Simple, Fair, and Pro-Growth:

Proposals to Fix America's Tax System

Report of the President's Advisory Panel on Federal Tax Reform

November 2005

The President's Advisory Panel on Federal Tax Reform

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In addition, we would like to acknowledge the assistance of the Council of Economic Advisors, the Government Accountability Office, the Organization for Economic Cooperation and Development, the nearly 100 witnesses who appeared at the Panel meetings, and the thousands of interested parties who contributed their views and insights to the Panel.

The President's Advisory Panel on

Federal Tax Reform

www.taxreformpanel.gov

November 1, 2005

The Honorable John W. Snow
Secretary of the Treasury
The Department of the Treasury
1500 Pennsylvania Avenue
Washington, DC 20220

Dear Mr. Secretary:

President George W. Bush formed this Panel to identify the major problems in our nation's tax code and to recommend options to make the code simpler, fairer, and more conducive to economic growth. The Panel heard from nearly 100 witnesses and received thousands of written comments. Together, these witnesses and these comments described the unacceptable state of our current tax system. Yet this tax code governs virtually every transaction in the world's largest economy, affecting the daily lives of nearly 300 million people.

Our tax code is rewritten so often that it should be drafted in pencil. Each year, the tax code is adjusted to meet multiple policy goals – some are broadly shared, but many are not. Myriad tax deductions, credits, exemptions, and other preferences may be a practical way to get policy enacted, but it is a poor way to write a tax code. Whether the government spends more or extends a special tax break, the effect is the same: everyone else must pay higher taxes to raise the revenue necessary to run the government.

During the past few decades, panels have been formed repeatedly, legislation introduced annually, and hearings scheduled regularly to study our tax code and recommend changes. In 1986, a bipartisan effort yielded the last major tax reform legislation. But because of the ever-present tendency to tinker with the tax code, we must redouble our efforts to achieve fundamental reform.

Since the 1986 tax reform bill passed, there have been nearly 15,000 changes to the tax code – equal to more than two changes a day. Each one of these changes had a sponsor, and each had a rationale to defend it. Each one was passed by Congress and signed into law. Some of us saw this firsthand, having served in the U.S. Congress for a combined 71 years, including 36 years on the tax-writing committees. Others saw the changes from different perspectives – teaching, interpreting, and even administering the tax code. In retrospect, it is clear that frequent changes to the tax code, no matter how well-intentioned, ultimately undermine the integrity of the code in real and significant ways.

As we moved forward with recommendations for reform, we followed the President's instructions to emphasize simplicity, fairness, and to remove impediments to growth. Achieving all of these principles is no easy task. We recognized from the start of our meetings that while it is relatively straightforward to point out flaws in a tax system and to express a desire for change, it is much more challenging to settle on a specific solution. There are difficult trade-offs. While we have differed at times and we may not all agree with every word in this report, we all fully endorse it.

We unanimously recommend two options to reform the tax code. We refer to one option as the Simplified Income Tax Plan and the other option as the Growth and Investment Tax Plan. Both of them are preferable to our current system. Both satisfy the President's directive to recommend options that are simple, fair, and pro-growth.

The Simplified Income Tax Plan dramatically simplifies our tax code, cleans out targeted tax breaks that have cluttered the system, and lowers rates. It does away with gimmicks and hidden traps like the Alternative Minimum Tax. It preserves and simplifies major features of our current tax code, including benefits for home ownership, charitable giving, and health care, and makes them available to all Americans. It removes many of the disincentives to saving that exist in our current code, and it makes small business tax calculations much easier. It also offers an updated corporate tax structure to make it easier for American corporations to compete in global markets.

The second recommended option, the Growth and Investment Tax Plan, builds on the Simplified Income Tax Plan and adds a major new feature: moving the tax code closer to a system that would not tax families or businesses on their savings or investments. It would allow businesses to expense or write-off their investments immediately. It would lower tax rates, and impose a single, low tax rate on dividends, interest, and capital gains.

As directed by the President, our recommendations have been designed to raise approximately the same amount of money as the current tax system. The issue of whether the tax code should raise more or less revenue was outside of our mandate. Regardless of how one feels about the amount of revenue required to fund our government, all should agree that the tax system needs a solid and rational foundation.

We recognize that our report is just the beginning of the process to fix our broken tax system. The hardest work lies ahead. As a bipartisan Panel, we have heard from witnesses and elicited proposals from members of both major parties. We hope that the Administration and the Congress will carry forward this spirit of bipartisanship.

The effort to reform the tax code is noble in its purpose, but it requires political willpower. Many stand waiting to defend their breaks, deductions, and loopholes, and to defeat our efforts. That is part of the legislative process. But the interests of a few should not stand in the way of the tax code's primary goal: to raise funds efficiently for the common defense, vital social programs, and other goals of shared purpose. If we agree the goals serve us all, we must also agree that the costs must be fairly borne by all.

This report aims to give voice to the frustrated American taxpayer and to provide a blueprint for lasting reform. We look forward to a national debate and a better tax system.

Connie Mack

Connie Mack, III, Chairman

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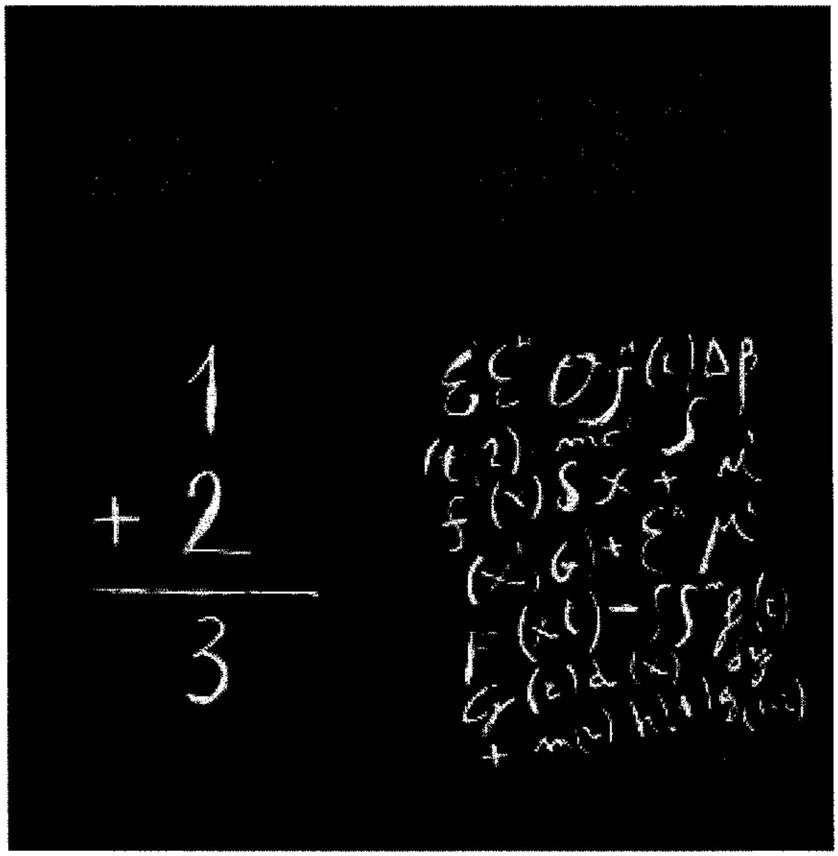
Chapter Six

The Simplified Income Tax Plan



Courtesy of Marina Sagona

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

The Simplified Income Tax Plan would simplify the process of filing taxes and would make it easier to predict tax consequences when planning for the future. It would consolidate and streamline a number of major features of our current code – exemptions, deductions, and credits – that are subject to different definitions, limits, and eligibility rules. It would make the tax benefits for home ownership, charitable giving, and health coverage available to more taxpayers, simpler to calculate, and

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

Table 6.5. Asset Categories Under the Simplified Depreciation System

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

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

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

Simplifying the Taxation of International Business

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

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

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

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

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

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

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

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

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

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

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

Strengthening Rules to Prevent International Tax Avoidance

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

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