16.

[19] For explanations of these proposals, see: Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals*, February 2010, pp. 39-68.

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