

SUMMARY

President's Advisory Panel on Federal Tax Reform

October 18, 2005 Meeting

Courtesy of the Benefits Group of Davis & Harman, LLP

On October 18, 2005, the President's Advisory Panel on Federal Tax Reform met and agreed to recommend to the Secretary of the Treasury two alternative proposals for reform of the tax code: (1) a simplified income tax proposal, and (2) a modified progressive consumption tax proposal. Both proposals would entail very significant changes to the tax incentives for savings and these changes are discussed below. The panel members also discussed a value added tax proposal, but agreed only to provide details about the proposal in its report rather than recommending it to the Secretary. There were no dissenting views expressed by the panelists with regard to these decisions.

Each of the proposals presented by the panel is revenue neutral, using the President's budget as a baseline, and each will have the same distributional effects as current law. Panel Chairman Connie Mack (former Republican U.S. Senator from Florida) indicated that he expects the recommendations to be further refined by the President and the Congress. However, during the discussion several panelists stressed that it is important for provisions of the proposals to be viewed as a package and suggested that cherry picking among them should be discouraged.

The panelists had been divided into subgroups to develop the proposals and members of the various subgroups led the discussions with the other members adding their views. Not all details of the proposals were discussed during the meeting and some of these details are yet to be determined. At the end of the meeting, Panel Chairman Mack noted that a lot of details remain for staff to address over the next week. In addition, some details will not be addressed by the panel. Below is a summary of the proposals discussed at the meeting.

Simplified Income Tax Proposal

The members of this subgroup were Charles Rossotti (former IRS Commissioner), Elizabeth Garrett (Professor of Public Interest Law, University of Southern California), Timothy Muris (Foundation Professor, George Mason School of Law and former Federal Trade Commissioner), and Bill Frenzel (Brookings Institution and former member of the House of Representatives from Minnesota).

Under the simplified income tax proposal, the current six individual income tax brackets would be replaced by 4 brackets (15%, 25%, 30%, and 33%), and the standard deduction, personal exemption, and child tax credit would be replaced with a family credit of

\$1,650 for individuals, \$3,300 for married couples, and \$2,800 for single, heads of households. In addition, a credit will be given for each child. The earned income tax credit and refundable child credit would be replaced with a new work credit.

The proposal would cap employer-provided health insurance at \$11,500 for families and \$5,000 for single individuals and the amount would be indexed to the CPI. Employers would be permitted to deduct the entire amount of insurance (even if it is above the cap). Those individuals without employer-provided insurance would receive a deduction equal to the exclusion. Other fringe benefits would be included in income except in-kind benefits provided to all employees.

Owners of homes would receive a credit of up to 15% of mortgage interest paid to acquire, construct, or improve a primary residence. It would apply to mortgage indebtedness equal to the FHA amount in the individual's area. This amount ranges from \$172,000-\$312,000. Individuals would still be permitted to exclude capital gains on the sale of their homes and that amount would be increased to \$600,000 for married couples and indexed for inflation.

Charitable deductions would be permitted for all contributions over 1% of an individual's income and contributions would be permitted from retirement accounts.

According to the panelists, they attempted to simplify incentives for savings by combining current savings vehicles into three new vehicles and establishing a refundable savings credit for low-income taxpayers. The proposal creates a "Save at Work Account" to replace all current employer-provided plans including 401(k)s, 403(b)s, and SARSEPS. (Although it was not clear, the fact that only these 3 plans were listed may indicate that they are referring only to defined contribution plans.) The proposal also would simplify nondiscrimination rules and would provide for automatic enrollment, automatic placement in a diversified investment, and automatic rollover into a new plan if a person leaves a job before retirement.

The panelists also proposed to replace all current retirement accounts outside of employment (which includes deferred compensation (the panel's term), cash value life insurance, annuities and IRAs) with a "Save for Retirement" account. Individuals would be permitted to save up to \$10,000 annually in such an account. These accounts could only be used for retirement. An additional "Save for Family" account created under the proposal would replace health savings accounts (HSAs), 529 college savings plans, flexible savings accounts (FSAs), and Coverdell education savings accounts (ESAs). In addition, all other tax benefits for education would be eliminated. Individuals would be permitted to save up to \$10,000 annually into these accounts and withdrawals would be permitted only for health, education and training, a primary residence, or retirement. In addition, Professor Garrett said that the panelists did not want to deal with hardship rules so they would allow a withdrawal of \$1,000 per year from the account, but she did not provide any details about how this would work.

Professor Garrett explained that transition rules for current products (and she specifically mentioned life insurance and annuities) would be needed, but she did not discuss the rules.

The deductions for state and local taxes, including property taxes, would be eliminated under the proposal, and as part of the integration provisions included in the proposal, capital gains not associated with corporate stock would be taxed (except for homes). The individual AMT would be eliminated.

The proposal would eliminate the double taxation of dividends by providing a 100% exclusion (for individuals) for dividends of all U.S. companies and a 75% exclusion (for individuals) for the sale of stock of U.S. companies.

The proposal includes a 32% top corporate tax rate and treats all large businesses the same regardless of form of business. The corporate AMT would be eliminated and depreciation classification would be simplified and reduced from 9 to 4 classes. Simplified rules for small businesses would be provided. Multi-national corporations would not pay tax on active foreign operations, and income could be repatriated to the U.S. tax free. Mr. Rossotti discussed this portion of the proposal and noted that a method of allocating worldwide expenses would be necessary, but the subgroup did not address this in its recommendations.

Progressive Consumption Tax

Jim Poterba (Department of Economics, MIT), Liz Ann Sonders (Chief Investment Strategist, Charles Schwab), Edward Lazear (Senior Fellow, Hoover Institution and Professor of Human Resources, Management and Economics, Stanford), and John Breaux (former U. S. Senator from Louisiana) served on this subgroup.

Liz Ann Sonders described the proposals of the progressive consumption tax relating to individuals and said that it is the equivalent of an unlimited Roth IRA – no tax on savings or capital income. The proposal provides for 3 individual income tax brackets of 15%, 25%, and 35%. In developing the proposal, the subgroup tried to keep the base as broad as possible, but their discussions assumed adding in some types of incentives, and after hearing the proposal discussed by the previous group, she said that the Work Credit and homeownership credit from that proposal would fit well with the consumption tax proposal. The progressive consumption tax proposal also would allow an exclusion for a portion of employer-provided health insurance (\$8,400 for families and \$4,000 for singles) and a deduction for those without such insurance.

Jim Poterba described the business provisions of the proposal which would tax corporate tax cash flow (defined as sales, minus purchases, less wages and compensation) at a rate of 35%, eliminate the interest deduction for non-financial businesses, and treat all entities the same for tax purposes (except financial businesses). Members of the subgroup discussed the difficulty of addressing financial institutions and international entities under this tax regime. The subgroup recognized that financial institutions in particular would have to be treated differently than other entities, but did not decide what that treatment

should be. The subgroup also did not determine specifically how to address international entities and will simply recommend that a destination tax system with border adjustability be considered. Also left open was the issue of transition rules.

Several members of the panel expressed concern that high income individuals who have only interest, dividend, or capital gains income would pay no income tax under this system. Senator Breaux and Professor Garrett in particular raised this issue. Both also expressed concern about the \$8,400 and \$4,000 exclusion limit on employer-provided health insurance, preferring the amounts provided in the simplified income tax proposal. As a result of these concerns, Dr. Porterba offered a modified progressive consumption tax which would add a 15% flat tax rate on all interest, dividends, and capital gains. This modified proposal also would add a \$10,000 savings vehicle (as provided in the simplified income tax plan). Under the modified proposal, the top corporate tax rate would be 32% and the individual tax brackets would be 15%, 25%, 30%, and 35%.

The panel agreed to recommend the modified approach in its report to the Secretary and Mr. Rossotti suggested that the report acknowledge that that they do not know how to handle a lot of pieces of a consumption tax because it is new.

VAT

The panel almost rejected this proposal last week, but Chairman Mack asked them to postpone their decision. After a brief discussion of the proposal developed by the working subgroup (15% VAT, 15% top corporate income tax rate, and 15% top individual income tax rate), the panel again decided not to recommend such a tax to the Secretary. However, the report will include a description of the subgroup proposal along with a discussion of the advantages and disadvantages of a VAT.

Next Meeting of the Panel

The panel is scheduled to meet via teleconference on October 27, 2005. In addition, a teleconference is scheduled for November 1st, which is the due date for submitting the panel's recommendation to the Secretary.