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PREFACE

What follows is a report of the President's Economic Recovery Advisory Board (PERAB) on options for changes in the current tax system to achieve three broad goals: simplifying the tax system, improving taxpayer compliance with existing tax laws, and reforming the corporate tax system.

The Board was asked to consider various options for achieving these goals but was asked to exclude options that would raise taxes for families with incomes less than $250,000 a year. We interpreted this mandate not to mean that every option we considered must avoid a tax increase on such families, but rather that the options taken together should be revenue neutral for each income class with annual incomes less than $250,000. A similar principle of revenue neutrality was used in the 1986 tax reform legislation in which changes that raised revenue were combined with cuts in personal income tax rates. The specific changes we considered can either raise or lower revenue. We realize that revenue neutrality by income class might result in increases or decreases in tax liability for subgroups or individual taxpayers within each income class – that is, revenue neutrality might result in "winners" and "losers." We hope that the Administration and the Congress will select changes that are desirable on their merits and not worry about the distributional effects of each of them individually. The entire package of options selected should be evaluated by the Treasury or the Joint Committee on Taxation (JCT) to see what impact it has on tax liability by income class. If, as seems likely, the package raises taxes for some income groups and lowers them for others, this could be offset by adjustments to the standard deduction, tax rates or other provisions. Of course, even if the rates are adjusted to be revenue neutral in each income class, there will be individual taxpayers who gain and lose. We did not try to hold all taxpayers harmless in the options we evaluated, and we were not asked to do so by the President. It would be impossible to do so without substantial costs in terms of lost revenues.

The Board gathered information from business leaders, policy makers, academics, individual citizens, labor leaders, and many others. Our findings are the result of months of input from many people, and we thank them for their advice. In addition, over the years there have been many reports on tax reform options by both government agencies and private entities. There has also been substantial academic research on these issues. We have benefited greatly from studying these previous reports and materials.

The Board was not asked to recommend a major overarching tax reform, such as the 1986 tax reform, the tax plans proposed by the 2005 Tax Reform Panel, or proposals for introducing a value-added tax in addition to or in lieu of the current income tax system. We received many suggestions for broad tax reform, and some members of the PERAB believe that such reform will be an essential component of a strategy to reduce the long-term deficit of the federal government. But consistent with our limited mandate, we did not evaluate competing proposals for overarching tax reform in this report.

Finally, it is important to emphasize at the outset that the PERAB is an outside advisory panel and is not part of the Obama Administration. We have heard the views of experts in the government in the same way that we have heard the views of outside experts and interest groups. We have attempted to distill these views in this report to provide an overview of the advantages and disadvantages of tax reform options that achieve the three goals of our mandate: tax simplification, greater tax compliance, and corporate tax reform. Our report is meant to provide helpful advice to the Administration as it considers options for tax reform in the future. The report does not represent Administration policy.

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II. SIMPLIFICATION OPTIONS

The tax code is complex. This complexity imposes significant costs on affected taxpayers and is reflected in the amount of time and money that people spend each year to prepare and file their taxes. Taxpayers and businesses spend 7.6 billion hours and incur significant out-of-pocket expenses each year complying with federal income tax filing requirements. In monetary terms, these costs are roughly equivalent to at least one percent of GDP annually (or about $140 billion in 2008). These costs are more than 12 times the IRS budget and amount to about 10 cents per dollar of income tax receipts. The IRS estimated that for 2008, taxpayers filing Form 1040 spent an average of 21.4 hours on federal tax-related matters. Most taxpayers—about 60 percent—now pay tax preparers to fill out their returns, and at least 26 percent use tax software. Specially targeted provisions now require low-income taxpayers, Social Security recipients, individuals subject to the Alternative Minimum Tax (AMT), and many other groups to calculate their incomes multiple ways and multiple times. The burden of this complexity falls especially heavily on lower-income families and on households with complicated living arrangements. Families claiming a child-related credit are about 40 percent more likely to use a paid preparer, and more than 70 percent of low-income recipients of the Earned Income Tax Credit (EITC) used a paid preparer to do their taxes. For businesses and the self employed, the compliance burden is particularly high, and because this burden has a large fixed component, these costs are regressive.

The complexity of the tax code is partly the result of the fact that new provisions have been added one at a time to achieve a particular policy goal, but with inadequate attention to how they interact with existing provisions. This results in duplicative and overlapping provisions, multiple definitions of concepts like income and dependent children, differences in phase outs, and differences in the timing of expiring provisions. Between 1987 and 2009, the instruction booklets sent to taxpayers for the Form 1040 increased in length from 14 pages to 44 pages of text. The tax code has become more complex and more unstable over the last two decades, in part because legislators have increasingly used targeted tax provisions to achieve social policy objectives normally achieved by spending programs. There have been more than 15,000 changes to the tax code since 1986, and a current JCT pamphlet lists 42 pages of expiring provisions.

The complexity results in errors and mistakes that adversely affect tax compliance and add to administrative and enforcement costs. Internal Revenue Service (IRS) studies suggest that non-compliance is higher among filers faced with complex eligibility rules and recordkeeping requirements. For example, an IRS study suggested that between 23 and 28 percent of EITC payments in fiscal year 2006 were incorrect. Similarly, the Government Accountability Office (GAO) estimated that for tax year 2005, 19 percent of eligible tax filers failed to claim either a tuition deduction or a tax credit for which they were eligible. The complexity of the system also makes it harder for the IRS to do its job by increasing the difficulty of identifying non-compliant and improper behavior.

Beyond these direct costs that can be measured in time, money, and revenue lost to noncompliance, the complexity of the tax system is a tremendous source of frustration to American taxpayers, reduces the system's transparency, and undermines trust in its fairness.

The task force received many different ideas for tax simplification. In this report, we group these ideas into a few broad categories: Simplification for Families; Simplifying Savings and Retirement

Incentives; Simplify Taxation of Capital Gains; Simplify Tax Filing; Simplification for Small Businesses; and the AMT.

a. Option Group A: Simplification for Families

In our public meetings, in conversations with tax experts, and through submissions from individual taxpayers, tax provisions related to families and children were among the most cited sources of complexity in the tax code. The tax code provides numerous credits and deductions that reduce taxes for families with children and for child-related expenses like day care and education costs. There is also a special rate structure for unmarried individuals with family responsibilities. Currently, more than 50 million taxpayers with children claim at least one of these child-related tax benefits; most families with children receive at least two and frequently three or more.

Each of these child-related provisions has different eligibility rules, many of which are difficult to interpret or enforce and some of which we heard criticized as unfair and arbitrary. Confusion about the rules for these benefits contributes to mistakes and noncompliance. In addition, having many different benefits often requires parents to make multiple calculations to compute each credit amount, either because the credits are determined on a specific definition of earnings or an alternative measure of income, or because a benefit phases out in certain income ranges. Some provisions can be calculated in alternative ways, requiring parents to try different calculations to pick the most advantageous one. The system also requires children (or their parents) to file millions of returns that raise little revenue.

To get an idea of why this is a problem, take the example of a middle-class family with teenage children aged 16 and 19, the eldest a student who lives away at college and is supported by the parents. The family has typical middle-class income, a very basic family structure, and only wage income. Under current law, the family is eligible to claim dependent exemptions for both children, allowing the parents a deduction against their taxable income. Because they have one child under 17 they are also eligible for the $1,000 child tax credit. The college student is too old for the child credit, but the parents may be able to claim one of a number of education credits for the student depending on the amount of their educational expenditures.

Despite the simplicity of this situation, the process for claiming the benefits for which this family may be eligible is non-trivial. The instructions for claiming the dependent exemption include a multi-part checklist and more than two pages of instructions. A dependent child must normally be 18 or younger and reside with the parents, but an exception applies for a student living away at school. (However, just because the older child is a college student for the purposes of the dependent exemption does not necessarily make him eligible for education credits, which are governed by other eligibility and recordkeeping requirements.) Before calculating the child tax credit for the younger child, the parents must read through an eligibility test intended to screen out taxpayers in certain rare situations. Like the vast majority of families, these situations do not apply to the family in this simple example, so they can skip to the next (and for them final) step: a 10-line, two-page worksheet needed to calculate the size of the child tax credit. In this they are fortunate—a family with less income or more children may need to calculate an alternative definition of income and file an additional two-page, 13-line form for the additional child tax credit, and a family with higher income may have to calculate a reduced benefit.

Because the parents in this example pay tuition for the college student, the family would likely qualify for at least three different education benefits but must choose only one. Making this choice will require the parents to consult an additional publication, make three separate calculations to find the most advantageous benefit, and then file additional forms to claim the credit.

Because both children are claimed as dependents by their parents, they may be subject to the "kiddie tax," requiring the college student to file a separate dependent return even if the student earns as little as $950. If the children have high enough incomes, they may be taxed at the parents' tax rate, requiring parents and children to coordinate their filings.

As complicated as these steps are, this family has it relatively easy. At higher income levels, the child tax credit, dependent exemption, and education credits all phase out (in different income ranges), requiring additional calculations for each credit or deduction, and raising effective tax rates on family income. At lower income levels, the situation is arguably more complex. Parents must make calculations based on different definitions of income to claim benefits like the EITC (a refundable work credit whose value is tied to the number of children) or the additional child tax credit—calculations that can require more than 100 lines on worksheets in some cases. It is little wonder that the vast majority of the poorest families must pay a tax preparer to claim these benefits. On top of this, many family-related tax provisions are predicated on family relationships, the residence of the child, and expenditures made by taxpayers to support the child and maintain the child's household. These rules are difficult to understand and follow, particularly for families in complicated living situations—households that include extended family and multiple generations, or that are headed by an unmarried, separated, or divorced parent.

While explaining the complexities of the current family and child tax provisions to us, experts emphasized that they exist for good reasons: to promote equity and to embody the principle that tax burdens should reflect differences among families in their ability to pay; to defray employment-related child-care expenses; to encourage higher education; and to provide incentives to work. Some level of complexity is required to target these goals appropriately. Moreover, the phase-outs of eligibility for credits and the limitations of eligibility often reflect fiscal restraint or the principle of "vertical equity"—the idea that families with greater ability to pay should shoulder a larger share of the tax burden.

Thus, there are tradeoffs between simplifying existing family and child tax provisions and achieving these other goals of tax policy. The distributional and incentive effects of proposed simplification measures must be considered. But the case for simplification has become stronger over the years as a result of the growing number of family-related provisions and their applicability to a growing number of middle-class taxpayers.

Experts also told us that another difficulty is that meaningful simplification of family and dependent provisions would either be costly in terms of foregone tax revenues or would create losers among certain lower and middle-income households. This difficulty reflects the generosity of current provisions for lower- and middle-income households and the overlapping of provisions that benefit slightly different groups of households. The scheduled expiration of portions of these provisions in 2011 may provide an opportunity to review and consolidate the remaining family and dependent provisions while ensuring that the vast majority of lower- and middle-income households remain at least as well off as they would be after the provisions expired.

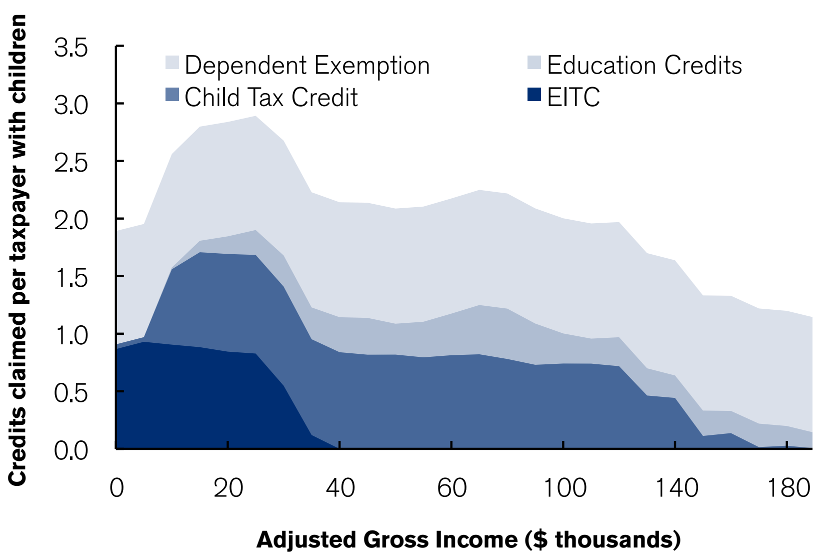
Below we outline four options for simplifying the tax treatment of families. Some (but not all) of the options comprise several proposals.

i. Option 1: Consolidate Family Credits and Simplify Eligibility Rules

Recurrent criticisms of the present family-related credits and deductions are that there are too many different credits and that figuring out how to claim each benefit is difficult and time consuming.

Families often receive multiple benefits in a single year. In 2005, more than 80 percent of families claiming one of the EITC, Child Tax Credit, or dependent exemption claimed more than one and almost 30 percent claimed all three. Figure 1 illustrates the average number of child-related credits and exemptions claimed per taxpayer with children at different levels of income. As the figure shows, taxpayers earning close to $25,000 receive, on average, about three different credits. As income rises these credits phase out and taxpayers become ineligible for certain benefits. Because of the expansion of the EITC and the child tax credit under the American Recovery and Reinvestment Act (ARRA), the number of taxpayers receiving multiple credits has increased.

Figure 1: Family–Related Tax Credits per Family Taxpayer



Source: Statistics of Income Public Use File (2005).

This is burdensome because each credit or deduction is governed by slightly different eligibility rules and benefit calculations. Table 1 provides a description of the largest child-related benefits and a comparison of rules that govern each one. As the table shows, each benefit is reduced (phased out) in a different range and at a different rate. Many of the credits require multiple, sometimes dozens of lines of calculations, and each defines an eligible child using a different combination of age, residency, and relationship requirements.

Table 1: Comparison of Provisions Relating to Families with Children

	Dependent Exemption	Child Tax Credit	Earned Income Tax Credit	Child and Dependent Care Tax Credit	Head of Household Filing Status	Education Credits
Tax benefit (2009)	Deduction of $3,650 for each dependent.	Credit of $1,000 per child. Partially refundable.	Credit up to $3,043 for one child, $5,028 for two children, and $5,657 for more than two children. Refundable.	Credit of up to 35% of up to $3,000 of work-related expenses for one child, $6,000 if more than one.	More favorable rate schedule and higher standard deduction than for other unmarried taxpayers.	$2,500 for American Opportunity Tax Credit (AOTC); $2,000 for Lifetime Learning Credit (LLC); and others. AOTC partially refundable.
Phase-Out Threshold (Joint Filers)	Over $250,000	Over $110,000	Over $21,420	Phases-down in 16 steps from $15,000 to $43,000.	NA	Over $160,000 for the AOTC. Over $100,000 for LLC.
Phase-Out Rate (Joint Filers)	2.97 percent per exemption	5 percent	21.06 percent	Credit falls from 35 percent of expenses to 20 percent of expenses in phase-out range.	NA	12.5 percent per student for the maximum AOTC credit. 10 percent for LLC.
Maximum Lines to Calculate Credit	10	64	40	34	NA	42
Age Requirement	Under 19 or under 24 and a student; any age if permanently and totally disabled.	Under 17.	Under 19 or under 24 and a student; any age if permanently and totally disabled.	Under 13; any age if unable to care for himself or herself.	Under 19 or under 24 and a student; any age if permanently and totally disabled.	Under 19 or under 24 and a student; any age if permanently and totally disabled; yourself or your spouse at any age.
Residency requirement	Qualifying child must live with taxpayer for over one half of the year. Other non-qualifying child relatives must live with the taxpayer for the entire year. Exception for students at school. Exception for divorced parents.	Same as dependent exemption.	Child must live with taxpayer for over one half of the year.	Must live with the taxpayer for the period during which the expenses were incurred. Exception for divorced parents.	Qualifying child must live with the taxpayer for over one half of the year.	Same as dependent exemption.

All of these differences require parents to consult pages of instructions, multiple checklists, and occasionally to turn to alternative publications to determine whether their child or dependent qualifies for a credit or deduction. Moreover, because eligibility rules for credits are similar but not identical, many of these tax forms and checklists ask for similar or, in some cases, exactly the same information. For example, a parent claiming the dependent exemption, the child tax credit, EITC, and dependent care credit must report the same child's name and Social Security number four times, and may have to calculate and report their earnings on four different forms. Because the phase-outs of these credits are all different, each credit may need to be calculated separately. In certain cases, the benefit amount must be calculated using alternative measures of income. For example, the dependent exemption and dependent care credit phase out as adjusted gross income (AGI) increases, but the child tax credit phases out with a modified version of AGI; the EITC, additional child tax credit, and dependent and child care credits use earnings in their calculations—and the definition of "earnings" is not even the same for the EITC and additional child tax credit.

Many families will not receive the same set of benefits from year to year. Many families with transitorily low income because of unemployment, maternity leave, or illness will be eligible for the EITC for only one year. Children will age out of the dependent and child care credit at 13 and the child tax credit at 17. They will become newly eligible for education benefits at 18 or 19 but may not receive the same education credit for each year of school. This lack of consistency requires parents to learn new rules each year and reduces the familiarity of taxpayers with the benefits for which they are eligible.

Consolidating tax benefits for families would reduce the number of credits and deductions and standardize eligibility rules, eliminating much of the complexity, computational burden, taxpayer confusion, and difficulties with enforcement in the current system. A consolidation that reduced the number of credits need not reduce tax benefits; benefit amounts could be adjusted to maintain the current level and distribution of such benefits. As noted above, most parents receive multiple credits. Moreover, most of the differences in eligibility for family and child credits depend on family income and the ages of children, suggesting that some credits could be combined by adjusting age or income eligibility rules. Consolidating credits may take any number of permutations, but some general principles apply. This section provides three examples of consolidations to illustrate potential options with the pros and cons of each.

1. Consolidate Family Benefits into a Work Credit and a Family Credit

The proposal and its advantages:

The experts we heard from repeatedly referenced an option advocated by the 2005 Tax Reform Panel and modified in a policy paper from the Center on Budget and Policy Priorities by Jason Furman. In the 2005 Panel's option, the dependent exemption, standard deduction, and child tax credit were consolidated into a "Family Credit" available to all taxpayers, and the EITC was replaced by a "Work Credit." The dependent care credit was eliminated, and specific tax benefits for higher education were replaced with a similarly generous extended family credit for full time students under age 22. The value of these new credits was calibrated to mirror the level and distribution of benefits available to families under current law.

Advocates of this system point to numerous simplifications. This option replaces an array of tax benefits with two relatively simple credits, eliminating a number of overlapping provisions. The Family Credit would provide a uniform tax benefit that does not phase out with income, eliminating the phase-out calculations of the personal and dependent exemptions, the child tax credit, and the dependent and child care credit. The Work Credit would replace the EITC and the refundable portion of the child tax credit, and would maintain work incentives. Calculating benefits would be simplified because duplicative computations of income and earnings would be eliminated. Replacing multiple education benefits with a fixed benefit for families with full time students would maintain the subsidy to pursue higher education, but without the complexities associated with claiming education benefits and requirements to maintain records for qualifying expenses. With only two credits, a number of steps in the tax filing process would be eliminated. Additionally, with fewer credits, the ability of taxpayers to game the system by shifting dependents between unmarried parents or to other relatives to achieve larger tax benefits would be reduced, improving compliance.

Disadvantages:

In order to simplify the calculation of benefits, the Family Credit proposed by the 2005 Tax Reform Panel would not phase out with income, as does the child tax credit and other benefits under current law. In the absence of phase-outs, the proposal would significantly increase the cost of the credit and lose revenue relative to current law. Some non-standard students—older students or part-time students—could lose education credits. In addition, the value of family-related benefits, particularly refundable credits like the additional child tax credit and the EITC, have increased since 2005, making the distribution of family-related benefits more variable across income groups. With only one phase-out of benefits in the Work Credit, the 2005 Panel's recommendation would not replicate the current progressivity of family benefits. In the absence of other changes to the tax system, two or even three phase-outs would be needed to approximate the phase-outs of the EITC, the child tax credit, education benefits, and the personal exemption, and achieve the progressivity of the current system.

Moving from six types of family benefits to two would also reduce the ability to use the tax code to target benefits to specific groups. The current system reflects a desire to provide greater benefits to younger children, to taxpayers with higher education expenses or child-care expenses, to families in certain living arrangements, and to taxpayers based on their marital status. Consolidating credits would result in these different groups facing more similar tax burdens.

2. Combine the EITC, Child Tax Credit, and the Child Dependent Exemption

The proposal and its advantages:

These three provisions would be combined into a single family benefit with harmonized eligibility requirements, and the credit would be refundable for taxpayers with (uniformly defined) earned income. This option would reduce the complexity of family-related benefits by eliminating two provisions (and their associated instructions, checklists, and worksheets). Multiple computations for the additional child tax credit and EITC would be eliminated, and other eligibility rules would be harmonized, streamlining the filing process.

Disadvantages:

Because the phase-outs for each of these credits differ substantially under current law, a more complicated phase-out schedule would be required to maintain the current distribution of benefits. The age-eligibility rules of the dependent exemption and child credit differ. Hence, extending the benefits of the child tax credit to higher-income children would either reduce tax revenues or require a reduction in tax benefits for children under age 17. The dependent exemption (or a similar benefit) would be required for non-child dependents, like elderly parents, limiting the simplification benefits. Harmonizing rules across these credits could raise taxes for certain groups—for example, applying the EITC eligibility rules to the combined credit would eliminate child-related benefits for non-U.S. residents and for non-custodial parents.

3. Consolidate the Child Tax Credit and Dependent Exemption, and Repeal (or Reduce) Some Education Credits

The proposal and its advantages:

This option would apply the same age tests used for the dependent exemption to the child tax credit, allowing families with children under age 24 who are full-time students to receive the child tax credit. The education credits available to this group would then be reduced or repealed, but the Lifetime Learning Credit (LLC) would be offered to taxpayers who cannot be claimed as dependents. In addition to the advantages of the previous option, additional simplification would arise by replacing the multitude of education benefits with a simple flat credit, eliminating third-party reporting from universities and burdensome recordkeeping for expenses like books and supplies. Compliance and enforcement of these credits would improve and taxpayers would no longer need to make multiple calculations to learn which education credit to take.

Disadvantages:

Again, depending on the value of the consolidated credit and the qualified expenses of students, some families may receive larger or smaller credits.

ii. Option 2: Simplify and Consolidate Tax Incentives for Education

The tax system includes at least 18 different provisions benefiting taxpayers with educational expenses (see Table 2). Some provisions reduce the cost of education directly, including the American Opportunity Tax Credit (AOTC), the LLC, the tuition and fees deduction, and the student loan interest deduction. Other provisions encourage saving for future expenses with savings bonds or through tax-preferred accounts (these are discussed in greater detail in the section under savings incentives).

Table 2: Summary of Education Provisions, 2009

	Type of Benefit	Qualifying Expenses	Eligible Individuals	Maximum Annual Amount	Income Limits (single/joint filers)
American Opportunity Credit (effective through 2010)	Per student credit against tax	Tuition, required fees, non-academic fees, books, supplies, equipment	Taxpayer, spouse or dependent in first 4 years of higher education pursuing degree enrolled at least half-time	$2,500: 100% of the first $2,000 and 25% of the next $2,000 (indexed for inflation)	Phase-out begins at $80,000/$160,000
Hope Scholarship Credit	Per student credit against tax	Tuition and required fees	Taxpayer, spouse or dependent in first 2 years of higher education pursuing degree enrolled at least half-time	$1,800: 100% of the first $1,200 and 50% of the next $1,200 (indexed for inflation)	Phase-out begins at $50,000/$100,000
Lifetime Learning Credit	Per taxpayer credit against tax	Tuition and required fees	Taxpayer, spouse or dependent in post-secondary or professional education	$2,000: 20% of the 1st $10,000 total across all eligible students in household (not indexed for inflation)	Phase-out begins at $50,000/$100,000
Student loan interest deduction	Above-the-line deduction	Tuition, required fees, non-academic fees, books, supplies and equipment, room and board	Taxpayer, spouse, or dependent	$2,500	Phase-out over $55,000-$70,000 ($110,000-$140,000 joint filers) modified AGI.
Education expenses deduction (effective through 2009)	Above-the-line deduction	Tuition and required fees	Taxpayer, spouse or dependent receiving higher education	$4,000 or $2,000 subject to income limits	Deduction limited to $4,000 if modified AGI is less than $65,000 ($130,000 joint); and to $2,000 if modified AGI is less than $80,000 ($160,000 joint),
Dependent exemption for children aged 19 through 23	Personal exemption deduction for dependent students aged 19 through 23	NA	Student enrolled full-time for at least 5 months of preceding year	$3,500 (indexed for inflation)	Phase-out begins at $166,800 ($250,200 joint filers) AGI
Earned Income Tax Credit for dependent for children aged 19 through 23	Refundable credit for families with students children aged 19 through 23	NA	Student enrolled full-time for at least 5 months of preceding year	$2,917 for families with a single dependent child	Phase-in complete at $8,580. Phase-out begins at $15,740. Phase-out complete at $33,995
Employer provided education assistance program (EAP)	Exclusion from gross income for employer provided education assistance	Tuition, required fees, non-academic fees, books, supplies, equipment and special needs	Employee	$5,250 (not indexed for inflation)	Limits on share of benefit that can go to the highly compensated, no individual income limits

Table 2: Summary of Education Provisions, 2009 *(continued)*

	Type of Benefit	Qualifying Expenses	Eligible Individuals	Maximum Annual Amount	Income Limits (single/joint filers)
Cancellation of debt	Exclusion from gross income for income from cancellation of certain student loans	NA	Borrower who works for a certain period of time in certain professions	None	None
Business expense deduction	Itemized deduction	Most business or work related education expenses including transportation and childcare	Taxpayer or spouse	None	Overall limitation on itemized deductions may apply to AGI over $156,400
Scholarships and fellowships	Exclusion from gross income for scholarships and fellowships	Tuition, required fees, non-academic fees, books, supplies, equipment	Degree candidate	None	None
Tuition reduction	Exclusion from gross income for tuition reduction	Tuition	Employee of college, spouse or dependent; graduate student	None	None
Traditional and Roth IRAs	Exception from 10% additional tax on early distributions	Tuition, required fees, non-academic fees, books, supplies, equipment, room and board, special needs	Taxpayer, spouse, child or grandchild (enrolled at least half-time for room and board)	None	None
Qualified Tuition Plan (QTP) or 529 Plan	Exclusion from gross income for distributions from QTP accounts	Tuition, required fees, non-academic fees, books, supplies, equipment, room and board, special needs, and computer technology* (*ARRA addition)	Any post-secondary student (enrolled at least half-time for room and board)	None	None
Coverdell Education Savings Account	Exclusion from gross income for distributions	Tuition, required fees, non-academic fees, books, supplies, equipment, room and board, and special needs	Any student, including primary and secondary (enrolled at least half-time for room and board)	Contributions limited to $2,000 per year, per recipient	Phase-out of eligibility for contributions from $95,000-$110,000 (single filers)
Savings bond interest	Exclusion from gross income for U.S. savings bond interest	Tuition and required fees	Taxpayer, spouse, or dependent	None	Phase-out $50 per $1000, from $67,100-$82,100 (single filers)
Gift tax exclusion	Exclusion for tuition paid directly to educational institution	Tuition	Any student	None	None

The purposes of the different credits and provisions described in Table 2 are to encourage educational investment and to help reduce the cost of higher education. However, the experts we heard from argued that the current multiplicity of credits is, at best, an inefficient way to achieve those goals. First, the current system obscures the tax benefit of educational investments until after they are made. This reduces the visibility of the incentives and makes these provisions less effective at promoting educational investment. Moreover, tax credits have up to a 10-month lag between when tuition or other costs are incurred and when the credit is awarded, something that poses intolerable financing hardships on those without substantial income or other resources. A second concern is that the tax benefits for which a student attending college is eligible are difficult to understand. For example, several of the education benefits are mutually exclusive—a parent (or student) may claim only one of the deduction for "tuition and fees," the LLC, or the AOTC for a particular student. Thus taxpayers must evaluate multiple provisions and make alternative calculations—often well after educational expenditures are made—to figure out their eligibility for different tax credits and the amounts for which they are eligible. Thus, the incentives in these credits are neither transparent enough nor timely enough to encourage education for many taxpayers. Experts contrasted these benefits with the program of Pell Grants, which target lower-income groups and are awarded concurrently with application and admission to college. Many argued that Pell Grants are more helpful to the poor and to middle-income households than refundable credits, and that increasing educational funding for these groups may be better done through improved Pell Grants than through the tax system.

Another concern is that the credits and other provisions are themselves complex and confusing, making it hard for taxpayers to claim the benefits properly. The publication that discusses education benefits offers 11 definitions of a "qualifying expense" and a "qualifying institution" for a total of 12 education-related tax provisions. In many cases, these alternative definitions imply substantive differences in what qualifies for a tax break: taxpayers cannot claim most credits for costs of room and board, but may use funds from an education savings account or deduct interest from a student loan to pay for those costs. Similarly, the AOTC is available for a student pursuing a degree in the first four years of post-secondary education, while the LLC is available for an unlimited number of years and to non-degree students. Taxpayers may take multiple AOTCs for multiple students but only one LCC independently of the number of students; they may be unaware that they can take the AOTC for one student and the LLC for another. The system is sufficiently complicated that many taxpayers fail to claim education benefits to which they are entitled. The GAO reported that 19 percent of eligible tax filers in 2005 did not claim either a tuition deduction or a tax credit that could have reduced tax liability by an average of $219, probably due to the complexity of the tax provisions. Taxpayers may also erroneously claim tax benefits to which they are not entitled or may not claim the credit which would be most advantageous to them.

Finally, the system imposes sizable compliance and recordkeeping burdens on students, parents, and educational institutions. Colleges and universities must document enrollment and tuition, and taxpayers must document and maintain records of payments for qualified tuition and fees and other non-reported expenses, like books and supplies.[1] Administering these benefits is difficult because the IRS cannot evaluate many claims without an intrusive audit.

Overall, the system of education tax benefits would be more effective if the incentives were more transparent and timely, and benefits were easier to claim and enforce.

The proposal and its advantages:

Replacing the large number of subsidies that exist to help taxpayers pay for current education expenses with one or two alternatives would eliminate multiple, redundant definitions, pages of instructions and worksheets, and would reduce the need for individuals to compute their taxes multiple times. Taxpayers would know in advance which credit they are eligible for and what amount they would receive, increasing the transparency of the tax code and the salience of incentives. Harmonizing the definition of qualified educational expenses would help families understand which expenses are deductible and which are not. From an administrative perspective, it is important to recognize that compliance and administration are easier for qualified expenses like tuition for which there is good third-party reporting, and more difficult for expenses that are hard for the IRS to document like expenses for books, or expenses that might be considered abusive, like rent for a luxury condo.

Some experts suggested modest changes like allowing the tuition and fees deduction, which is redundant for most families, to expire while simplifying and narrowing the definition of qualified expenses for certain benefits. A more broad-reaching reform would consolidate education credits with other family- and child-related credits. For example, one proposal would extend eligibility for the child tax credit to any taxpayer claiming a dependent exemption for a full time student up to age 23, while eliminating or reducing certain education credits. This proposal could replace hard-to-administer and understand education credits with the relatively simple child tax credit requiring little recordkeeping or compliance effort.

The literature on behavioral economics emphasizes that the presentation of incentives often affects the choices individuals make. Recent research shows that simply filling out federal student aid forms at the time taxpayers file their returns would influence the likelihood that they enroll themselves or their children in school. This research suggests that a better integration of student aid provisions with the tax system and a more visible preview of the tax benefits available to students could encourage enrollment without requiring increases in the value of government-provided subsidies.

Disadvantages:

A concern with a consolidation of credits is that the current variation in credits and eligibility rules reflects the variation in types of students and types of educational investments. The AOTC and LLC provide overlapping coverage to most college students and most choose the AOTC because of its more generous benefits. However, a consolidation that eliminated the LLC would either deprive about 7 million part-time students from these education benefits or extend more costly benefits to this large group. Similarly, a proposal to replace certain education credits with an extended child tax credit would need to address benefits for the almost 7 million students over the age of 25. Har-

1 Universities can report either tuition billed or tuition paid, which may lead to confusion on the part of the taxpayer and errors in the amounts of deductions they claim.

monizing rules regarding qualified expenses would also require difficult tradeoffs. Part of the complexity, recordkeeping, and administrative burden arises from hard-to-document expenses related to books, supplies, and room and board. Eliminating these expenses would simplify the credit and improve compliance, but would provide equal treatment to taxpayers with unequal expenditures.

iii. Option 3: Simplify the "Kiddie Tax" (Taxation of Dependents)

Current law requires approximately 10 million dependents to file taxes each year to report relatively small amounts of tax. This "kiddie tax," enacted to prevent parents from reducing their family's tax liabilities by shifting investment income to their children, includes rules that can require a dependent to file a return with as little as $950 of investment income. If investment income exceeds a second threshold of $1,900, the income is taxed at rates that depend on the income of siblings and parents. The tax generally applies to children under age 18, full-time students age 19 to 24 who can be claimed as dependents—even if they are not claimed—and to elderly or disabled dependents. About half of kiddie tax filers are college students and about 40 percent are between age 14 and 18. In 2005, 5.7 million dependent filers (out of 9.9 million) paid less than $50 in taxes, and most of those 5.7 million owed no taxes and filed only to get a refund.

In addition to stringent filing requirements, the tax calculation itself is particularly complex. In the most basic case of dependents receiving only investment income, the first $950 is exempt based on a special standard deduction for dependent filers, the next $950 is taxed at the dependent's tax rate, and additional income is taxed at the parents' tax rate, if higher. If the dependent has earned income, say from a summer job, the standard deduction is more complex and depends on the combination of earned and investment income. In most situations, the dependent's standard deduction is less than the standard deduction for other single filers. If a parent has more than one child subject to the kiddie tax, an even more complicated provision requires adding up the investment income of all the children and the parents and then allocating the resulting additional tax among the children's tax returns. Navigating these rules requires a 28-page IRS booklet that includes worksheets to calculate the dependent's taxable income and tax liability.

The interdependence between a dependent's tax return and that of siblings and parents can create significant issues in certain situations. First, this requires coordination among family members when filing taxes, which may be difficult when students are away at college or when family disputes make it difficult to obtain the required information about parents' returns. Additionally, interdependence requires special rules to deal with amended returns and the AMT. These provisions apply to individuals who could be claimed as dependents of another taxpayer regardless of whether they are actually claimed or not. Thus, a parent does not escape the complexity simply by not claiming a dependent. College students who could be claimed as dependents should be filing their returns as dependent filers and may need to coordinate their returns with those of their parents and siblings if they are subject to the kiddie tax. In many instances, the kiddie tax could be considered to be a tax on a family's lack of sophistication. That is typically the situation when families do not understand or use the special tax provisions that provide favorable tax treatment for funds set aside for the dependent's education.

The proposals and their advantages:

The burden of the kiddie tax arises because of the low filing threshold that requires taxpayers to file millions of returns that generate little money, because of the fact that millions must file for refunds despite owing no taxes, and because the computation of the required tax is itself complicated. The filing burden could be reduced by raising the standard deduction for dependents and by improving rules for withholding so that fewer dependent workers had taxes withheld on small amounts of income. Providing a safe harbor withholding exemption for young filers (less than age 18, for example) whereby individuals and employers were not penalized for imposing zero withholding would reduce the number of dependents required to file just to receive a refund. Because these taxpayers owe little in taxes, the compliance issues and revenue consequences would be small. Similarly, raising the standard deduction for dependents could reduce the burden of filing significantly at a relatively small revenue cost; doubling the $950 standard deduction to $1,900 makes a single threshold at the current kiddie tax level and makes 300,000 dependent returns non-taxable.

There are also several advantages to simplifying the tax calculation for dependents who must file. First, eliminating any interaction in the calculation of the tax rate between the dependent's income and siblings' income would reduce the number of computations required at relatively small revenue cost. The additional step of eliminating interactions with a parent's tax rate would provide greater simplification, but policy makers would need to choose which tax rate to apply to a dependent's investment income to ensure that parents were not avoiding taxes by transferring assets to their children. One option would tax a dependent's ordinary income and a modest amount of investment income at the tax rate for dependents and then tax any remaining investment income at the maximum rate. Another option would use the rate schedule for fiduciary returns, which has narrower tax brackets.

Disadvantages:

Raising the filing threshold or increasing the amount of income taxed at the dependent rate could increase parents' incentive to shelter investment income as their children's, since the tax rate for children is generally lower than that of the parents. Simplification that applied the top tax rate to the dependent's income over a threshold to discourage such sheltering could raise tax rates on dependents with relatively modest amounts of income. Taxing investment income of dependents at the maximum rate could be viewed as punitive as it would mean taxing that income at a rate higher than the parents' rate in most cases.

iv. Option 4: Simplify Rules for Low-Income Credits, Filing Status, and Divorced Parents

A number of experts cited the rules that apply to low-income provisions like the EITC, the child tax credit, and head of household filing status, as particularly complex, inconsistent, difficult to interpret and to enforce, and inequitable. These provisions provide refundable credits for low-income households and reduce the tax burden for families with children.

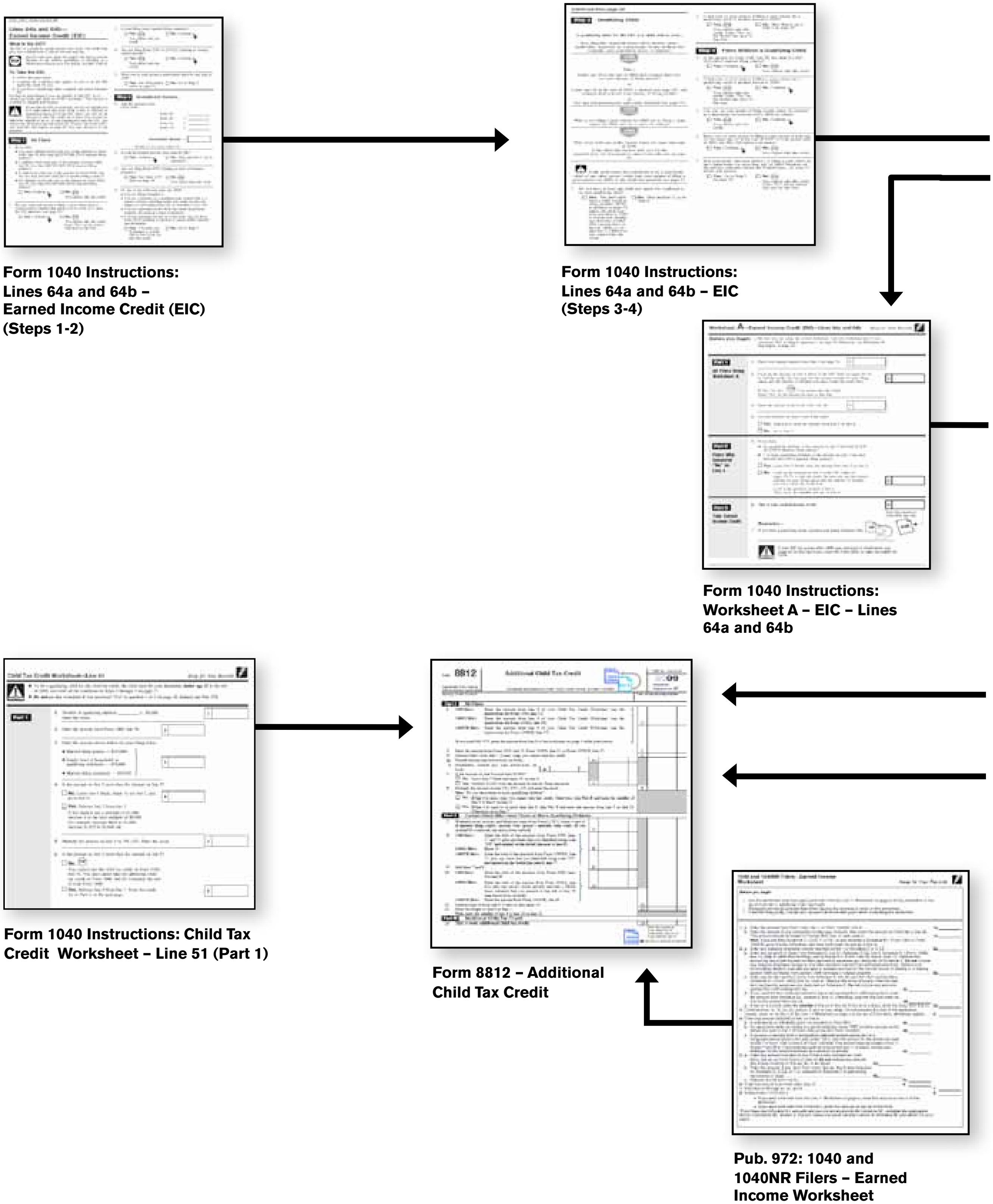
Some of the complexity associated with claiming these credits is illustrated in Figure 2, which shows the actual checklists, worksheets, and forms a low-income parent must navigate to claim and calculate the EITC and the refundable child tax credit. Additional complexity arises from the variation in definitions and eligibility criteria for the different programs. Because the eligibility criteria affect only a very small subset of taxpayers for many of these provisions, the additional complexity provides little benefit in terms of revenue collection.

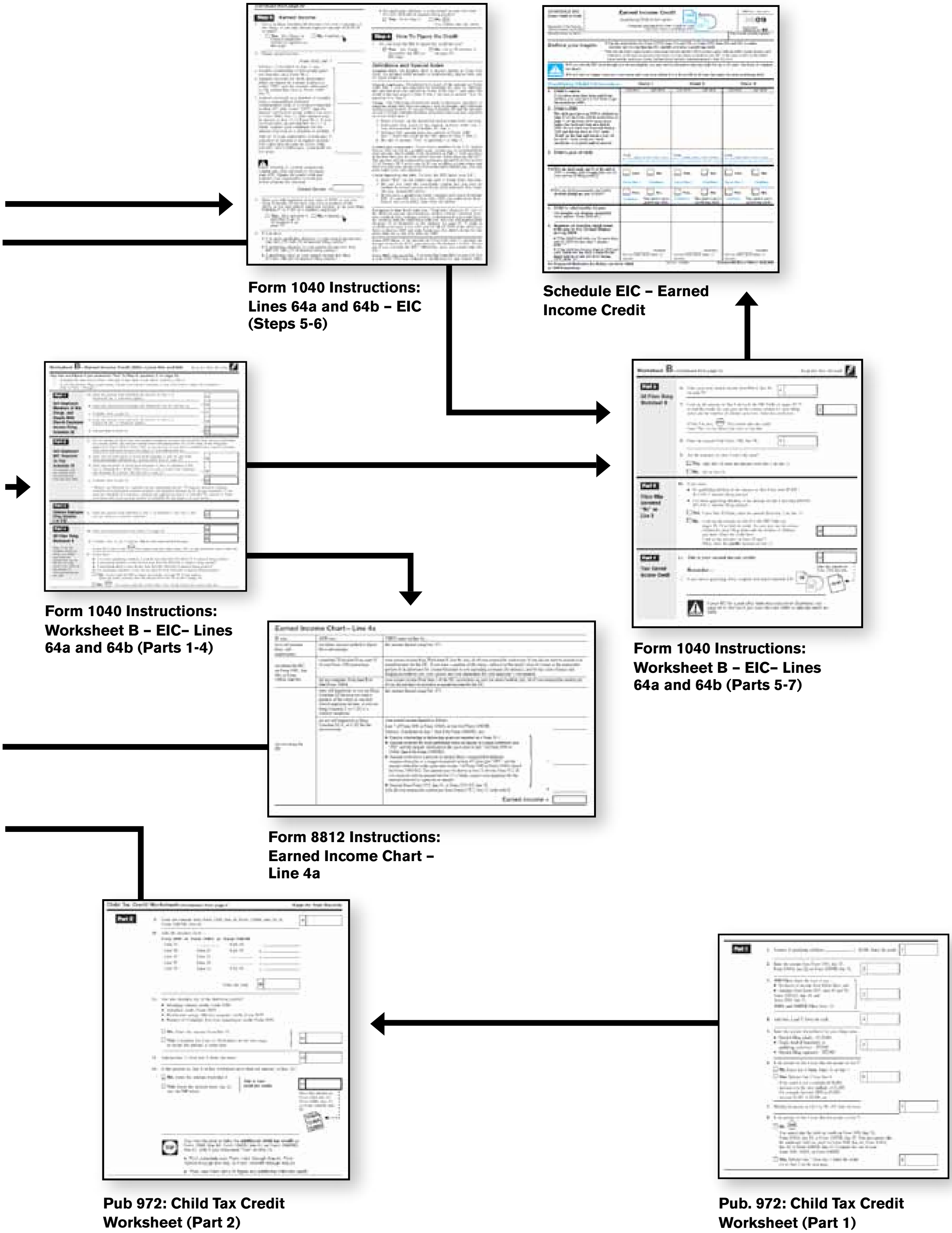
An additional cost of the complexity of these provisions is increased noncompliance. According to the IRS, errors in claiming tax credits and deductions including those described above contributed $32 billion to the tax gap in 2001. In its most recent study of EITC noncompliance, the IRS estimated that the EITC over-claim rate was about 27 percent. While complexity is often cited as a reason taxpayers over claim credits, other studies point out that between 15 and 25 percent of apparently eligible individuals do not claim the EITC, possibly due to the complexity of the eligibility rules and the credit computation. Hence, the complexity of these provisions also results in taxpayers forgoing the benefits they are provided by law.

1. Harmonize the EITC and Additional Child Tax Credit

Figure 2 shows the actual forms a taxpayer claiming both the EITC and the additional child tax credit may need to file to claim these benefits (and the figure excludes other forms for other benefits such a parent would likely claim). Much of the complexity illustrated in the figure arises because of differences between the EITC and the additional child tax credit that require taxpayers to assess eligibility under different rules and to calculate benefits in different ways. For example, both the EITC and the Child Tax Credit are predicated on earned income. However, the definition of earned income differs between the two credits, and families with three or more children can choose among alternative definitions of earnings for the child tax credit. This latter provision alone requires over one million families to compute their credits twice in order to maximize tax savings.

Figure 2: The Process for Claiming the EITC and Additional Child Credit





Form 1040 Instructions: Lines 64a and 64b – EIC (Steps 5-6)
Schedule EIC – Earned Income Credit
Form 1040 Instructions: Worksheet B – EIC– Lines 64a and 64b (Parts 1-4)
Form 1040 Instructions: Worksheet B – EIC– Lines 64a and 64b (Parts 5-7)
Form 8812 Instructions: Earned Income Chart – Line 4a
Pub 972: Child Tax Credit Worksheet (Part 2)
Pub. 972: Child Tax Credit Worksheet (Part 1)

To target benefits to the needy, the EITC uses investment income as a proxy for wealth, and in 2010 limits eligibility to families with under $3,100 in investment income from sources like capital gains, property sales, rents, royalties, and net income from passive activities. This test, which is not applied to the refundable child tax credit, requires additional instructions and a 16-line worksheet.

The proposal and its advantages:

Harmonizing the rules governing eligibility, the definition of earned income, and the calculation of benefits for the EITC and the child tax credit would eliminate the multiple schedules required for families with three or more children. This could potentially halve the number of calculations and worksheets needed to figure these credits and eliminate pages of instructions.

In addition, reducing the scope of the definition of disqualified investment income to only the most common income sources reported on the 1040 would reduce the complexity of the instructions. Eliminating the test entirely would provide further simplification, and would reduce the implicit tax on saving and asset accumulation in working families. Alternatively, the same test could be applied to both the EITC and the additional child tax credit. This would be a simplification in the sense that families would face consistent requirements for both credits.

Disadvantages:

The complexity of these credits partially reflects the desire to target benefits to certain groups. A harmonization of rules that adopted the EITC definition of earnings and of qualifying children would reduce the size of the refundable child tax credit for certain groups, or eliminate it entirely for some families with three or more children. For example, ending multiple computations for the child tax credit would eliminate the child tax credit for a few hundred thousand families with three or more children living in Puerto Rico, who currently file largely to receive this benefit.

Eliminating or simplifying the disqualified income test would expand eligibility to families with potentially considerable assets and wealth; without the investment income test, about 500,000 taxpayers would become eligible for the EITC. A simplification (rather than elimination) of the test, however, would expand eligibility less and at a smaller revenue cost. Alternatively, applying the disqualified income test to the additional child tax credit would reduce eligibility for that credit and increase revenues.

2. Simplify Filing Status Determination

Unmarried taxpayers living with dependents may qualify to file as head of household, a filing status that provides a larger standard deduction and more generous tax brackets. Similarly, taxpayers who qualify as "surviving spouses" after the death of a spouse may use the same standard deduction and tax brackets applied to married couples. In either case, to qualify, a taxpayer must pay over half the cost of maintaining the home in which he or she resides with the dependent during the year (the household maintenance test). This test is burdensome because it requires taxpayers to produce and retain documentation showing their household expenditures, and because of the complicated definition of what is or is not a qualifying expenditure. The recordkeeping requirements are a frequent subject of enforcement disputes because they cannot be verified in the absence of a cumbersome audit.

The proposal and its advantages:

Eliminate the household maintenance test for unmarried taxpayers who reside with and claim a dependent, and allow them to claim head of household filing status (or surviving spouse status) without regard to whether they maintain the home in which they reside. Alternatively, eliminate head of household filing status entirely and require that unmarried taxpayers file returns as single filers. Either of these changes would eliminate a lengthy worksheet and its instructions, and reduce recordkeeping for more than 24 million filers. Eliminating head of household filing status entirely would remove a separate rate schedule and standard deduction.

Disadvantages:

This option would cause marriage penalties to increase unless special rules were applied for unmarried parents who reside together. A single home with multiple families could potentially include multiple heads of household. If head of household filing status were eliminated, the standard deduction for household heads would shrink and some taxpayers would be bumped into higher tax brackets. The 2005 Tax Reform Panel advocated eliminating head of household filing status, but suggested addressing these distributional concerns by replacing it with a tax credit for unmarried individuals with family responsibilities.

3. Eliminate the "Household Maintenance Test" for "Estranged" Spouses

Married individuals cannot claim the EITC unless they file jointly or unless they qualify to file as head of household as an "estranged" or "abandoned" spouse. To qualify as an abandoned spouse, a taxpayer must live with his or her child apart from his or her spouse, and must also pass the household maintenance test described above. Because of the complexity of the rule and the difficulty of maintaining appropriate records, this rule contributes significantly to non-compliance: almost 11 percent of EITC overpayments in 1999 were due to married taxpayers filing as single or head of household who did not meet the requirements. Many of these claims would not be erroneous absent the household maintenance test.

The proposal and its advantages:

Eliminating the test would reduce the recordkeeping burden of this provision and improve compliance. (An alternative proposal with a similar effect would allow married taxpayers who file separate returns to claim the EITC provided they live with a child and apart from their spouse.) This would also improve equity by extending the same treatment to abandoned spouses who may be unable to procure a divorce as currently provided to divorced parents who automatically qualify for the EITC. This treatment would more closely reflect the treatment of other child-related benefits like the child tax credit and dependent exemption, which are available independently of living arrangements and to married taxpayers filing separate returns. The current test contributes to accidental noncompliance because taxpayers in these situations appear to claim the EITC erroneously, not realizing they are ineligible.

Disadvantages:

Eliminating the test would expand eligibility to a broader group. However, the revenue loss is likely to be modest, in part because many ineligible taxpayers already take up the EITC mistakenly.

4. Simplify the EITC for Childless Workers

The proposal and its advantages:

The rules that apply to low-income families in complicated living situations are a source of additional complexity when claiming the EITC. A worker that lives with a "qualifying child" but does not claim the child for the EITC may not claim the EITC for childless workers. This means, for example, that an uncle that lives with his sister and her child is never eligible to claim a childless EITC. Allowing relatives who are not the child's parent to claim the EITC for childless workers even if they live with a qualifying child would equalize the treatment of similar individuals regardless of their living arrangements and would eliminate an error-provoking regulation.

Disadvantages:

Expanding EITC eligibility would reduce revenues. However, the maximum childless EITC is $457 and, in practice, many individuals affected by the rule probably already take the credit erroneously, implying the revenue losses would be small. Some of the targeting that motivates the current complexity would be lost, and the simplification gains would be minimized because rules prohibiting co-resident unmarried parents from receiving the childless EITC would be required to reduce marriage penalties.

5. Clarify Child Waivers in the Event of Divorce or Separation

The rules pertaining to divorced and separated parents are particularly complex and dissimilar to the rules that apply to other parents. Divorced or separated parents are allowed to exchange their rights to certain child-related benefits—the dependent exemption and the child credit—but not others, like the EITC. These rules burden all taxpayers who read instructions and fill in checklists. They also burden divorced families, who may have to compute their taxes under different scenarios to calculate their maximum tax savings. Moreover, these benefits are increasingly litigated in child support or divorce settlements, resulting in a patchwork of rulings from state courts that now determine who may claim these federal benefits. The rule also reduces EITC compliance because noncustodial parents who claim the child tax credit and other benefits may also intentionally or erroneously claim the EITC as well. Finally, this situation may produce a "divorce subsidy" by providing parents with the ability to lower taxes by separating.

The proposal and its advantages:

One option to address this situation is to eliminate the ability of divorced or separated parents to exchange tax benefits. This would simplify the instructions for almost all child-related benefits by eliminating the special provisions for divorced parents. This would also improve horizontal equity by treating people in similar custodial and residential situations the same way.

Disadvantages:

A downside to this is that it could increase complexity in the interim if current agreements were grandfathered. Such a change would increase taxes on noncustodial parents currently claiming child-related benefits and would reduce taxes on custodial parents. The economic effect of such a change is uncertain, as parents could presumably undo this redistribution by modifying child support agreements. However, given that the dependent exemption is worth more to taxpayers in higher tax brackets, the net effect of such a change could be to raise revenues in the aggregate if noncustodial parents are in higher brackets.

b. Option Group B: Simplifying Savings and Retirement Incentives

More than 20 provisions in the tax code provide incentives to save for retirement and for other purposes like education and medical expenses. We heard that individuals can be intimidated and confused both by the sheer number of accounts to choose from and by the fact that each account is governed by a different combination of rules regarding eligibility, contribution limits, and when money may be withdrawn. We heard concerns that this confusion reduces take-up of retirement plans by workers and the propensity of employers to offer plans, with negative effects on the goal of increasing saving. Given that saving incentive provisions in the tax code are the third-largest tax expenditure—costing $118 billion in 2008—it is imperative that their public benefits justify their cost.

We heard three types of criticisms of the current system. First, many argued that the array of options presented to individual households, businesses, and their employees makes it difficult to choose a plan in the first place and the complicated rules make it hard to understand the incentives to save, undermining their effectiveness. A second group pointed out that for most workers the choice of an employer-sponsored saving plan was not the largest issue—most employees at medium and large employers are only eligible for one plan, for example, a 401(k) if they work for a private employer or a 403(b) if they work for a non-profit. This group suggested that most of the costs of complexity arise at smaller employers and for employees with more complicated employment situations. This group emphasized administrative hurdles for employers sponsoring a plan and inequities caused by the different rules; they suggested "behavioral" interventions (like automatic enrollment) to raise savings within the current system. A third concern raised by some experts was that the distribution of benefits of the current set of savings incentives was not well aligned with the public goals of increasing savings among groups with low savings rates; instead most of the benefits of savings-related tax provisions accrue to higher-income groups who already have high propensities to save. According to the Tax Policy Center, about 84 percent of the tax expenditure for retirement savings incentives accrues to taxpayers earning more than $100,000.

Improving the effectiveness of tax preferences for retirement saving could be achieved along multiple dimensions. Consolidating accounts and harmonizing rules would simplify the retirement system for many workers and employers. Other rules, like those governing when and how money may be withdrawn from accounts could also be changed to reduce the burden on taxpayers. In addition, incentives to save could be improved with simple behavioral interventions, like automatic enrollment and offering the Saver's Credit as a match instead of a credit.

We discuss eight options for simplifying savings and retirement incentives.

i. Option 1: Consolidate Retirement Accounts and Harmonize Statutory Requirements

The tax code offers more than a dozen varieties of tax-favored retirement saving accounts including the 401(k), Savings Incentive Match Plan for Employees (SIMPLE) 401(k), Thrift, 403(b), governmental 457(b), Salary Reduction Simplified Employee Pension Plan (SARSEP), and SIMPLE Individual Retirement Account (IRA) plans. These accounts often have different rules regarding eligibility, contribution limits, and withdrawals.

Table 3 below provides details on a few representative employer-sponsored retirement plans and summarizes many of the key regulations governing the plans.[2] As the table makes clear, there is a wide variety of rules across plans. Most plans penalize early withdrawals from retirement accounts, but some retirement plans allow early withdrawals without penalty for "hardship" (using different definitions of hardship) or allow for loans; others allow early withdrawals for medical, home buying, or educational expenses; and some accounts define "early" as before age 59 ½ and some as anytime before an employee leaves a firm. The rules for when an employee may "roll over" contributions from one account to another have been partially harmonized, but there are still certain accounts which cannot be rolled into others, or can only be rolled over after a waiting period. On the employer side, different plans have different rules for which employees must be covered, with some rules focusing on age, some on compensation, and some on more comprehensive "coverage" tests.

2 The table does not include individual plans like Traditional, non-deductible, or Roth IRAs, nor education-related accounts like 529 plans or Coverdell plans, nor medical expense savings accounts like Health Savings Accounts or Medical Savings Accounts.

Table 3: Employer-Sponsored Retirement Plans

	Payroll Deduction IRA	SEP	SIMPLE IRA Plan	SIMPLE 401(k)	Safe Harbor 401(k)	Traditional 401(k)	403(b)	457(b)
Sponsor/ Eligible Employer	Any employer	Any employer	Employer with 100 or fewer employees and no other qualified plan	Employer with 100 or fewer employees and no other qualified plan	Any employer other than a state or local government	Any employer other than a state or local government	Public education employers and tax-exempt 501(c)(3) organizations	State and local governments; non-church tax-exempt organizations
Maximum Employee Contribution	$5,000	$0	$11,500	$11,500	$16,500	$16,500	$16,500	$16,500
Employer Contribution	None	Optional	Required	Required	Required	Optional	Optional	Optional
Maximum Total Employer + Employee Contribution	$5,000	Lesser of 25 percent of compensation and $49,000.	$11,500 by employee plus 2 or 3 percent match up to $245,000 in compensation.	$49,000 or 100 percent of compensation.	$49,000 or 100 percent of compensation.	$49,000 or 100 percent of compensation.	$49,000 or 100 percent of compensation.	$16,500 or 100 percent of compensation.
Catch-up Contributions	$1,000	$0	$2,500	$2,500	$5,500	$5,500	$5,500; additional contribution of $3,000 allowed for certain employees with more than 15 years of service.	$5,500; may allow additional catch-up contributions up to $28,000 three years prior to the year of normal retirement age.
When can funds be withdrawn without penalty?	Subject to IRA rules; after age 59 1/2	Subject to IRA rules; after age 59 1/2	Subject to IRA rules; after age 59 1/2	Subject to 401(k) rules; after age 59 1/2	Subject to 401(k) rules; after age 59 1/2	Subject to 401(k) rules; after age 59 1/2	After age 59 1/2.	After severance from employment or 59 1/2.
Hardship Withdrawal allowed?	No	No	No	Yes, if distribution is necessary to satisfy "immediate and heavy financial need."	Yes, if distribution is necessary to satisfy "immediate and heavy financial need."	Yes, if distribution is necessary to satisfy "immediate and heavy financial need."	Yes, if distribution is necessary to satisfy "immediate and heavy financial need."	Yes, for "unforeseeable emergency."
Loans allowed?	No	No	No	Yes	Yes	Yes	Yes	Yes

The current system also provides different contribution limits and eligibility limits to different employees, depending on where they work, what retirement options their employer chooses to provide (if any), and on individual characteristics like the employee's age. Taxpayers whose employers offer a retirement plan pay less in taxes (if they or their employers contribute to a qualified retirement plan) than those whose employers do not. In 2010, individual employees at firms that do not sponsor retirement accounts are limited to IRA contributions of $5,000 (or $6,000 if 50 years or older). Employees at firms that offer retirement accounts may choose to defer up to $16,500 ($22,000 if 50 years or older), plus whatever their employer chooses to contribute up to a combined total of $49,000. Participants in a SEP may contribute up to 25 percent of compensation up to $49,000. Employees at certain governmental employers can contribute (including matches) up to both 403(b) and 457 plans; their effective contribution limit is $33,000 ($44,000 if 50 years or older). Self-employed individuals and small business owners direct both the employee and employer contributions to their own plans and have discretion to contribute up to $49,000. Differences in contribution limits and eligibility rules lead to inequities in tax burdens. Many experts also believe that such differences undermine the efficiency of the tax incentives for increasing saving because the more generous limits and eligibility rules primarily benefit individuals who already save more than average. Thus, these provisions may encourage these individuals to shift their saving to tax-advantaged accounts rather than to increase their saving. However, the current rules were formed with competing policy objectives in mind. For example, offering higher contribution limits for employer-sponsored plans relative to individual plans provides an important incentive for employers to choose to sponsor a plan.

Administrative and compliance costs have also been cited as a deterrent to employer sponsorship of retirement plans. Only about half of private employers offer a defined contribution retirement plan to their workers. For small businesses, the administrative costs are particularly large relative to the size of the business, and less than 25 percent sponsor any retirement plan. SIMPLE and similar plans exist largely to reduce these costs. Nevertheless, faced with many choices, small business owners may have to spend considerable time and energy choosing the 'optimal' plan for themselves and their workers. Small business owners may also desire to change the structure as their business grows, creating further complications.

The multiplicity of employer-sponsored retirement plans may also burden employees. Employees may be required to evaluate multiple accounts and choose among alternative options, discouraging or delaying participation. In the current system, any number of common life events can disrupt a worker's saving plan. Marriage or divorce, job changes, or changes in income all can result in workers becoming ineligible for their previous plan or suddenly eligible for a new plan. Often, these changes are not recognized until tax time the year after savings contributions are made; special (and unfamiliar) tax provisions like "recharacterizations" and nondeductible Traditional IRAs were created to address these types of surprises. A worker who changes jobs frequently may have multiple retirement accounts spread among past employers, each holding only small sums of money. Frequently, workers changing jobs have their retirement contributions returned to them in lump-sum distributions rather than rolling them over into another account. Such distributions reduce retirement savings and expose workers to unexpected tax penalties.

The proposals and their advantages:

Experts suggested consolidating employer-based retirement accounts and simplifying eligibility and contribution rules. Consolidating plans and simplifying rules would reduce costs for businesses as well as help clarify incentives and simplify saving for workers. A first step could harmonize rules and simplify tax-preferred savings accounts by imposing uniform rules for eligibility, contributions, and administration. For example a consolidated set of rules could follow existing contribution limits and regulations for 401(k) plans. Particular areas where harmonization may be desirable include the rules for penalties for hardship withdrawals—the definition of "hardship" differs plan-to-plan and some accounts do not allow hardship withdrawals—and rules allowing loans against certain plan balances. Simplified rules regarding paperwork, reporting, and legal liability could be applied to the smallest employers to further reduce their administrative costs.

Certain retirement accounts appear very similar—like 401(k)s, 403(b)s, and 457 plans—and are in many ways redundant. They are distinct because they were created to serve different employers—for profits, non-profits, and governments—but they serve the same basic function for each. Consolidating such plans could eliminate extra accounts, rules, and documentation, and would simplify the number and variety of accounts for workers changing jobs between sectors. For example, a small group of workers (including state university professors) who are currently eligible for unusually high contributions would be held to the same contribution limit as everyone else.

A more aggressive consolidation would eliminate more significant sources of complexity. For example, the 2005 Tax Reform Panel advanced a plan to consolidate employer-based defined contribution plans into one work-based account (with current-law 401(k) limits), all individual plans into one individual account, and all special purpose savings accounts into one account for savings other than for retirement. This consolidation would have swept out rules for phase-outs, minimum distributions and other provisions. This plan was also part of a broader reform intended to increase opportunities for tax-free savings. It would also have expanded the size of accounts and eligibility for accounts, eliminating phase-outs and making the accounts available to all taxpayers. However, the 2005 Panel also recommended reducing taxes on capital gains at the same time, making tax-preferred accounts less desirable and limiting the revenue cost of offering such plans. Overall, the reforms proposed by the 2005 Panel increased opportunities for retirement saving and reduced taxes on saving in general, while making up revenue elsewhere.

Disadvantages:

The multiplicity of plan types partially reflects a desire to offer plans with reduced administrative costs, like SIMPLE plans, for small businesses. Consolidation of these accounts could increase the administrative burden on small firms. Much of the burdensome complexity arises from provisions to limit the budgetary cost of tax-preferred vehicles, to promote broad participation in plans (like coverage tests), and to ensure that tax subsidies available for savings do not accrue disproportionately to high-income groups (like phase-outs and "nondiscrimination" rules). Easing these provisions would conflict with the goals they are meant to achieve.

The simplification benefits of consolidating certain accounts could ultimately be modest. The three plans described above are offered only by employers in the private sector, the non-profit sector, and the government sector, respectively; employees in those sectors often have no choices and the rules that apply are the same for most employees within those sectors.

Applied to the current tax system, a plan like that in the 2005 proposal would lose considerable revenue and would significantly expand tax-preferred savings opportunities to higher-income groups, who already disproportionately benefit from them. Therefore, a consolidation of accounts would need to address both the revenue cost and distributional consequences, for example, by limiting the tax advantages of accounts for higher-income groups by phasing out the size of the deduction available for contributions or by applying a flat credit (rather than a deduction) for contributions.

ii. Option 2: Integrate IRA and 401(k)-type Contribution Limits and Disallow Nondeductible Contributions

Under current law, deductible contributions to IRAs are phased out for higher-income groups while contributions to employer plans are not, and the phase-out range differs based on whether an employee is covered by an employer-sponsored plan. Largely to allow individuals who are ineligible to make deductible IRA contributions (often due to unexpected income or other rules discovered at tax time) to avoid the administrative hassle of having to take out excess contributions at the end of the year, individuals are allowed to make nondeductible contributions to Traditional IRAs. This requires them to file supplemental annual forms to track the cost basis of the assets in accounts, and to pay tax on the income earned in these accounts in a singular way.

The proposal and its advantages:

One proposal would allow all workers irrespective of income to contribute to either or both an IRA and an employer-sponsored plan. The current limits for contributions to IRAs and employer plans would be maintained ($5,000 and $16,500, respectively), but the combined contributions would be limited to the 401(k) limit ($16,500). Nondeductible IRAs could be eliminated because income limits on contributions would be removed. Eliminating nondeductible contributions to traditional IRAs would reduce the number of IRA vehicles and would simplify recordkeeping for participating taxpayers. Complicated IRA qualification and phase-out rules would be repealed. This would also encourage additional end-of-tax-year saving by workers with employment-based retirement coverage.

Disadvantages:

The proposal could reduce revenues to the extent that increasing IRA eligibility results in greater take up. Moreover, eligibility would be increased primarily at higher income levels. However, both concerns are reduced by the fact that most high income taxpayers generally already have access to more generous plans. Another downside is that integrating contributions up to a combined limit would itself add some complexity by requiring individuals to track contributions in multiple accounts and ensure that the sum of contributions fell below the limit.

iii. Option 3: Consolidate and Segregate Non-Retirement Savings

Over the past 30 years, there has been a growing list of tax-preferred savings vehicles for nonretirement purposes, including Section 529 plans (whose rules are set by states and vary widely), Coverdell IRAs, Health Savings Accounts (HSAs), Archer Medical Savings Accounts (MSAs), and Flexible Savings Accounts (FSAs). Taxpayers with IRAs and certain employer-sponsored retirement accounts may also withdraw funds from those accounts for education and medical expenses or other purposes. An individual saving for both retirement and for other purposes faces even more choices when deciding which account or accounts provide the best alternative.

The proposal and its advantages:

One proposal would consolidate all these non-retirement savings programs under a single instrument. Contributions to this instrument could be tax-deductible up to a limit, as is currently the case for HSAs. Alternatively, contributions could be made with after tax dollars, as is currently the case for 529 and Coverdell plans. Earnings would accumulate tax-free, and all qualified distributions would be excluded from gross income.

Segregating non-retirement savings into a consolidated health and education account that was separate from accounts for retirement savings would simplify rules for both retirement and non-retirement accounts, reduce administrative costs, and limit pre-retirement "leakage" from retirement accounts. Consolidating multiple education savings plans and medical savings plans would make this tax expenditure more effective at increasing saving. (The PERAB group on retirement recommends segregating retirement savings accounts from tax-advantaged savings accounts for other purposes and imposing strict limits on the use of funds in retirement saving accounts for non-retirement purposes.)

An alternative plan would consolidate all education savings in one type of account, and all health savings in another. For example, FSAs (which are employment based) could be replaced with a new non-retirement saving vehicle that has some tax preferences but does not subject the account holder to stringent year-end forfeiture requirements.

Disadvantages:

Disallowing non-retirement uses of IRAs or employer plans could reduce the desirability of those plans, potentially reducing participation. (However, reductions in IRA use could presumably result in increases in these special accounts.) HSAs are designed to improve incentives in health care spending and are integrated with specific health insurance plans; it would not make sense to combine HSA dollars with money destined for other uses. Moreover, such a proposal could be costly depending on eligibility rules and contribution limits. Mixing savings plans for education and medical expenses, which currently have disparate tax treatment for contributions and vary with state laws or health insurance parameters, may create significant winners and losers.

iv. Option 4: Clarify and Improve Saving Incentives

Research suggests that a number of tax provisions intended to increase saving could be improved by strengthening savings incentives and by adopting rules that allow for automatic saving. One specific provision that could be improved is the Saver's Credit, a credit that provides a subsidy to low-income workers for making voluntary contributions to retirement plans, like 401(k)s and IRAs (much like higher-income groups receive a tax subsidy for their contributions). Several features of the credit have made it less effective than it might otherwise be. Most significantly, the saving incentives provided by the credit are not visible or salient to taxpayers because of the design and presentation of the credit. Researchers suggest the opacity of the incentives is one reason that take-up of the credit is extremely low.

In addition, arbitrary "cliffs" in the matching rate with respect to income and other complications on the match formula make it difficult to understand and use. For example, at certain points in the schedule a taxpayer may lose up to $1,200 in credits for earning an extra $1 in income.

Other concerns we heard about the current system were the low participation rates and small contributions by employees in savings plans sponsored by their employers. There are several options for remedying these problems.

1. Make the Saver's Credit a Match

Researchers have demonstrated that the design of the Saver's Credit reduces its efficacy. In an experiment involving thousands of low-income tax filers at H&R Block tax preparation offices, Duflo et al. (2006) showed that matching IRA contributions in lieu of tax credits can significantly raise take-up and contributions. In the experiment, increasing the effective federal Saver's Credit value had trivial effects on participation in IRAs. In contrast, presenting the credit as a match—without changing the actual value of the credit—actually improved participation significantly. Contributions to retirement accounts were also larger when the credit was presented as a match. The researchers concluded that taxpayers were more responsive to matching incentives because they are more transparent and easier to understand than similarly generous tax credits in the current system. In addition to changing its form to a match, the Saver's Credit could be made more generous and universal, and the loss in revenues could be offset by reducing or eliminating some of the other tax deductions for retirement saving that disproportionately benefit those with high incomes.

The proposal and its advantages:

Designing the Saver's Credit to be more like a match would increase its salience and its effectiveness as an incentive to promote saving.

An additional improvement would adjust the match or credit rate to phase down with AGI instead of abruptly ending as in the current system. Removing the "cliffs" in the current credit structure would remove the very high effective marginal tax rates for the many savers who use the credit. (The Saver's Credit proposal included in the FY2011 Budget addresses this issue.)

Disadvantages:

Administrative hurdles would need to be addressed in order to make a matching grant work. For example, a matching credit would need to be directly deposited into the retirement accounts of qualified taxpayers, requiring new procedures and administrative infrastructure at the IRS or at financial institutions. Specific provisions would need to address how the credit would apply to

Roth versus Traditional IRAs. Transforming the "cliffs" in the credit into a smoother phase-out would reduce some very high marginal tax rates, but phase-outs can be difficult to understand and add complexity. Also, depending on the specific proposal, this idea could add to the cost of the program.

2. Expand Automatic Enrollment in Retirement Savings Plans

The proposal and its advantages:

Under automatic enrollment employers directly deposit a small percentage of each paycheck into workers' retirement accounts like 401(k)s or even into workers' IRAs, unless the employee affirmatively tells the employer not to do so. Employees would maintain full choice over whether and how much they want to save because they could choose to opt out of the plan or save a different amount. As in the current system, employers could easily match employee contributions. Research shows that automatic enrollment boosts participation in retirement plans to more than 90 percent, and is particularly effective at increasing the participation of low-income and minority workers.

The policy is feasible, and could be tailored with appropriate safeguards to ensure that the administrative burden on small employers is not too great. Indeed, the President's FY2011 Budget includes a proposal to require employers in business for at least two years and with more than ten employees to offer an automatic IRA with regular payroll deductions to their employees. (Employers sponsoring a qualified retirement plan, SEP, or SIMPLE would be exempt.)

In addition, other automatic features of accounts could be implemented to further encourage saving. For example, providing an automatic default investment choice like a life-cycle fund or automatic escalation of contributions could increase contributions and asset accumulation, and reduce the risks of poor investment choices. Similarly, the automatic annuitization of retirement balances could help workers achieve a steady stream of income that is guaranteed for life.

v. Option 5: Reduce Retirement Account Leakage

A sizable fraction of separated workers who receive lump-sum distributions (particularly small distributions of $5,000 or less) from their employers' retirement plans do not roll it over to another qualified plan or IRA. Some separated workers do not pay back outstanding 401(k) loans (in which case the loan becomes a withdrawal). Moreover, many IRA holders also take early withdrawals for other expenses. The failure to roll over 401(k) funds or pay back 401(k) loans, as well as the tendency to take early withdrawals from IRAs, can reduce savings that have been set aside for retirement.

The proposals and their advantages:

Upon leaving a job, an employee's plan balance would be required to be retained in the existing plan or would be automatically transferred to an IRA account or an account with their new employer. This "Automatic Rollover" would ensure that amounts put aside for retirement continue to grow.

Limits on tax-free and penalty-free distributions for non-emergency purposes could be tightened to reduce "leakage." Tax-free distributions from individual accounts could be made only after age

59 ½ (as under current law for the majority of accounts), or in the event of death or disability, or for a standard definition of "hardship" such as that currently applied to 401(k) plans. Applying the more stringent rules for 401(k)s to IRAs and other accounts would close the exceptions for early withdrawals for education, first-time home buyer expenses, and medical expenses that are more lenient in IRAs. Early distributions would be treated as taxable income and would be subject to an additional 10 percent tax, similar to the penalty paid on early withdrawals from Roth IRAs under current law. These rules would ensure that accounts set aside for retirement (and rewarded for doing so with generous tax benefits) would still be there at the time of retirement.

Disadvantages:

Requiring rollovers or the maintenance of accounts for small amounts of money would raise administrative burdens on employers and financial intermediaries. Limiting the ability to take early distributions from IRAs and other accounts could discourage the use of these accounts. Moreover, it may be difficult to limit early withdrawals for popular expenditures like education or to try to limit hardship withdrawals.

vi. Option 6: Simplify Rules for Employers Sponsoring Plans

About half of all workers are not offered a retirement plan at work. One reason is that the administrative burdens of employer-sponsored plans discourage some businesses—particularly small businesses—from adopting them.

Much of the employer-side complexity arises from provisions that ensure that the benefits of savings-related tax expenditures are distributed fairly to workers at a given firm and not just to the owners or to highly-paid executives. For example, "nondiscrimination requirements" apply a set of tests that ensure that highly compensated employees do not receive disproportionately high benefits relative to other employees. Satisfying the test can require employers and small businesses to examine the contribution amounts of their employees throughout the year and adjust their own contributions accordingly to avoid penalties. The complexity surrounding these rules has increased because of related provisions that allow employers certain exemptions from the original rules. "Cross-testing" allows alternative methods of fulfilling the nondiscrimination requirements and has spawned a new generation of pension plans engineered to allow greater tax-free savings for highly compensated employees. Similarly, Social Security integration (or "permitted disparity" rules) allows for higher contribution limits for employees earning over the Social Security maximum ($110,000 for 2010).

The proposal and its advantages:

One option would be to simplify the nondiscrimination test, for example by simplifying the definition of a high-paid employee and to provide a standard safe harbor to avoid these requirements. An alternative proposal would repeal nondiscrimination rules entirely and require all plans to meet a safe harbor standard. This option would require all medium and large employer plans to have minimum contribution standards with non-elective and/or matching employer contributions; the current SIMPLE 401k plan safe harbor requirements could be applied to small employers. The cross-testing and Social Security integration rules could be eliminated.

These changes would simplify plan administration and regulation through the repeal of the non-discrimination rules, and reduce the administrative cost of plan maintenance. Appropriate safe harbor provisions could be designed to ensure contribution adequacy. On balance, these changes would likely increase tax revenues while directing a greater portion of the current tax expenditure to middle-class workers.

Disadvantages:

If safe harbor requirements are too stringent, this could erode plan sponsorship, especially for small and midsized employers.

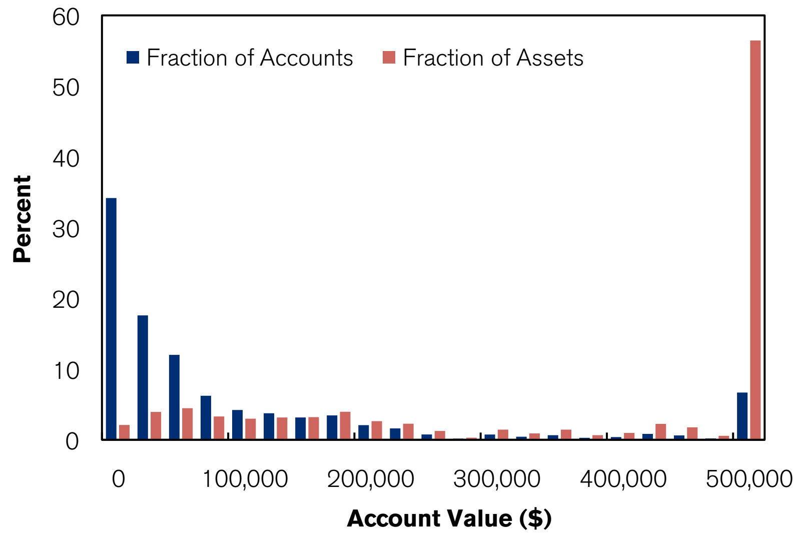
vii. Option 7: Simplify Disbursements

A taxpayer must take Minimum Required Distributions (MRDs) from most retirement accounts starting at the age of 70½. (The rules do not apply to Roth accounts.) The rules governing these distributions are complex—requiring calculations involving age-specific survival factors—and the calculations are even harder for retirees with more than one account. Taxpayers who fail to comply with these rules are assessed a penalty of 50 percent of the required distribution.

The proposal and its advantages:

Eliminating minimum required distributions for individuals with retirement assets below a threshold would relieve many taxpayers from the burden of these regulations at a relatively small revenue cost. As Figure 3 shows, most households headed by individuals over age 70 hold relatively small amounts in their retirement accounts: about 35 percent of these households with retirement accounts have less than $25,000 in retirement-account assets and more than half of households have less than $50,000. A policy that exempted taxpayers with total account balances of less than $50,000 from MRDs would relieve more than half of those currently affected by MRDs from the rules. Moreover, because the accounts that would be affected by this proposal are relatively small—they account for only 6 percent of retirement-account assets—the revenue losses would be small (about 55 percent of assets are held in accounts larger than $500,000).

Figure 3: Retirement Accounts
(Individuals Age 70 and Over)



Source: Survey of Consumer Finances (2007).

Disadvantages:

This proposal retains the complex rules for about half of taxpayers currently subject to the MRD rules.

viii. Option 8: Simplify Taxation of Social Security Benefits

The taxation of Social Security benefits is among the most difficult part of calculating income taxes for most elderly taxpayers. Determining the amount of benefits subject to tax involves an 18-line worksheet that requires retirees to calculate an alternative measure of income and then compare this "modified adjusted gross income" (MAGI) to a three-tiered schedule to determine the amount of Social Security benefits to include in taxable income. This phase-in schedule results in steep marginal tax rates—as high as 85 percent above the normal rate—on ordinary income, discouraging work, imposing high rates of taxation on income from retirement accounts, and encouraging inefficient "tax planning" to avoid paying the tax. The use of software to prepare income tax returns eliminates the computational burden, but it does not eliminate the problems taxpayers have in predicting how much of their benefits will be subject to taxation or their marginal tax rate. Because the income thresholds in the formula are not indexed for inflation, more and more Social Security recipients are subject to these provisions over time, and more people who would ordinarily be non-filers have to file on the basis of this tax alone.

The proposal and its advantages:

Simplifying the formula used to calculate the tax on Social Security benefits would reduce the compliance burden on older taxpayers and improve economic efficiency. First, replacing the multitiered phase-in schedule with a single phase-in would eliminate a number of lines on the worksheet and make the taxation of benefits more transparent. For example, instead of the current system that requires including either zero, 50, or 85 percent of benefits in taxable income depending on different MAGI thresholds, one could specify a single percentage rate—say 40 percent—over a single threshold. Such a change would represent a return to the pre-1993 system. Second, one could simplify the calculation of MAGI, for example by eliminating the inclusion of Social Security benefits in MAGI entirely.

In this option, MAGI would be defined as all non-Social Security income (excluding the 50 percent of benefits currently included in MAGI), the MAGI threshold for including Social Security benefits in income subject to taxation would be lowered to $12,000 of MAGI for a single taxpayer ($24,000 married filing jointly), and $0.40 of benefits would be included in AGI for each $1 of MAGI over the threshold. Table 4 illustrates the advantages and disadvantages of such a change. The table shows the average tax rates, marginal tax rates, and amount of Social Security benefits subject to tax under the current system and under a simplified system. The example is intended to be roughly revenue neutral (based on 2005 data), and to illustrate the tradeoffs involved in simplifying the formula.

Table 4: Taxation of Social Security Benefits (Single Taxpayer)

Example:	(1)	(2)	(3)	(4)	(5)	(6)
Total Income	20,000	40,000	40,000	40,000	50,000	110,000
Ordinary Income	10,000	15,000	20,000	30,000	35,000	95,000
Social Security Income	10,000	25,000	20,000	10,000	15,000	15,000
Current Law						
Benefit Amount Subject To Tax	–	1,250	2,500	5,350	11,725	12,750
Marginal Tax Rate on Ordinary Income	10.0%	15.0%	22.5%	27.8%	46.2%	28.0%
Average Tax Rate	0.3%	1.7%	3.9%	8.7%	11.1%	19.3%
Alternative: 40% Phase-In, $12,000 Threshold on Ordinary Income						
Benefit Amount Subject To Tax	–	1,200	3,200	7,200	9,200	12,750
Marginal Tax Rate on Ordinary Income	10.0%	14.0%	21.0%	21.0%	35.0%	28.0%
Average Tax Rate	0.3%	1.7%	4.1%	9.4%	9.8%	19.3%

This proposal would simplify the calculation of benefits by reducing the calculations for MAGI—taxpayers no longer need to include a fraction of benefits in MAGI—and eliminating the calculation of multiple phase-ins—if taxpayers are above a threshold, they are taxed on a flat percentage of benefits over the threshold, similar to the system that existed prior to 1993. As is apparent, the alternative system results in lower marginal tax rates on ordinary income for taxpayers within the phase-in range of the current system. This change reduces the incentives for inefficient tax planning and improves the incentives to work and save.

Disadvantages:

While this would lower marginal tax rates for some taxpayers and overall average marginal tax rates, some people would fall into the phase-in range so they would face somewhat higher marginal rates. This policy would create winners and losers. For example, people with high Social Security income but low non-Social Security income would pay more in taxes. Indeed, individuals with the same total income—like those in columns 2-4—would be affected slightly differently, and some would pay slightly more and some slightly less. To maintain revenue while lowering the phase-in rate to 40 percent, the phase-in threshold would need to be lower—while some low-income taxpayers would pay less in taxes, others would pay more. An adjustment to the additional standard deduction for taxpayers age 65 and over could be used to offset these distributional effects.

c. Option Group C: Simplify Taxation of Capital Gains

Capital gains are taxed at the individual level at special rates which depend on factors like the type of income or type of asset, the holding period of the asset, and other accounting rules. Long-term capital gains and qualified stock dividends are taxed separately from other income at rates of 0 percent or 15 percent. The capital gains rules slated to return in 2011 include 10 and 20 percent basic rates and 8 and 18 percent rates for gains on assets held over 5 years The Administration's Budget calls for a 20 percent tax rate on long-run capital gains and dividends starting in 2011. In addition, starting in 2013, the recently enacted Patient Protection and Affordable Care Act imposes a new 3.8 percent Medicare contribution on capital gains and other investment income of married taxpayers with AGI over $250,000 ($200,000 for single taxpayers).[3] This increases the top statutory rate on capital gains to 23.8 percent. The capital gains rate of most high-income taxpayers is also affected by the "Pease" 3-percent phase-out of itemized deductions, which adds 1.19 percentage points to the effective rate.

The system of capital gains also includes special rates for certain types of investment. Long-term gains on collectibles—for example, gold, jewelry, or art—are taxed at ordinary tax rates up to a 28 percent maximum rate. Gains from the sale of certain small business stock are taxed at ordinary rates up to a maximum of 28 percent but with exclusions of 50, 60, 75 or 100 percent depending on when the stock was initially issued and whether the corporation is located in an enterprise zone. The taxation of the gain on certain real estate (Section 1250 real property) is particularly complex, and proceeds from a single transaction may be taxed partially at ordinary rates, partially as "unrecaptured Section 1250 gain" subject to ordinary rates up to a 25 percent maximum, and partially at the capital gains rate. (Moreover, the maximum rate of 25 percent on "unrecaptured Section 1250 gain" applies to the portion of the gain attributable to depreciation deducted at potentially higher ordinary tax rates.) In the case of "carried interest," capital gains treatment is applied to certain income that does not represent a return on invested capital.

Because capital gains are taxed separately from other income, taxpayers must compute the tax on capital gains and dividends on an alternative schedule. Further, because there is not enough room on Schedule D for all of the special rates and provisions, many of these are now included in separate schedules in the instructions. Having separate schedules increases taxpayer burden and makes it more difficult to check whether taxpayers are properly computing their tax because these schedules

3 The tax applies to the lesser of the taxpayer's net investment income and modified AGI in excess of the $250,000 or $200,000 income thresholds. The new definition of modified AGI adds back any foreign income exclusion in excess of any deductions and exclusions disallowed with respect to that income.

are not sent to the IRS. This may increase the likelihood that taxpayers will claim tax benefits to which they are not entitled and thus increase noncompliance. In addition to contributing pages of instructions and worksheets, having multiple tax rates for different types of capital gains affects the after-tax rate of return on different assets, distorting investment decisions.

Another source of complexity arises when a capital gain has occurred and thus when taxes are due. An exchange of property, such as a sale, generally is a taxable transaction—i.e., you pay the tax when you sell an asset. However, several provisions allow taxes on capital gains income to be deferred or for the gain to be calculated differently, adding complexity and providing incentives for socially unproductive tax planning. For example, present law provides that no gain or loss is recognized if property held for productive use in a trade or business or for investment purposes is exchanged for like-kind property (a Section 1031 exchange). Although traditional like-kind exchanges typically involve two persons trading real property with each other, this form of exchange has given way over time to exchanges intermediated by a third party market maker. Most transactions that occur under Section 1031 only loosely resemble an exchange and instead effectively confer rollover treatment on a wide range of business property and investments. Rollover treatment is conferred only if the taxpayer complies with a series of complicated rules, and there is much uncertainty surrounding these transactions.

Another area of concern is the taxation of carried interest. The manager or "general partner" of an investment fund typically receives two types of compensation: a management fee and a percentage of profits generated by the investments called a "carried interest." The management fee is taxed as ordinary income, but the carried interest is generally taxed at the lower capital gains tax rate to the extent that the underlying investment has generated long-term capital gains eligible for the lower rate. Many tax experts consider some or all of the carried interest as compensation for managers' services, and therefore argue that some or all of this compensation should be taxed as ordinary earned income, as is performance-based pay in other professions.

We discuss four options for simplifying the taxation of capital gains.

i. Option 1: Harmonize Rules and Tax Rates for Long-Term Capital Gains

1. Harmonize 25 and 28 Percent Rates on Capital Gains

When a taxpayer deducts depreciation expense, the taxpayer's cost basis is reduced by the amount of depreciation claimed. Thus, when the taxpayer later goes to sell the asset, he may have a gain as a result of claiming the previous deduction. Since the depreciation was deducted at ordinary income tax rates, it makes sense that any gain due to the deduction should be taxed ("recaptured") at ordinary rates, and this is how most assets are treated. However, gains on certain real estate sales (so-called Section 1250 gains) are taxed at ordinary rates only up to 25 percent. Similarly, collectibles are taxed at ordinary rates, but up to a maximum rate of 28 percent.

The proposal and its advantages:

Since the separate capital gains rate adds complexity to forms and tax planning and the rationale for a preferential rate is weak in both cases, one reform option would be to tax Section 1250 recapture and collectibles at ordinary tax rates. A smaller simplification would use the same rate for both provisions: 25 percent, 28 percent or an intermediate rate such as 27 percent.

Disadvantages:

Real estate held for investment (non-owner occupied) and collectibles investors would be adversely affected by eliminating or raising these preferential rates.

2. Simplify Capital Gains Taxes on Mutual Funds

Investors in mutual funds currently have the choice of using several different methods of computing their basis for purposes of computing capital gain. They can choose the average cost basis method, the first-in, first-out method or the specific identification of shares method. Specific identification is the most taxpayer friendly as it allows selling those shares that have the highest cost and thus the lowest capital gain first. First-in, first-out is generally least taxpayer friendly as the oldest shares are more likely to have been purchased when stock prices were lower, resulting in a larger taxable gain. The average cost method would generally be in between these two methods. With new reporting of basis requirements in effect, however, this creates the potential for confusion and errors if taxpayers use a different method than used by the mutual fund.

The proposal and its advantages:

Requiring standardization using the average cost method for all shares in a particular mutual fund account would provide the greatest simplification and be a compromise among the methods available. Taxpayers would still have some flexibility as separate accounts would be treated separately. As a transition measure, this could be mandatory only for new shares purchased after date of enactment (or alternatively starting at the beginning of that calendar year). This option would also help improve compliance as over time all mutual-fund gain information would be computed and reported by mutual funds.

Disadvantages:

Some mutual fund investors would face higher effective tax rates on their mutual fund investments.

3. Small Business Stock

The small business stock exclusion (Section 1202) has a highly complex set of requirements that must be met throughout the holding period of a shareholder who hopes to benefit from the exclusion. The complex requirements are designed to prevent abuse of this generous provision. In addition, the Small Business Investment Act has been repealed, and there are now only a few small grandfathered Specialized Small Business Investment Companies (SSBICs). Because capital gains tax rates have declined substantially and the excluded gains are taxed as a preference under the AMT, there is almost no benefit from these exclusions. Both the small business stock exclusion and the rollover of qualified small business stock gains have suffered from compliance issues because of limited reporting requirements and enforcement by the IRS. The IRS does not receive third-party information on eligibility of stock owners of potentially qualified small business stock, making the provision difficult to enforce. The rollover provision has also been criticized because of the short 6-month holding period, which mainly benefits insiders and traders rather than long-term investors. This provision has been described as a tax benefit allowing a zero capital gains tax, but some small business investors do not re-invest their gains in replacement-qualified small business stock. The President proposed a zero percent capital gains rate on equity investments (stock) in small businesses and a 75 percent exclusion was enacted for investments in 2009 and 2010 as part of ARRA.

The proposal and its advantages:

Some simplification could be achieved by allowing the 100 percent exclusion for stock purchases starting in 2009 and changing the prior 50 percent exclusion off ordinary income tax rates to a 25 percent exclusion off capital gains rates. This simplification would retain the extra incentive for qualifying small business investments and result in similar effective tax rates while greatly simplifying the tax calculations. The alternative of repealing these special small business provisions for pre-2009 investments would still provide these investments with the benefits of the general preferential rate for long-term capital gains. Whatever option is chosen, improved reporting is required to help prevent abuse of this provision.

The rollover of gains from qualified small business stock (Section 1044) into an investment in another qualified small business stock could be repealed or reformed by lengthening the holding period from 6 months to at least one year. The short 6-month holding period requirement is inconsistent with the "patient capital" rationale for special small business stock incentives.

Disadvantages:

Eliminating the small business stock exclusion would raise the tax rate on investments in small businesses. However, few businesses actually make use of these provisions, so the effect would be limited.

ii. Option 2: Simplify Capital Gains Tax Rate Structure

The combination of the expiration of the zero and 15 percent capital gains tax rates in 2011, the President's proposal for a 20 percent rate on capital gains of taxpayers with incomes over $250,000 and the 3.8 percent Medicare tax on capital gains of high-income taxpayers in the recently enacted health care bill, suggests that it is timely to review the taxation of capital gains.

The basic 10 and 20 percent rates enacted in 1997 (along with the depreciation recapture provision discussed above) were thought to allow reduction of the top capital gains rate without loss of tax revenue because of the revenue efficiency of the design of the proposal. The zero percent rate under current law raises little revenue (only through the effect of including the full capital gain on income-based phase-out provisions). The zero rate also raises questions about whether even middle-income taxpayers should pay some capital gains tax on their capital gains income.

The proposal and its advantages:

One option would be to convert the separate rates into a 50 percent exclusion. A 50 percent exclusion would result in approximately the same top income tax rate (19.6 percent vs. 20 percent) while imposing rates of 5 and 7.5 percent on gains of taxpayers in the 10 and 15 percent tax brackets. Such a percentage exclusion would simplify the computation of the tax on capital gains, especially if other capital gains provisions were also converted into percentage exclusions. The same percentage exclusion would apply to net capital losses to make the tax treatment symmetric and reduce any revenue losses. While the separate calculation of the tax on capital gains is slightly more complicated than an exclusion, simplification benefits would come from cleaning up the other provisions on special types of capital gains.

A more modest option would be to replace the zero percent rate with the 5 percent capital gains rate in effect from 2001 through 2007 for taxpayers with taxable income placing them in the 10 or 15 percent rate brackets. While this would increase taxes for some middle-income individuals, capital gains are infrequent and tend to be relatively small in this income range. As a result, the overall income tax of these households would stay roughly the same because of changes to other provisions in the simplification package. The 5 percent rate would raise capital gains taxes on higher-income taxpayers without distorting their decisions about stock sales because those decisions would be affected only by the maximum rate that applied to their gains.

Disadvantages:

A significant drawback of such an exclusion is that the basic income measure (AGI) would be distorted, especially for taxpayers whose income consists primarily of capital gains. This distortion would affect the starting points for income phase-outs and published tables that use AGI to show the distribution of income. However, this might be an appropriate treatment for individuals for whom a large capital gain is a one-time or infrequent event.

iii. Option 3: Limit or Repeal Section 1031 Like-Kind Exchanges

The proposal and its advantages:

One simplification option is to tighten the eligibility for this treatment to better align the operation of Section 1031 with the justifications for tax deferral treatment. An alternative option would be to disallow deferral of gain on like-kind exchanges. Other proposals would limit the rollover to property in certain cases. For example, some proposals would make developed property and structures a separate category from undeveloped land. Some developers are able to defer taxation continually by rolling over gains from the sale of developed properties into new investment in increasing amounts of land.

Disadvantages:

The proposal would raise tax rates on real property. The Section 1031 provision interacts with and is an escape valve for capital gains tax rates. Thus, it is most important for corporations as they face a 35 percent corporate capital gains tax rate. Substantial limitation of like-kind exchange rules would increase the pressure to reduce the corporate capital gains rate (or the overall corporate rate). On the other hand, limiting the like-kind exchange rules could partially fund a lower corporate rate.

iv. Option 4: Capital Gains on Principal Residences

Homeowners may exclude up to $500,000 ($250,000 for a single individual) of capital gain from the sale of principal residences provided the home was their principal residence in two of the last five years. This provision was enacted as a simplification measure—at the time of enactment over 95 percent of home sales produced capital gains below the exclusion amount and even fewer sales were subject to tax if they met the holding period requirement—and as a middle-class tax break. With the passage of time, the real value of the exclusion has been eroded, limiting simplification benefits.[4]

Calculating the capital gain is itself a complex procedure because the tax basis of the home—the adjusted purchase price against which to compare the sales price—includes transaction costs, fees, investments, and renovations (but not routine maintenance) that occurred since purchase. Records documenting all of those expenditures (often covering many years of expenditures) are required.

The proposal and its advantages:

These issues suggest indexing the exclusion for inflation. A higher threshold would prevent the erosion of the simplification benefits of this provision and prevent increasing numbers of homeowners from paying taxes on appreciated residences.

Disadvantages:

Indexing the threshold for inflation would expand the already very favorable treatment afforded to owner-occupied housing and would benefit those with the largest capital gains.

d. Option Group D: Simplifying Tax Filing

Based on IRS research, on average individual tax filers spend more than 17 hours on tax-related matters each year. Overall, that means that the roughly 140 million filers expend almost 2.5 billion hours devoted to federal income taxes. In addition to the time cost, taxpayers spend $32 billion paying accountants, lawyers, and tax preparers or purchasing tax software. All told, the monetized cost (at $25 per hour) of this compliance burden for individual taxpayers is about $92 billion. Of course, these calculations ignore the hard-to-monetize costs of frustration and anxiety.

About 30 percent of the time is spent actually preparing and submitting a tax return, and the remaining 70 percent is spent on recordkeeping, tax planning, and other tax-related items. Recordkeeping alone is nearly half of the total time burden. Much of that is devoted to documenting

4 The relatively short holding period requirement of two years and allowing repeat use every two years is thought to invite abuse of the provision by homebuilders living in a house they built for two years to get tax-free earnings from their profit on the house, by conversion of rental or vacation properties into principal residences, and by serial fixer-upper specialists who also get tax-free income on their labor on the house. An option in the compliance section addresses this issue.

wages, income from dividends, interest, retirement distributions, and other sources, and deductions for mortgage and student loan interest or IRA contributions—information that is usually provided by third parties to the IRS already. Then taxpayers must input this information and other routine information like names, Social Security numbers and children's ages, into the correct forms on worksheets, which on average takes another 4 hours and 20 minutes according to the IRS.[5]

In our meetings, we were urged to consider reforms to reduce the burden of filing through information technology, particularly through "return free" systems like California's "ReadyReturn" pilot program. This program targeted a small group of individuals with the simplest tax returns–single individuals with no dependents, no itemized deductions, and only wage income—and mailed them a pre-filled return. All of the content on the form was provided using computer records. Participants' Social Security numbers were used to retrieve earnings data from tax records already supplied to California by employers, and information on the individuals like their filing status was supplied from last year's return. (Individuals whose tax situation had become more complicated still had to file a full return.) Individuals simply had to check to make sure that the information on the pre-filled return they had received was correct, sign the form, and mail it back. Among those who chose to participate, the median user reported saving 40 minutes and $30, and participants gave rave reviews, with 98 percent saying that they wanted to use the program again the following year. These time and money saving benefits of automatic filing do not include the additional benefits of reduced frustration by taxpayers and their increased trust in the system. Less than 5 percent of the roughly 2 million eligible taxpayers participated, however.

Some estimate that it would be possible to serve up to 40 percent of all U.S. taxpayers with a similar system, saving hundreds of millions of hours and billions of dollars in preparation fees, while actually reducing the cost to the IRS of administering the tax system by reducing errors and resultant investigations.

The California experience also highlighted certain challenges to simplifying the filing process. Taxpayers with complicated returns, with income from unreported sources, like self-employment income, or with unreported deductions, like charitable contributions, would be hard to accommodate. As the costs of filing are disproportionately borne by those with complex returns, this limits some of the potential cost savings from filing simplification. In addition, modifying the filing system would require changes for the IRS and the Social Security Administration and for the employers and other third parties who are required to submit information to the IRS and who would now have to send in that information on a much-compressed time frame. In addition, new technological systems and databases would need to be developed and implemented. Currently, the IRS does not receive and process third-party reported information in time for the filing season. Thus, the timing of reporting and processing would need to be accelerated, with associated investments in administrative personnel and computing infrastructure at each step of the process. (California processed its state unemployment insurance records for wages by tax filing season for this project, and wages for unemployment purposes are not necessarily the same as for income tax purposes.)

We received two primary options for simplifying the filing process; implementing either—or both—would substantially reduce the compliance burden for millions of taxpayers.

5 These estimates include the much larger amounts of time and monetary costs of taxpayers with business income, such as sole proprietors. For taxpayers without any business-related income, the average burden is lower.

i. Option 1: The Simple Return

The proposal and its advantages:

One option, modeled after the California pilot program, is to send taxpayers a pre-filled return. Taxpayers with relatively simple returns would receive a pre-filled tax return from the IRS that included information taken directly from employers and from last year's return as well as a preliminary calculation of tax liability. Taxpayers would be responsible for updating their returns as needed—for example, changing the number of dependents, adding a deduction for home mortgage interest, or adding in self-employment income—but many taxpayers would have no changes and would only have to sign and return their pre-filled returns.

Taxpayers with relatively simple returns would be the most likely initial candidates for the program, starting with the more than 17 million taxpayers with only wage income and simple family arrangements. From there, the program could reasonably be expanded to as many as 60 million taxpayers—about half of the total number—who have third-party reported income and who did not itemize deductions.

Providing pre-filled returns would relieve millions of taxpayers from the chore of filling in tax forms, whether on paper or via tax software, and would reduce the frustration and anxiety of taxpayers at tax time.

Disadvantages:

This option alone would provide little relief for taxpayers with complicated returns, taxpayers with business income, or low-income filers in complicated living arrangements. Taxpayers in these situations would still need to file a regular return. Further, the IRS currently has neither the computing infrastructure, nor the ability to obtain in a timely manner the required third-party reports of income and deductions needed to fill out a complete return, even for simple returns. Considerable investment in technology and manpower would be required to implement such a system. (As indicated below, such investment would also be required to increase overall tax compliance and reduce the tax gap significantly.) A pre-filled return that omitted certain income sources or that misstated a taxpayer's income or deductions in the taxpayer's favor could reduce tax compliance and collections by revealing the gaps in the government's information. However, compliance for such income sources, like cash receipts by small businesses, is very poor already. (A study of California's ReadyReturn concluded that the program in fact reduced revenues only slightly.) Adapting the system to address all the special credits for low-income households with children, retirement savings, or other purposes would be difficult or impossible unless those credits were also simplified. Finally, even with technological improvements, the IRS would not be able to prepare returns as soon after the close of the year as many taxpayers currently file their returns in order to obtain their tax refunds. Thus, the attractiveness of the program for lower-income families who receive large refunds due mainly to the EITC and child credits might be limited. California's ReadyReturn was a paper form mailed to taxpayers. The use of a paper-based filing system would tend to eliminate the benefits (such as automatic computations, fewer computational errors, and reduced data entry costs) of electronically prepared and submitted returns for both the IRS and taxpayers.

ii. Option 2: Data Retrieval

The proposal and its advantages:

An alternative—or auxiliary—proposal would allow taxpayers (or their preparers) to download their own tax information from the IRS. Instead of mailing a pre-filled return to taxpayers, the IRS would provide a secure database where individuals could look up and retrieve third-party reported information, like wages, interest income, dividends, income from sale of securities, state taxes paid, and deductions like home mortgage interest, all of which taxpayers must currently assemble and fill in themselves. All of this information is maintained by third parties and could be made available in a database. Rather than being mailed to the taxpayer item-by-item the information would be available for downloading directly into the taxpayer's return at his convenience. Eliminating much of the paperwork needed to prepare taxes would save time, decrease taxpayer frustration, and reduce errors in transcription and other mistakes. While taxpayers would still need to fill out other information on the tax form like charitable contributions and certain capital gains, this option has the advantage of providing filing simplification to all taxpayers, not just those with simple tax returns. Most individual line items reported by the majority of taxpayers are subject to third-party reporting, even for high-income taxpayers, who tend to have the most complicated returns.

Disadvantages:

One concern is that electronic storage and downloading of tax information to individual tax payers by the IRS would be subject to security breaches. But proponents of this approach argue that the standards for security for other online transactions are very high and they point out that online systems could improve security compared to mailing hundreds of millions of paper forms across the country. As in the previous option, data retrieval might make taxpayers aware of all the items to which the government does not have access and make honest reporting of these items less likely. This option would also require additional resources for investments in technology and databases. Also, this option has the same costs and difficulties as Option 1 of getting the third-party data submitted and processed early enough to enable taxpayers to file their returns and obtain their refunds on their current schedule. Moreover, if third parties no longer had to send copies directly to taxpayers, they would not be able to accelerate their tax filing by using the information sent to them directly.

iii. Option 3: Raise the Standard Deduction and Reduce the Benefit of Itemized Deductions

Taxpayers choose either to take the standard deduction or to claim the sum of itemized deductions when calculating their taxable income, generally depending on which is larger. Taxpayers who itemize their deductions must maintain records of those deductions and file an additional schedule with their return, and additional recordkeeping and reporting is required by third parties for deductions such as mortgage interest. Taxpayers who take the standard deduction do not face these requirements.

Overall, in 2007, 50 million taxpayers or 38 percent of regular taxpayers (other than dependent filers and those who filed only to claim a stimulus rebate) claimed itemized deductions. The itemization rate increases with income: for those with AGI under $50,000, 18 percent itemize; 55 percent with AGI between $50,000 and $75,000; 73 percent with AGI between $75,000 and $100,000 and 89 percent of those with AGI over $100,000. Itemization is highest for taxpayers age 45 to 64 and lower for younger taxpayers and those age 65 and over. Many taxpayers in the $50,000 to $100,000 income range have relatively modest amounts of itemized deductions and could be relieved of the recordkeeping burden if the standard deduction were higher.

The proposal and its advantages:

Increasing the standard deduction and reducing the benefit of itemizing deductions would simplify the filing process, reduce recordkeeping requirements for many taxpayers, and relieve some taxpayers from filing a return entirely. For example, a proposal could limit itemized deductions to 75 percent of certain expenses and use the resulting revenue raised to increase the standard deduction. Such a limitation already applies to certain deductions like business expenses for food and entertainment and for total itemized deductions for high-income taxpayers. The revenues generated by this limitation could then be used to finance a substantial increase in the standard deduction.

Increasing the standard deduction would mean that many more people would choose to take the standard deduction rather than itemizing, meaning that fewer people would need to spend time keeping records of eligible deductions and resulting in more streamlined returns. Raising the standard deduction would offset the reduced deduction for most lower- and middle-income itemizers.

Some rough calculations that ignore potential behavioral responses illustrate the effects of this option.[6] The calculations suggest that limiting itemized deductions to 75 percent would generate enough revenue to increase the standard deduction by 55 to 85 percent, depending on whether the President's tax proposals in the Budget are enacted or current law applies. For example, under current law with the AMT provisions indexed for inflation (the so-called AMT "patch"), the standard deduction could be increased by up to 85 percent by 2015. Under this scenario, nearly 30 million taxpayers would shift from itemizing deductions to claiming the standard deduction by 2015, while about 26 million taxpayers would continue to itemize deductions. This would provide a substantial amount of simplification for taxpayers who no longer need to itemize deductions. The percentage of taxpayers with AGI between $60,000 and $75,000 who itemize would decrease from 51 percent to about 18 percent, providing substantial simplification while still allowing itemization for those with large amounts of such deductions. Among taxpayers in this income group, tax liabilities would be reduced or remain the same for about 70 percent of taxpayers. Moreover, tax liabilities would remain the same or be reduced for 96 percent of taxpayers with AGI less than $50,000 under this option. Taxes would increase for more than three-fourths of taxpayers with AGI over $200,000. Over a longer horizon, the standard deduction could be increased further or revenues could be allowed to rise because itemized deductions typically rise faster than the inflation-indexed standard deduction.

6 Possible behavior responses could include reductions in charitable donations and some taxpayers using savings to pay down their mortgages since the interest would no longer be fully deductible. In addition, over time state and local governments might reconsider their mix of types of taxes, fees and borrowing.

Limiting itemized deductions would also improve economic efficiency. Certain itemized deductions—for example the deduction for mortgage interest—provide subsidies for specific activities that encourage them relative to other possibly more productive activities.

Several limitations on itemized deductions were included in the Tax Reform Act of 1986, and the Administration's Budget proposal recommends limiting the benefit of itemized deductions for higher-income taxpayers to 28 percent rather than up to the ordinary income tax rate of 35 percent.

Disadvantages:

Limiting itemized deductions would be criticized on fairness grounds. For example, limiting charitable contributions would reduce the incentives to give to charity and could therefore adversely affect both charitable organizations and their beneficiaries. Deductions for work-related expenses would also be hard to limit—the costs of producing income are fully deductible for all businesses and for the self-employed, but currently only partially deductible for employees with unreimbursed expenses. Similarly, the deduction for large medical expenditures is intended to adjust for ability to pay and the threshold has recently been increased to only allow deductions over 10 percent of AGI. Limiting itemized deductions would also raise taxes more from those with large deductions than otherwise similarly situated taxpayers with fewer deductions. For example, homeowners would see their taxes rise more than renters. There may be more efficient ways to limit the costs of charitable deductions without reducing the incremental incentive to give, such as a modest floor under deductions, like the 1 percent floor suggested by the 2005 Tax Reform Panel, or a fixed dollar floor suggested by others.

e. Option Group E: Simplification for Small Businesses

Simplified Accounting for Small Businesses

Small businesses spent close to 1.8 billion hours complying with the income tax in 2004 and paid as much as $16 billion for professional help, according to one study. These compliance costs fall disproportionately on smaller businesses, as smaller firms bear a larger compliance burden relative to the size of their business than do larger firms. For the smallest businesses—those with one to five employees—the average monetized cost of compliance is estimated to be $4,500 per employee. According to the National Federation of Small Business's Problems and Priorities Poll, tax complexity ranks fifth of 75 issues. This complexity is a primary reason why 87 percent of small business owners rely on a paid tax preparer.

The largest cost of tax compliance for small businesses is the time burden associated with the additional recordkeeping needed for complying with tax accounting. Businesses may need to keep at least two sets of books, one for financial accounting and another for tax accounting purposes; often businesses must also maintain additional sets of accounts for states that have de-coupled from federal tax rules. For most small businesses, these books may not be that different because they already use cash accounting for both financial and tax purposes; about 80 percent of businesses with gross receipts less than $500,000 and that make or sell goods use cash accounting for tax purposes. With cash accounting, firms generally include all receipts in gross income in the year they are received, and deduct many expenses when paid—except for the costs of materials and supplies, inventories, and other capital expenditures. Taxpayers cannot deduct their costs for materials and supplies until they are used. Similarly, taxpayers generally may not deduct the costs of inventory until the goods are sold. However, many small taxpayers need only capitalize the costs of merchandise purchased for resale. Other costs, such as direct labor costs and overhead costs may be expensed by these small taxpayers. Nevertheless, the tax rules require even very small firms to maintain records for purchased supplies and inventory beyond the year in which they were bought. Similarly, expenditures for depreciable property must be deducted over time, and the depreciated basis tracked from year to year. Current law provides some relief by allowing small businesses to deduct immediately up to $250,000 of investments in certain property. (This limit is scheduled to decline to about $135,000 in 2011.)

In addition to direct bookkeeping costs, recordkeeping at small firms is frequently subject to error. According to one IRS study, some recordkeeping items reported on the returns of sole proprietorships have error rates over 50 percent.

Witnesses also cited the difficulty of claiming a deduction for the business use of a home as a drain on small businesses. Nearly half of small businesses are home-based and many could be eligible to deduct home office costs. However, to qualify for the deduction a number of stringent tests must be met and records documenting household and business expenditures related to the office maintained. For example, a self-employed worker using a den for business purposes may need to document costs for utilities, mortgage interest or rent, and general repairs, allocate those costs to the business portion of the home, and otherwise differentiate costs specifically related to the business (like a dedicated phone or fax line) from those related to the home. Also, there are strict requirements that limit the deductibility of home office expenses by generally requiring that the home office space be used exclusively for business.

A final issue raised by many business representatives deals with property (other than home offices) that potentially has both business and personal uses, such as automobiles, computers, and cell phones–known as "listed" property. To prevent the taking of tax deductions for the personal use of listed property, Congress requires taxpayers to report as income the personal use of this property. Strictly speaking, in order to comply with these rules, employers and employees must go call by call through cell phone records to allocate business and personal use.

i. Option 1: Expand Simplified Cash Accounting to More Businesses

The proposal and its advantages:

"Simplified cash accounting" or "checkbook accounting" eliminates the need to maintain multi-year records for supplies, inventories, and most depreciable property. In this system (advocated by the 2005 Tax Reform Panel), taxable income for most small businesses would simply equal cash receipts minus cash business expenses—including cash outlays for inventories, materials, and depreciable property other than buildings. Rather than having to keep an additional set of books solely for tax purposes, small businesses could simply use their cash flow records—mainly their bank accounts. Expanding full cash accounting to all but the largest firms could allow millions of small businesses to simplify their tax accounting and lower their compliance costs. Relieving small businesses of the burden of maintaining these records could free up resources for more productive uses and, by simplifying rules, could reduce errors and improve compliance. Taxpayers currently using cash accounting are the vast majority of businesses, but they account for only a small share of overall business activity. Hence, the dollar amounts involved for provisions related to supplies, inventories, and depreciable property are very low, making the current recordkeeping requirements related to such property onerous relative to the revenue gained.

An additional benefit of this option is that it could facilitate improvements in third-party reporting and therefore compliance for small businesses. Under simplified cash accounting, the bank account of a business essentially records the taxable income of the business—receipts minus expenses. If firms were required to maintain a separate account for these transactions, reporting by banks on these accounts would provide tax administrators with more complete records of the income of small businesses. (This proposal is discussed further in the options to improve compliance.)

Disadvantages:

Providing simplified cash accounting to small firms would reduce the present value of revenues collected. In addition, certain administrative issues would need to be addressed with a permanent law such as how to treat firms moving across the threshold for simplified accounting. Transition issues, like how current inventories were treated, would need to be addressed. Aggregation rules would be needed to prevent large businesses from creating smaller units to take advantage of the simplified treatment.

ii. Option 2: Simplified Home Office Deduction

The proposal and its advantages:

Simplifying the home office deduction would reduce the recordkeeping and compliance burden on small firms. One approach would permit a standard deduction—a flat dollar amount—for home-based businesses, similar to the standard deduction for individual taxpayers. At-home workers would file Schedule C (income from self-employment) only if self-employment gross income exceeded that threshold and would be permitted a safe harbor for expenses up to that amount—recordkeeping for those expenses would be eliminated. Businesses could choose to continue to follow the current home office deduction rules, or they could choose the new standard deduction. Under an alternative approach, at-home workers could use a standardized formula more similar to the current method that is based on the size of the home office. Taxpayers would figure their deduction by multiplying the square footage of their office by a standard home office rate, eliminating the need to maintain records documenting costs for home expenditures. Either of these simplifications would reduce the burden of claiming a home office deduction and would encourage more taxpayers to deduct expenses associated with the business use of their home.

Disadvantages:

Either of these provisions would likely reduce revenues by increasing the likelihood that taxpayers would claim these expenses and, for some taxpayers, the amount of expenses they could claim would increase. (This revenue loss could be reduced, for example, if only expenses over a threshold could be claimed.) Many of the strict tests applied in the current system are designed to discourage abusive use of the home office deduction. Taxpayers would still have to meet the eligibility conditions for deducting home office expenses. Finally, adding an optional standard deduction could actually increase taxpayer burden without decreasing recordkeeping costs, since many would elect to compute both ways (standard deduction and exact method) and then deduct the larger of the two.

iii. Option 3: Simplify Recordkeeping for Cell Phones, PDAs, and Other Devices

The proposal and its advantages:

Declassifying cell phones and PDAs from "listed property" would eliminate the requirement to document each individual call and allow firms to deduct the expenses using the same methods they use for other expenses. (The Administration's 2011 Budget included this proposal.) Alternatively, the IRS could provide a safe harbor method under which a certain percentage of cell phone or PDA use was deemed to be for personal use. For example, 50 percent of the cost of an employer-provided cell phone could be assumed to be for personal use. These simplifications would eliminate a costly recordkeeping requirement for businesses.

Disadvantages:

Removing cell phones and other personal digital assistants (PDAs) from classification as "listed property" would encourage firms to offer employees devices and phone plans as fringe benefits, increasing the need to clarify the circumstances in which those benefits may be excluded from income.

f. Option Group F: The AMT

The item that was mentioned more than any other tax provision was the individual Alternative Minimum Tax (AMT). The AMT is a parallel tax system that requires millions of Americans to calculate their taxes twice, once under the regular tax and once under the AMT, and then to pay the higher of the two. Without legislative intervention to increase the AMT exemption amount, more than 28 million taxpayers would need to pay the AMT in 2010; by 2020 the number would climb to more than 53 million. Even with relief, in 2009 about 4 million taxpayers paid AMT (in 2020, with the AMT "patch" almost 8 million filers would pay the AMT). Millions more faced uncertainty about whether they would be subject to the AMT—and be hit with a "surprise" tax payment—and needed to fill out a preliminary form and read pages of instructions just to find out whether they would need to file an AMT return. Moreover, because the AMT adjustments eliminate many popular exemptions and deductions including those for taxpayer and dependent exemptions, the standard deduction, state and local taxes, and business expenses, the AMT now threatens to ensnare many ordinary households. Without continual AMT "patches" the vast majority of taxpayers affected by the AMT would earn less than $200,000.

The uncertainty created by the AMT is a primary concern—many argued that what a taxpayer owes at tax time should never be a surprise. In addition, many cited the direct burden of calculating the AMT on the 55-line form. Other comments focused on the many features of the AMT that seemed at odds with common features of the regular income tax system. For example, many asked why the AMT eliminates personal exemptions and therefore treats families of different sizes the same, while the ordinary income tax includes many provisions to address horizontal equity.

i. Option 1: Eliminate the AMT

The proposal and its advantages:

Most observers suggested eliminating the AMT entirely, and eliminating all the headaches of the AMT directly.

Disadvantages:

The major problem with complete repeal of the AMT is cost: estimates from a variety of sources suggest that repealing the AMT would cost on the order of $1.4 trillion over 10 years relative to the current policy baseline. "Patching" the AMT by indexing its parameters at their 2009 levels would limit the number of AMT taxpayers substantially—to millions rather than tens of millions of taxpayers—but would still cost just over $1 trillion over ten years. Alternative options to eliminate the AMT for taxpayers below some income threshold—say under $250,000—would also reduce the number of AMT taxpayers significantly but would still be very expensive—reducing revenues by an amount somewhere between the two estimates above.

Legislators have historically "patched" the AMT each year (as is now assumed in the Administration's Budget proposal), so the de-facto cost of repealing the AMT is about the $320 billion difference (over 10 years) between full repeal and indexing the "patch" for inflation.

ii. Option 2: Modify and Simplify the AMT

The proposal and its advantages:

An alternative option would be to simplify the AMT and harmonize its provisions more closely with those in the regular income tax. The compliance burden of the AMT arises because the AMT adjustments are sufficiently opaque that taxpayers cannot predict whether they will be subject to the AMT and because many taxpayers must fill out their taxes twice, using a different set of rules and a different set of calculations each time. If we are stuck with the AMT because of the costs of repeal, we could at least make it less burdensome.

The AMT schedule includes 28 adjustments to ordinary income that are often only slightly different from similar provisions in the ordinary income tax. Medical expenses are deductible on the regular schedule only to the extent they exceed 7.5 percent of income but 10 percent for the AMT. (The recent health care legislation eliminated this difference.) The definition of deductible home mortgage interest is slightly different for the AMT. Employee stock options are taxed when exercised under the AMT but only when the stock is sold under the individual income tax. To eliminate the possibility of being taxed twice on the same compensation, AMT taxpayers get a credit against taxes paid in the future when the stock is sold and regular tax liability is incurred; hence the net revenue is generally close to zero. In the mean time, however, the taxpayer must carry forward two different bases in the options and stock and continue filing AMT returns for intervening years. Harmonizing these provisions would improve the predictability of AMT liability, save a lot of paperwork, and make the system more transparent.

Many of the other adjustments apply to very few taxpayers and could potentially be addressed elsewhere in the tax code. In 2006, fewer than 10,000 taxpayers of the 8.6 million who filed the AMT made adjustments for obscure items like "electing large partnerships" (811 taxpayers), the difference between regular tax and AMT treatment of "research and experimental costs" (1,743 taxpayers), or "intangible drilling cost preference" (5,969 taxpayers). Addressing these issues elsewhere in the tax code—for example, by modifying the tax treatment only for those few taxpayers "electing large partnerships," would relieve AMT filers from having to deal with these provisions.

Finally, a consolidation of family-related tax credits and deductions, as discussed above, could reduce the number of AMT taxpayers. Since personal exemptions are not deductible for AMT purposes, having a large family increases the likelihood of being subject to the AMT. If the standard deduction and personal exemptions were eliminated and consolidated with a "family credit," this would harmonize treatment of families between the regular tax and the AMT and could be used to reduce the number of AMT filers.

Disadvantages:

Much of the burden of calculating taxes twice would remain. Harmonization of individual tax provisions would help or hurt individuals affected by individual provisions.

III. COMPLIANCE OPTIONS

The second of the charges to the Tax Reform group was to suggest options for improving taxpayer compliance and reducing the tax gap.

Most taxpayers report and pay their taxes voluntarily and on time. Overall, the federal tax system achieves a high level of voluntary compliance with taxpayers paying about 83.7 percent of all taxes due in a timely manner. The remaining fraction of unpaid taxes is often called the gross tax gap—the difference between the amount of taxpayers' tax obligation for a given year and the amount that is actually paid on time. This gap was estimated to be $345 billion in tax year 2001. (There is no more recent IRS estimate.) Of the $345 billion, voluntary late payments and IRS enforcement brought in approximately $55 billion, leaving a "net tax gap" of $290 billion of unpaid, uncollected taxes. This gap results primarily from the underreporting of income, with much smaller amounts arising from taxpayers who fail to file, or who file and declare income but fail to pay. The total dollar amount of unpaid taxes has likely increased since 2001 because of the growth in the economy and the growth in tax revenues.

Despite the high rates of voluntary compliance, an unacceptably large amount of the tax that should be paid is not. This directly affects federal revenues, resulting in larger federal deficits, but also reduces tax revenues for state and local governments, which often rely on information reported on federal tax returns. Noncompliance also forces compliant taxpayers to shoulder a disproportionate share of the burden of government finance. The tax gap therefore represents an unfair burden placed on compliant taxpayers who must ultimately pay more for government services—an additional burden that runs to thousands of dollars per taxpayer to subsidize those who do not pay. Honest businesses are put at a competitive disadvantage relative to those that cheat, and everyone suffers when taxpayers inadvertently underpay their taxes. Therefore, reducing the tax gap is about more than just increasing government revenues. It is also about ensuring that everyone pays their fair share, which in turn supports the willingness of taxpayers to voluntarily comply with the tax system and their trust in it.

Reducing the tax gap is not an easy task. The net tax gap does not represent "tax due" bills that the IRS could send to taxpayers. Rather, the tax gap primarily reflects an estimate of noncompliance that the IRS has reason to believe exists, much of which has not been specifically identified, and which, in many cases, the IRS has limited resources or ability to assess or collect. (Indeed, limited IRS resources are the main reason the official estimate of the size of the tax gap is nearly a decade old.) Furthermore, some of the tax gap results from taxpayers who may have insufficient funds to pay the taxes they owe or from businesses that no longer exist. More fundamentally, substantially reducing the tax gap could require both a significant increase in IRS enforcement capabilities and would require more intrusive enforcement measures than may be acceptable to Congress and the public. Moreover, additional resources for collection and enforcement would compete for limited government resources that could be used for other purposes.

Both Congress and the IRS have taken significant actions to reduce noncompliance and the associated tax gap in recent years, and many of these changes were recently or will soon be put into effect. For example, information reporting will be enhanced by two requirements for credit card payment and stock basis reporting. Additionally, the recently passed Foreign Account Tax Compliance Act (FATCA) will add robust reporting for international transactions and provide the IRS key information to help identify offshore tax abuses. In the recently enacted health legislation, Congress expanded the requirement for businesses to report aggregate payments of $600 or more per year to recipients for all goods and services and to both non-corporate and corporate payees. Beginning in 2011, tax return preparers who file 10 or more returns will be required to file those returns electronically. The Administration's Budget includes additional compliance proposals that would affect worker classification and increase information reporting for items like rental property expense payments, private separate accounts of life insurance companies, and government payments for certain property and services, as well as other changes.

In order for these changes to be fully effective—both from a tax compliance perspective and from a "customer service" perspective of helping taxpayers avoid mistakes and providing timelier processing of returns—the IRS will need to devote new resources targeted in these areas; meanwhile, the IRS will still need to maintain its efforts elsewhere providing taxpayer service and reducing taxpayer burdens in the administration of tax laws. As a result, the IRS will need additional funding because without adequate resources, these new provisions will not be effective.

a. Background on Compliance and the Tax Gap

IRS research sheds light on the types of non-compliant taxpayers and the kinds of income and deductions where noncompliance is most severe. The following table shows the estimates of compliance by type of taxes. Over 70 percent of the gross tax gap is attributable to the individual income tax, and sole proprietors make up more than half of this percentage.

Table 5: The Gross Tax Gap, by Type of Tax, Tax Year 2001

Type of Tax	Gross Tax Gap ($ Billions)	Share of Gross Tax Gap
Individual Income	245	71%
Corporate Income	32	9%
Employment	59	17%
Estate	8	2%
Excise	NA	NA
Total[a]	**345**	**100%**

a. Items may not add due to rounding.

Source: Figure 2, "Reducing the Federal Tax Gap," IRS & Treasury, August 2, 2007.

Noncompliance can take the form of not filing required returns, underreporting income on filed returns, or underpaying taxes that are reported on time. It is estimated that 82.6 percent of the gross tax gap was attributable to underreporting of tax (including underreported income or overstated deductions and credits) for tax year 2001. The overall tax gap is dominated by the underreporting of individual income tax, estimated at $197 billion. Table 6 categorizes sources of individual income according to the visibility of the type of income and the associated "net misreporting percentage."[7] While the accuracy of reporting varies widely for different types of income or deductions, the reporting compliance is greatest where there is substantial information reporting or withholding, such as for wages and salaries.

Table 6: Individual Income Tax Underreporting Gap and Net Misreporting Percentage, by Visibility Groups, Tax Year 2001

Visibility Group – Type of Income or Offset	Underreporting Gap ($ Billions)	Net Misreporting Percentage[a]
Total Underreporting Gap	**197**	**18%**
Items subject to:		
Information reporting and withholding (wages, salaries, etc.)	10	1%
Information reporting (interest, dividends, pensions, social security benefits, etc.)	9	5%
Some information reporting (capital gains, S corp. & partnership, deductions, exemptions, etc.)	51	9%
Little or no information reporting (proprietor income, rents & royalties, "other" income, etc.)	110	54%
-- Non-farm proprietor income	68	57%
-- Rents & royalties	13	51%
-- "Other income"	23	64%

a. Net Misreporting Percentage – see footnote 7

Source: Figure 5, "Reducing the Federal Tax Gap," IRS & Treasury, August 2, 2007.

The largest source of underreporting of income is individual income tax for income sources not subject to withholding or document matching. Voluntary compliance is very high for income subject to both withholding and information reporting—more than 99 percent of wage and salary income actually reported on Forms W-2 is disclosed, and the reporting rate on income subject to third-party reporting is 95 percent. Compliance is low where the IRS does not receive third-party reporting, or where that reporting is incomplete, and where the IRS does not have "line of sight" to see transactions and accounts. For example, the income reporting percentage drops to 20 percent for income earned by certain sole proprietors (called "informal suppliers") who operate "off the books" on a cash basis in areas such as street vending, door-to-door sales, or moonlighting in a trade or profession. Underreporting of business income by small businesses, in particular, accounts for approximately $153 billion—44 percent—of the tax gap. The IRS estimates that only about half of self-employment taxes owed are actually paid on time, and that the underreporting of business income by individual income taxpayers cost the Treasury $109 billion in tax year 2001.

7 "Net misreporting percentage" is the aggregate net amount of income misreported divided by the sum of the absolute values of the amount that should have been reported. The estimates of the amounts that should have been reported account for underreported income that was not detected by the random audits (where the burden of proof is on the auditor) without a corresponding adjustment for unclaimed offsets (e.g., deductions, exemptions, statutory adjustments, and credits) that were not detected (where the burden of proof is on the taxpayer).

b. General Approaches to Improve Voluntary Compliance and Reduce the Tax Gap

When we asked experts how to improve voluntary tax compliance and reduce the tax gap, they advocated broad and general principles to promote compliance.

One theme we heard repeatedly was that voluntary tax compliance would be increased by having a simpler, more transparent and more easily understood tax system, and from stable and consistent tax law. The complexity of the current tax code results directly in involuntary errors and facilitates intentional evasion. Areas where the tax code is particularly complex—the EITC, tax credits and deductions for education expenses, and limits on contributions to retirement savings plans—are well-known sources of unintentional errors. One study of capital gains found that 33 percent of taxpayers who misreported gains from securities sales overstated their capital gains. These taxpayers overpaid and thus are unlikely to be trying to cheat. Complex provisions also facilitate intentional noncompliance (evasion) in part because they make it difficult for the IRS to determine whether a taxpayer is complying with the law absent a substantial and sophisticated audit.

We also heard a lot about the need for predictability and stability in the tax system. The more certainty taxpayers have about the law and the more predictable the law is from year to year, the easier it is for taxpayers to comply with the law and the less likely it is for taxpayers to make unintentional errors. However, tax rules change almost every year: there have been more than 15,000 changes since 1986 and changes are increasingly common. In addition, temporary provisions are increasingly used for things like education credits, stimulus rebates, disaster area relief, loss carrybacks, or the first-time homebuyer credit. These changes are confusing to taxpayers and to tax professionals. Additionally, each year taxpayers must await reauthorizations of expiring tax provisions like the Research and Experimentation credit, AMT relief, or the sales tax deduction. The JCT's list of expiring federal tax provisions includes more than 240 provisions that expire by 2020.

Expiring and temporary provisions and other changes to tax law increase the cost of compliance and create unpredictability for individuals, resulting in more confusion and mistakes. From an administrative perspective, such changes require major reprogramming of current technology systems, new information booklets, publications, and forms, and reeducating taxpayers, preparers, administrators, and enforcement officers. All of these costs divert resources from more productive uses and reduce the IRS's ability to establish best practices. For example, the recent homebuyer credit was particularly challenging to administer and enforce, and the risk of fraud was significant because of uncertainty about appropriate documentation requirements and a reluctance to impose excessive reporting burdens on taxpayers seeking to legitimately avail themselves of the credit.

A second theme we heard was that investments in research and technology would be necessary to improve compliance and reduce the tax gap. Continued improvements to information technology and databases would provide the IRS with better tools to promote compliance. Improving technological resources would enable the IRS to ensure all businesses and workers are in the tax payment system and thus increase the productivity of existing IRS resources. Such improvements would also speed refunds, help with customer service, and provide a stepping stone toward systems like data retrieval that would make filing easier.

Additional research is essential to enable the IRS to better understand sources of noncompliance, identify ways to minimize taxpayer burden arising from compliance activities, and target resources that facilitate voluntary compliance. Unless we understand the causes of noncompliance, we will continue to have difficulty knowing whether it is inadvertent or intentional or whether it is facilitated by certain individuals or organizations, and we will not know how to stop it.

A final theme was improving tax administration. Experts pointed out that the IRS has multiple objectives that include providing service for taxpayers, collecting revenue, and distributing benefits through credits and refunds, and that these different objectives compete for budget resources. New resources could be used to help develop modern and adaptable administration methods, improve the design of tax forms and educational materials, improve audit and enforcement procedures, and increase audits and collection activities where appropriate. An overarching theme identified in the compliance area is that compliance efforts could be better targeted with an increased use of electronic data. Not only would this allow faster processing, but it would also provide better capabilities for data analysis in researching areas of noncompliance.

We also received some more specific options for improving compliance.

c. Option 1: Dedicate More Resources to Enforcement and Enhance Enforcement Tools

In certain areas, enforcement through audits is often the only way to uncover underreporting of income. Overall, in fiscal year 2009, the IRS examined 1.4 million or about 1.0 percent of individual tax returns. The examination rates ranged from 0.4 percent of simple returns with total positive income under $200,000 up to 10.6 percent of returns with AGI of $10 million and over. The examination rates were lower for simpler returns such as those with only wage and investment income and higher for returns with characteristics known to have higher noncompliance rates including business and rental income. Most examinations are conducted by simple correspondence with the taxpayer, while more serious or complex issues may require a formal field audit.

In addition, the IRS checks for the accuracy of information on millions of additional returns. Over 2.8 million notices were sent out under the "math error" program, which is authorized by statute. The program allows the IRS to identify factually inconsistent or missing return information in specific areas (which are defined by statute) and correct the amounts reported during return processing prior to issuing a tax refund. For example, the IRS has math error authority to deny earned income tax credits to taxpayers who fail to provide valid Social Security numbers for each child for whom the credit is claimed. The most common math errors relate to the computation of the amount of tax, the EITC, the number and amount of personal exemptions, and the standard or itemized deductions. Expanding the set of circumstances where the IRS may use math error authority to adjust a return during processing could reduce the number of incorrect refunds and reduce the need to use a formal audit to correct mistakes.

Under the Automated Underreporter (AUR) Program, the IRS matches tax returns to information returns reported by third parties and contacts taxpayers to resolve discrepancies and identify unreported income. In fiscal year 2008, the IRS had 4.8 million contacts under the AUR Program that resulted in $16.5 billion of additional assessments.

As stated earlier, Congress has enacted a number of provisions to improve compliance that will go into effect over the next several years, and the Administration's Budget includes additional proposals to reduce the tax gap. In order for these efforts to be effective in improving compliance, the IRS will need additional resources targeted to compliance. The IRS received 1.9 billion information returns in fiscal year 2008 and will be receiving larger numbers in the future as additional information reporting requirements are phased in. The FY 2011 Budget request for the IRS is $12.6 billion, representing an increase of $487.1 million or 4.0 percent from the fiscal year 2010 enacted level. Of the total budget requested, $2.3 billion is for taxpayer services, $5.8 for enforcement, $4.1 for operations support, and $387 million for business systems modernization. The independent IRS Oversight Board supported the added funding for IRS enforcement and Business Systems Modernization program to upgrade IRS computer systems and information technology, and recommended even more for IRS taxpayer service and basic IRS operations support.

An additional consideration is the design of tax forms. While minimizing taxpayer burden is an important criterion, IRS forms and publications could be reviewed and redesigned to improve compliance. For example, a proposed new schedule for corporate taxpayers was intended to improve compliance by requiring the reporting of certain items that might indicate the use of questionable arrangements or deductions that could be considered in selecting firms for audit. Evidence suggests the design of tax forms matters: a recent study indicated that when the threshold for reporting specific information about noncash charitable deductions was increased to $500, a large number of taxpayers increased their claimed charitable deductions to just below that threshold. Additional resources would be needed for the IRS to implement and fully use the information from redesigned forms.

The proposal and its advantages:

More resources would enable the IRS to increase the number of examinations and follow-ups of mismatches between information documents submitted and tax returns filed, check more quickly for math errors and missing information in returns, and pursue audits and collections more efficiently and with a lower burden on compliant taxpayers. More resources would also relieve the budgetary tradeoffs between enforcement and provision of taxpayer services. Enforcement revenue was $48.9 billion in fiscal year 2009 through collection, examination and document matching for a total IRS-wide return on investment (ROI) of 4.2 to 1. This figure excludes the additional revenues that enforcement produces by deterring non-compliance from occurring in the first place. With additional resources, the IRS will continue initiatives implemented with the current funding and establish new initiatives to help increase enforcement revenue.

Disadvantages:

Spending on enforcement and reporting requires real resources both in terms of direct costs of enforcement and the cost to taxpayers in time and frustration. Many assume that it is optimal to increase enforcement until the additional dollar of enforcement brings in an additional dollar of revenue. This assumption ignores the fact that increasing enforcement uses real resources—hiring auditors and requiring taxpayers to spend time—that could be used more productively elsewhere. Instead, experts advise that enforcement spending should increase only to the level where the total cost of an additional dollar of revenue gained by enforcement just equals the cost of raising an additional dollar of revenue through some other means, for example by an increase in tax rates. Economists generally believe that most taxes reduce productive economic activity so that the true cost of raising a dollar of tax revenue through the tax system exceeds a dollar—typical estimates of the total cost range between $1.30 to $1.50. From this perspective, enforcement efforts should be increased only to the point where an additional dollar of enforcement still brings in more than the cost of raising a dollar of revenue. In addition, one must consider that the direct costs of additional enforcement are only one part of the total costs of increased auditing. An increase in audits has its downside, as it could be viewed as intrusive and onerous for taxpayers.

d. Option 2: Increase Information Reporting and Source Withholding

Comprehensive third-party information reporting is an important component of achieving a high rate of voluntary compliance. Tax compliance is extremely high for taxpayers subject to withholding and third-party information reporting. As discussed earlier, among workers whose wage income is reported on Form W-2, the noncompliance rate is only about 1 percent. Compliance is low where the IRS does not receive third-party reporting, or where that reporting is incomplete.

The proposal and its advantages:

Expanding information reporting to income sources with little third-party coverage would improve compliance and reduce the tax gap in those areas without the need for additional audits. For example, the new provisions in FATCA will significantly help the IRS to look through financial intermediaries to identify U.S. persons. Historically, however, reporting for international transactions has not been strong; a further enhancement could be made by imposing a requirement to report on international wire transfers by financial institutions.

In addition, expanded use of reporting on independent contractors by businesses could reduce underreporting in traditionally cash businesses. Requiring withholding on large payments to independent contractors and business-to-business payments could further increase compliance, although it could have adverse impacts on independent contractors, especially those who provide combinations of goods and services.

Disadvantages:

Third-party reporting imposes burdens on third parties—generally businesses but potentially individuals—as well as the IRS. Like enforcement costs, the cost of reporting is a real social cost. Expanded reporting on independent contractors would be burdensome for many individuals who are not currently required to do such reporting. Because of expansions of information reporting in recent legislation, the potential for further requirements may be more limited.

e. Option 3: Small Business Bank Account Reporting

Underreporting of small business income makes up 44 percent of the tax gap–the largest source of underreported income. Small business owners do not typically receive wages and salaries that are reported to the IRS and subject to withholding. In addition, many payments to small businesses are not subject to information reporting, so the accuracy of this information on a business taxpayer's return cannot be verified based on third-party reported information. This provides opportunities for taxpayers to underreport their income and makes it difficult for the IRS to identify noncompliance.

The proposal and its advantages:

In conjunction with a simplified tax accounting system for small businesses that permits cash accounting (described in the section on tax simplification), a small business would be required to use a designated bank account for all business receipts and expenditures that is segregated from any personal bank account. The bank would be required to report the receipts and expenditures within the designated account annually.

The proposal would offer both simplification and compliance improvements. As described above, simplified cash accounting for small businesses would allow business owners to dispense with many onerous tax accounting provisions, as their checkbook account would effectively provide all their tax records. Moreover, allowing businesses to expense certain depreciable business assets could provide a positive incentive in the form of better cash flow and lower effective tax rates to opt in to the system.

Disadvantages:

Bank account reporting would require millions of small businesses to open and pay for separate accounts. Additionally, many sole proprietorships use bank accounts and credit cards for both personal and business use. Requiring separate business accounts would have less impact on intentional noncompliance than on inadvertent noncompliance.

f. Option 4: Clarifying the Definition of a Contractor

Businesses are required to withhold income and payroll taxes on behalf of their employees, but are not required to do so for independent contractors. (In addition, a business must fulfill requirements under labor laws for employees that generally would not apply to contractors.) The distinction between an employee and a contractor is therefore important for the withholding of taxes and reporting of income—which are crucial for ensuring tax compliance—and for applying labor laws such as minimum wages, workplace safety, or eligibility for unemployment benefits.

However, the rules for distinguishing between independent contractors and employees are complicated, based on longstanding common law, and depend on as many as 20 factors related to the relationship between the worker and the business that frequently must be applied on a case-by-case basis. In addition, the rules for distinguishing employees and contractors are different for income taxes and payroll taxes and for purposes of labor laws. Moreover, some rules apply to all workers, while other rules exclude specific categories of workers, such as engineers, designers, or programmers. Additionally, for businesses that have historically classified workers as independent contractors, a special provision (Section 530 of the Revenue Act of 1978) provides a "safe harbor" exception from the usual 20-factor test. Under the safe harbor, the IRS may not reclassify workers as employees—even prospectively or for newly hired workers.

Because independent contractors are not subject to withholding and information reporting is less comprehensive, inadvertent misclassification of workers as independent contractors because of complexity and the classification of employees as contractors at firms "grandfathered" under the safe harbor rules tends to reduce tax compliance. Existing rules sometimes also place firms classifying their workers as employees at a competitive cost disadvantage relative to other firms that classify their workers as contractors.

The proposal and its advantages:

Repealing the common law rules and allowing the IRS to publish guidance on worker classification would reduce misclassification and disputes. Clarification of the distinction between employees and contractors and the elimination of the Section 530 safe harbor would improve tax compliance and help reduce the tax gap. Applying the same rules equally to all firms would help to level the playing field between employers who treat workers as employees versus those who classify them as contractors.

Disadvantages:

Eliminating the Section 530 safe harbor provision would almost certainly lead to many more workers being classified as employees rather than contractors, requiring some burdensome changes for both employees and employers, even for those already in compliance with their taxes. (The majority of firms and workers, however, already abide by these conditions.) Conversely, repealing the common law rules for worker classification with its necessary concurrent simplification and safe harbor rules would undoubtedly allow service providers and service recipients together (or service recipients alone) to develop work arrangements so that more workers would be treated as independent contractors. Such workers would lose the benefits of the social safety net—including workers' compensation, unemployment insurance benefits, and various federal, state and local health and safety provisions—available for workers classified as employees.

g. Option 5: Clarify and Harmonize Employment Tax Rules for Businesses and the Self-Employed (SECA Conformity)

Self-employed individuals pay employment (payroll) taxes on their self-employment income under the Self Employment Contributions Act (SECA) just as employers and employees pay employment taxes on wages paid to employees. Similarly, general partners in a partnership (such as lawyers at a law partnership) are generally subject to employment taxes on payments they receive from the partnership. However, limited partners and S corporation shareholders are exempt from these rules, and the law for owners of limited liability corporations (LLCs) is unclear. Owners of S corporations instead are instructed to pay themselves "reasonable compensation" and must pay employment taxes upon that amount, like any other employee. This differential treatment provides incentives for shareholders of S corporations to underreport their compensation and instead receive their business income as distributions that are not subject to employment tax. This may result in lower effective tax rates on shareholders in S corporations and members of LLCs than in other businesses or the self-employed. At present, general partners pay employment tax on 100 percent of their active earnings while other types of owners may pay little or nothing.

The proposal and its advantages:

This option would require all partners, LLC members, and S corporation shareholders to pay self-employment taxes (SECA) on the distributions from their businesses (other than those who do not materially participate in the business). This would essentially apply the same tax treatment to LLC members, limited partners, and S corporation shareholders that currently applies to the self employed and to general partners. (Exclusions in current law for specified types of income or loss such as interest and rental income would remain in effect.) This would improve the equity and fairness in the tax system by treating general partners, limited partners, LLC members, S corporation shareholders, and self-employed workers equally.

The proposal would raise considerable revenue—perhaps $50 to $60 billion over ten years—by limiting the underreporting of reasonable compensation by S corporation shareholders, the lack of employment tax clarity for LLC members, and the potential for tax avoidance by limited partners.

In addition, this option would eliminate the difficult-to-administer concept of "reasonable compensation" for most taxpayers and would clarify and simplify rules for LLC members and limited partners. The proposal also eliminates employment taxes as a distortion in the choice of organizational form.

Disadvantages:

The revenues raised from the proposal would come primarily from owners of small businesses. Moreover, it would impose employment taxes on income that is partially a return on capital rather than a return on labor. Providing an exclusion for invested capital is possible, but could be difficult and complicated to calculate and administer.

h. Option 6: Voluntary Disclosure Programs

Voluntary disclosure programs or temporary tax amnesties have been proposed as a means to bring non-compliant taxpayers back into the tax system, and increase future compliance and revenues. Under such programs, taxpayers who voluntarily come into the tax system and pay the taxes they owe would be subject to reduced penalties or in some cases no penalties at all. State governments and many foreign governments have used amnesties in the past, and the federal government recently provided a period of voluntary disclosure for taxpayers hiding income abroad.

The proposal and its advantages:

These programs could increase revenues in the near term and improve future compliance by bringing tax evaders back into the system and informing tax administrators about tax evasion practices. The most effective programs generally involve increased future enforcement or penalties to discourage taxpayers from waiting for the next voluntary program.

Disadvantages:

In practice, the evidence on these programs is mixed. Most states (and certain foreign countries) have offered multiple programs, which may actually provide incentives for continued evasion to the extent that taxpayers believe they will be forgiven in the future. The experience of states is that most taxpayers using these programs were already filing taxes and only amended old returns; few new taxpayers were brought in. Even the revenue supposedly received from amnesties is subject to debate. Much amnesty revenue merely represents accelerated receipt of revenue that would have been paid later as the result of enforcement activities, and the benefits of amnesties for revenue purposes are reduced by the forgiveness of interest and penalties that would otherwise be received.

i. Option 7: Examine Multiple Tax Years During Certain Audits

Currently, the statute of limitation for auditing individuals and businesses extends back only three years. Given the long lag in information gathering and processing, auditors may be able to investigate only one year of tax records before the limit runs out, even if noncompliance is discovered that might have occurred in prior years as well. The limit can be extended back to six years if noncompliance greater than 25 percent of total liability is found, but this is a high threshold. Thus an auditor who discovers a pattern of noncompliance that was likely to have occurred in many years cannot look for that pattern in prior returns.

The proposal and its advantages:

Multi-year audits are generally used for larger businesses. Expanding their use to smaller businesses and individuals would reduce noncompliance and would enable the IRS to use audit resources more efficiently. In addition, a longer statute of limitations where there are adjustments by a state that could affect federal liability, as proposed in the Administration's Budget, would also facilitate multi-year audits and could increase IRS audit efficiency. Another option is to lower the threshold for IRS auditors to re-open earlier returns when they have found noncompliance. The current standard is quite restrictive so that IRS agents are rarely able to go back beyond the three-year open period.

Disadvantages:

A longer statute of limitations could be more burdensome for taxpayers required to keep records. An extension without conditions might be seen as reducing the incentive for the IRS to initiate and resolve enforcement actions promptly.

j. Option 8: Extend Holding Period for Capital Gains Exclusion on Primary Residences

Homeowners may exclude up to $500,000 ($250,000 for a single individual) of capital gain from the sale of principal residences provided the home was their principal residence in two of the last five years, and the exclusion may be used every two years. The relatively short holding period requirement of two years and the potential for repeat use every two years invites abuse of the provision. Some homeowners may seek to convert rental or vacation properties into principal residences. Builders or serial fixer-upper specialists may also use the provision to get tax-free earnings from building or remodeling homes by living in them for two years.

The proposal and its advantages:

The 2005 Tax Reform Panel and experts we heard from proposed lengthening the required holding period to three years out of six, or four years out of seven, and also increasing the time between uses. A longer holding period would limit abuses. Taxpayers in hardship situations would still be eligible for a pro-rated maximum exclusion if forced to sell due to death of a spouse, divorce, job change or other reasons currently allowed by IRS regulations. Other studies have suggested improved information reporting of principal residence sales could improve compliance. This change could be implemented in conjunction with increasing or indexing the maximum exclusion as discussed earlier under simplification options.

Disadvantages:

Lengthening the holding period could increase taxes on some taxpayers who move more frequently but do not qualify for one of the exceptions.

IV. CORPORATE TAX REFORM

The United States has the second highest statutory corporate income tax rate in the Organization for Economic Co-operation and Development (OECD) behind Japan. Despite the high statutory rate, the average effective tax rate paid by corporations is close to the OECD median, and the corporate tax raises relatively little revenue—the fourth lowest in the OECD as a share of GDP. One reason for this apparent incongruity is that the corporate tax base is relatively narrow compared to the size of the business sector. About half of business income now accrues to "pass-through" entities like S corporations and partnerships; although the income of such pass-through entities is subject to tax at the individual level, it is excluded from the corporate tax. In addition, the business tax system—which often applies to non-corporate businesses as well as corporate businesses—has numerous provisions for special deductions, credits, and other tax expenditures that benefit certain activities. These provisions reduce the effective tax rate below the statutory rate.

The combination of a high statutory rate and numerous deductions and exclusions results in an inefficient tax system that distorts corporate behavior in multiple ways. The high statutory corporate tax rate reduces the return to investments and therefore discourages saving and reduces aggregate investment. Base-narrowing features of the business tax system create incentives that favor debt over equity, encourage investment in tax-favored equipment and certain other assets over other kinds of investment, and drive capital out of the corporate sector into non-corporate forms of business. Additional inefficiencies result from the way the U.S. taxes the foreign income of U.S. multinational corporations (MNCs), and from differences between the U.S. approach and the way other nations tax the foreign income of their companies.

Distortions in the corporate tax system have deleterious economic consequences. Because certain assets and investments are tax favored, tax considerations drive overinvestment in those assets at the expense of more economically productive investments. Because interest is deductible, corporations are induced to use more debt, and thus become more highly leveraged and take on more risk than would otherwise be the case. Because the corporate tax results in higher effective rates on corporate businesses, business activity and investment are shifted to non-corporate businesses like partnerships and S corporations, or to non-business investments like owner-occupied housing.[8] Because MNCs do not pay income taxes on income earned by foreign subsidiaries until that income is repatriated, those firms have incentives to defer repatriation, to shift taxable profits to low-tax jurisdictions, and to engage in costly tax planning; nevertheless, the system of international taxation makes U.S. MNCs less competitive in foreign markets and even at home. Because of its complexity and its incentives for tax avoidance, the U.S. corporate tax system results in high administrative and compliance costs by firms—costs estimated to exceed $40 billion per year or more than 12 percent of the revenues collected. All of these factors act to reduce the productivity of American businesses and American workers, increase the likelihood and cost of financial distress, and drain resources away from more valuable uses. Most of these distortions also affect businesses beyond the corporate sector.

8 The reduced individual income tax rate on dividends and capital gains provides partial relief from the combined effects of the individual and corporate income taxes on the after-tax returns to investment in the corporate sector.

The experts we spoke to believe that the current corporate tax system is deeply flawed and in need of reform. We heard repeatedly that reforms that move the business tax system from one with a high tax rate and a narrow tax base to one with a broader tax base and a lower tax rate could correct a number of distortions associated with the current system. We also heard from business representatives that the distinctive U.S. approach to taxing the foreign income of U.S. multinationals was putting them at a competitive disadvantage in their foreign operations. Some experts and business representatives argued that moving toward a territorial system like that used by most other developed nations could reduce this disadvantage, while others advocated a worldwide tax system at a lower rate to achieve the same objective.

a. Overview of the Corporate System

U.S. corporations pay taxes on their taxable income—total receipts minus costs of doing business and other deductions including wages, raw materials and supplies, depreciation, and interest expense—on a progressive scale with a top statutory federal rate of 35 percent. State corporate taxes increase the average overall top statutory rate to just over 39 percent. Compared to other developed countries, the U.S. statutory tax rate is high: the median statutory corporate rate in 2009 among OECD countries was 28 percent.

However, the effective federal tax rate on new investments by corporations is actually lower than 35 percent because of tax credits and deductions that reduce taxes owed. After factoring in these deductions and the benefits of financing investments using debt, the overall effective marginal tax rate on new investments in the corporate sector is about 29 percent according to one recent Treasury study.

This rate is still higher than the tax rate on comparable investments by non-corporate businesses or on other non-business investments, in part because business income earned by businesses in corporate form is subject to two layers of taxation: corporations pay tax on their corporate income and then individuals pay tax on distributions from corporations (on dividend payments) or on the capital gains from appreciated corporate stock. In contrast, business income earned by sole proprietorships, partnerships, and S corporations is "passed through" to the tax returns of the business owners. Although such pass-through businesses generally calculate income in the same way as corporations (using the same accounting rules and benefiting from the same deductions and credits), if the owners are individuals, the business income from these sources is taxed only once at the individual level.

One result of this system is that tax burdens on capital income in the non-corporate sector (i.e., businesses not operated through "C corporations") are lower than in the corporate sector.[9] This favors new investments and new business formation in non-corporate businesses relative to corporate businesses. Indeed, business income accruing to these non-corporate businesses has increased

9 Economists generally believe that part of the burden of the corporate income tax is ultimately shifted to owners of other types of capital, including the owners of pass-through businesses organized as partnerships, LLCs or sole proprietorships. This shifting occurs because the shift of investment from the corporate sector to the non-corporate sector reduces the rate of return in the non-corporate sector and thus reduces the after-tax returns of those business owners.

over time, and they accounted for about half of all net business income in 2007, up from about 20 percent in 1980. In 2004 among a sample of OECD countries, the U.S. had the highest share of businesses with profits of $1 million or more that were not incorporated (66 percent in the U.S. compared to 27 percent in Mexico (the second highest share) and 26 percent in the U.K.).

Another feature of the current tax system is that interest paid by businesses (both corporate and non-corporate) is deductible, but dividend payments are not. Thus businesses have incentives to favor debt finance rather than equity finance, even after taking into account the personal income tax, which taxes interest income more heavily than dividends and capital gains. The current system therefore results in high effective tax rates on equity-financed investments and low effective rates on debt-financed investment. This provides incentives for businesses to finance new investments with debt, and to maintain a higher level of debt in their capital structure, increasing the likelihood of financial distress and bankruptcy.

Many additional inefficiencies resulting from the corporate tax system arise from provisions that confer favorable treatment on certain business activities or expenditures but not on others. For example, the cost of investments in plant and equipment are recovered over time through depreciation allowances whereas investments in certain intangible assets like research and development and advertising are deducted immediately. Depreciation schedules for some tangible assets reflect depreciation rates that are faster than true economic depreciation (the real decline in the asset's value over time), while those for other assets reflect slower rates. Income from certain activities is also taxed at lower rates because of a special deduction for domestic production activities. Businesses may also claim tax credits for certain activities, for example, for research and experimentation or for low-income housing investment. As a result of these and other special provisions in the tax code, income from different types of assets is taxed at very different rates. Moreover, the corporate tax and other business taxes shift capital from manufacturing and services to owner-occupied real estate, which is subsidized in other ways by the tax system. While most of these discrepancies affect both corporate and non-corporate businesses, their effect is magnified for the former as a result of the additional, entity-level taxation for such businesses.

Overall, the current corporate tax system contains numerous provisions that encourage businesses to invest in certain kinds of assets or to engage in certain kinds of activities for tax reasons rather than for reasons of economic efficiency.

Table 7 shows the effective marginal tax rates—the tax rates that apply to an additional dollar of investment in various types of assets—that result from the current system as estimated in a recent Treasury study. The table shows that corporate businesses face higher effective marginal tax rates than non-corporate businesses; that equity-financed corporate investments face much higher effective marginal tax rates than debt-financed investments; and that the effective marginal tax rate on owner-occupied housing is close to zero. Within corporate businesses, tax rates also vary significantly by asset type and, as will be seen later, even on an asset-by-asset basis.

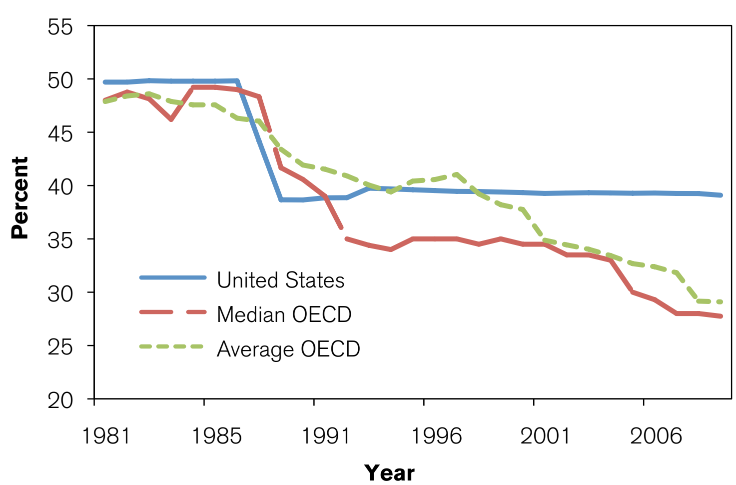
Table 7: Marginal Effective Tax Rates on New Investment

	Effective Marginal Tax Rate
Business	**25.5%**
Corporate Business	29.4%
Asset Type	
Equipment	25.3%
Structures	34.2%
Land	32.9%
Inventories	32.9%
Financing	
Debt financed	-2.2%
Equity financed	39.7%
Non-corporate Business	20.0%
Owner-occupied housing	**3.5%**
Economy wide	**17.3%**

Source: Treasury Conference on Business Taxation and Global Competitiveness: Background Paper. U.S. Department of the Treasury, Office of Tax Analysis 2007.

The U.S. system for taxing the foreign-earned income of domestic corporations is also a source of inefficiency. The U.S. taxes the foreign-earned income of domestic corporations not when the income is earned but when the resulting profits are repatriated to the United States. However, the U.S. statutory rate is high compared to other OECD countries, which have reduced their statutory rates (as seen in Figure 4) and have offset some of the revenue loss by broadening the corporate tax base.

Figure 4: Top Statutory Corporate Tax Rates U.S. and OECD



Notes: Selection of OECD countries with data available from 1981 to 2009. OECD average is weighted by 2007 GDP in PPP excluding U.S. Corporate tax rates include both national and subnational taxes.

Source: OECD.

As a result of these differences between the U.S. and the OECD countries, U.S. firms operating abroad report that they often face higher effective tax rates on their overseas activities than foreign competitor firms. In addition to affecting the international competitiveness of U.S. firms, the growing gap between the U.S. corporate tax rate and the corporate tax rates of most other countries generates incentives for U.S. corporations to shift their income and operations to foreign locations with lower corporate tax rates to avoid U.S. taxes. Over time as corporate tax rates have fallen around the world, these incentives have become stronger.

An important consideration when addressing the above issues through reform is the problem of transition. Many of the proposals discussed below result in shifting tax burdens, with certain businesses facing higher tax burdens and others facing lower ones. Those facing higher burdens will naturally seek relief. However, transition relief to address such issues could decrease revenues or could reduce the gains from such changes if transition relief necessitated higher corporate tax rates to maintain overall corporate tax revenues.

b. Option Group A: Reducing Marginal Corporate Tax Rates

The high effective tax rates that apply to corporate investments result in significant economic distortions and a lower tax rate on corporate investments would result in desirable changes in a number of areas. The two most feasible and effective ways to reduce the tax rate on corporate investments are to reduce the statutory corporate tax rate directly or to increase the value of deductions corporations may take for new investment. Because the high statutory corporate tax rate in the U.S. causes or exacerbates many distortions in the current tax system, lowering the rate would reduce these inefficiencies. Alternatively, providing accelerated depreciation or immediate expensing of corporate investments would result in similar improvements in efficiency. Reducing effective marginal tax rates without significant revenue losses would require applying the tax to a broader income base, and a discussion of options to broaden the base are included in Option Group B.

i. Option 1: Reduce the Statutory Corporate Rate

The proposal and its advantages:

In this option, the top statutory corporate tax rate would be lowered from 35 percent. Each percentage point decrease in the corporate tax rate reduces corporate tax revenues by about $120 billion over 10 years.[10] In a revenue-neutral reform, these revenue losses could be offset by base broadening measures like those described in Option Group B.

Lowering the top rate would reduce the cost of a number of significant economic distortions. In the aggregate, a lower corporate rate would lower the overall tax on capital, encouraging saving and new investment. The additional saving and investment by corporations would increase the stock

10 This exercise assumes that the top two corporate tax bracket rates (currently 34 percent and 35 percent) are each reduced by one percentage point.

of available capital—new businesses, factories, equipment, or research—improving productivity in the economy.

Reducing the corporate rate would also reduce the relative advantages of alternative investments. This is important because investment decisions should reflect their economic return rather than their tax advantages. First, a lower rate would help level the playing field across corporate and non-corporate investment and would reduce the incentive for businesses to organize in non-corporate forms. This would contribute to a more efficient allocation of resources between the corporate and non-corporate sectors and could encourage the expansion of the corporate sector with resultant increases in corporate tax revenues over the long term. Second, a lower corporate tax rate would reduce the relative advantage of investments in non-business assets like residential real estate. Residential real estate is already heavily tax advantaged, and many experts believe that as a result of these tax subsidies, investments in owner-occupied real estate provide a lower economic return than investments elsewhere. Third, a lower corporate tax rate would reduce the incentive to use debt rather than equity to finance new investments. This could result in lower debt levels, reducing the likelihood of financial distress at over-levered firms, and resulting in lower aggregate risks from corporate bankruptcies. Finally, in the international context, a lower corporate rate would lower the cost of capital for American firms, making them more competitive in relation to foreign firms both abroad and at home. It would also reduce the incentives of U.S. companies to shift operations abroad and to structure their operations and finances to shift profits to lower-tax jurisdictions abroad, or for foreign companies to acquire U.S. companies or their foreign subsidiaries.

Disadvantages:

A reduction in the corporate tax rate would have several disadvantages as well. First, as already noted, it would reduce tax revenues significantly, and this revenue would need to be replaced to avoid increasing the federal deficit. Second, it would reduce taxes on investments already made by existing companies. As a result, compared to other more targeted tax cuts to encourage investment, a reduction in the corporate tax rate would have a smaller incentive effect on new investment per dollar of tax revenue lost. Third, lowering the corporate rate to a level well below the top individual income tax rate could encourage both the shifting of income from the individual income tax base to the corporate tax base and the sheltering of income in corporations, although the incentive of individuals to shift income would be limited by the double taxation when they want to consume those funds.[11]

11 For example, if the top individual tax rate increased to 39.6 percent and the top corporate rate fell to below 30 percent or so, some individuals would find it advantageous to reorganize their business activities as C corporations. This would allow them to pay the lower corporate tax rate on their business earnings and to defer payment of tax at the individual rate until the earnings were distributed or the stock of the corporation were sold. Deferral would reduce the present value of the individual income tax liability. Moreover, the tax could be eliminated if the individual held the stock for life, because the tax basis of the stock would be stepped up to the fair market value upon the death of the individual shareholder. While existing law limits to some extent the ability to accumulate earnings in a corporation, additional safeguards could be required to prevent revenue loss if the disparity between corporate and individual rates were sufficiently large.

ii. Option 2: Increase Incentives for New Investment/Direct Expensing

The proposal and its advantages:

Reducing the tax burden only for new investment is an alternative approach to reducing the effective tax rate on corporate income. Businesses could be allowed to "expense" all or a portion of their new investment immediately—i.e. to deduct the cost of investment against taxable income in the year the investment was made instead of recovering it gradually over many years. The business tax system already allows a number of variants of this idea through accelerated depreciation (allowing businesses to take depreciation allowances faster than implied by true economic wear and tear) and temporary bonus depreciation (allowing firms to immediately expense 50 percent of new investment during the previous recession); smaller businesses are also currently allowed to immediately expense certain investments up to a limit. In fact, these provisions are the largest tax expenditure for businesses: prior to the recession, a Treasury study estimated that accelerated depreciation and expensing provisions (excluding temporary provisions enacted for economic stimulus) reduced revenues by more than $660 billion over ten years.

In addition to many of the advantages of cutting the corporate tax rate described above, expensing could provide more investment per dollar of tax revenue lost than simply cutting the corporate rate because "old capital" would not receive a tax break. Providing expensing for physical capital would also eliminate the differential tax treatment between investments in physical capital, which are currently deducted over many years, and investments in certain intangible capital (like research and development, or advertising), which businesses can currently deduct immediately. Immediate expensing of investment also has cash flow benefits for businesses because the tax deduction is received in the tax year in which an investment is made rather than in future years. In the international context, lower rates on new investments would make the U.S. more attractive for foreign and domestic investors.

Disadvantages:

Expensing would reduce revenues by allowing firms to deduct the cost of their investments more rapidly against their taxable income. Some industries would benefit more than others from this treatment: some argue that expensing would disproportionately benefit capital-intensive industries that make significant investments in physical capital compared to high-tech industries and industries that primarily invest in intangible and intellectual capital. But it is the capital intensive industries that are relatively disadvantaged by the high corporate tax rate and their differential tax treatment in the current system. Allowing expensing for new investment would lower the value of existing assets because existing capital would not benefit from expensing and would have to compete with new capital that does.

Allowing for immediate expensing of new investment while retaining the deductibility of interest would maintain or could even increase the incentives for debt financing in the corporate tax system. This disadvantage could be mitigated by reducing the deductibility of net interest as discussed below.

Business owners commonly regard expensing as a less attractive or powerful incentive for investment than a reduction in the tax rate on their business income. Expensing provides only a temporary reduction in taxes since it only accelerates the same amount of deduction. Under accounting rules, this means that expensing would not allow a business to show any increase in current earnings since an offsetting allowance is made for the additional taxes to be paid later. In addition, some business people argue that an important part of the incentive to invest is the pursuit of an above-normal rate of return. While a lower corporate tax rate would increase the incentive to pursue above-normal returns, the expensing of new investment would not.

Finally, allowing for the expensing of new investment or accelerated depreciation on new investments does not address issues related to the tax treatment of foreign source income the way that rate reduction does, because MNCs would still face higher taxes on their operations abroad than would their international competitors.

c. Option Group B: Broadening the Corporate Tax Base

Eliminating or limiting deductions, credits, and other base-narrowing features of the corporate income tax would allow for a lower corporate rate and could improve the incentives in the tax system. When other countries reduced their corporate tax rates over the past decade, they usually offset the revenue loss with measures to broaden the tax base through the repeal or reduction of various tax credits and deductions. (They also increased revenues from other sources.) As a result, the U.S. corporate tax base is now narrower than in many other countries. Our discussions with experts identified several ways to broaden the corporate tax base that would allow the same amount of tax revenue to be raised while lowering the corporate tax rate. In addition, a broader tax base would make the corporate tax more neutral across investment types and sectors of economic activity, and this is an important goal in itself because it reduces economic distortions.

Broadening the corporate tax base, however, is more difficult than simply eliminating "loopholes," or tax provisions that corporations use to avoid the taxes lawmakers intend them to pay. In fact, most provisions that narrow the corporate tax base are intentional—deductions, credits, or other provisions enacted to reduce taxes for certain businesses or industries or certain activities that are often referred to as "tax expenditures" and should be distinguished from "loopholes." In contrast to the individual tax code, which includes many sizable tax expenditures, there are a relatively small number of potential changes to the corporate tax code that could broaden the corporate tax base significantly. We considered a few of the large base-broadening changes (each of which could be scaled up or down in size). And we also considered a few specific tax expenditures to give some examples and to show how eliminating these expenditures individually would not raise large amounts of additional revenue and would need to be combined to have a meaningful impact on revenues.

i. Option 1: Provide More Level Treatment of Debt and Equity Financing

The tax code encourages debt relative to equity. Corporate dividends paid are not deductible at the corporate level. In contrast, corporations can deduct interest payments. Consider an investment that requires $1,000 today and will pay off $1,100 in the future. If financed by equity, a corporation would pay $35 in taxes (35 percent on the $100 profit) and pay out $65 as a dividend to shareholders. If financed by borrowing at 10 percent, the corporation would deduct $100 in interest payments made to the debt holder against the $100 profit—resulting in zero corporate taxes. Indeed, the combination of the deductibility of interest and depreciation reduces the cost of debt capital to what it would be with no corporate tax. When combined with accelerated depreciation and other provisions, however, the deductibility of interest makes the cost of capital even less than it would be with no corporate tax. In fact, according to Treasury studies, for certain firms the effective marginal tax rate on debt-financed investment is negative (the investments are subsidized) as deductions for interest, together with deductions for items such as accelerated depreciation, more than offset the income generated from debt-financed investment. In contrast, the average tax rate on equity financed investment is much higher and still positive even with accelerated depreciation.

The proposal and its advantages:

Limiting the deductibility of net interest (i.e., the excess of interest expense over interest income) would broaden the tax base and provide more level treatment of debt and equity. As an illustrative example, one option would be to limit the deductibility of net interest to 90 percent of expense in excess of $5 million per year (i.e. a business with $15 million of interest expense would be allowed to deduct the first $5 million and then $9 million (90 percent) of the remaining $10 million). Ignoring likely behavioral responses, a rough (static) computation suggests that this proposal would raise corporate tax revenues by enough to reduce the corporate rate by about 0.7 percentage point. If the same rules applied to non-corporate businesses, revenues would be increased somewhat more.

A limitation on net interest deductibility would lessen the bias against equity financing and could reduce dependence on debt, thereby reducing the leverage of firms and the likelihood of future financial distress. Limiting the deductibility of net interest would also level the playing field to some extent between business projects financed by debt and business projects financed by equity and between firms that have easy access to debt financing and those that do not.

If the deductibility of net interest expense were limited, MNCs would have a reduced incentive to shift borrowing to the U.S. to reduce domestic tax liability. In the current system, MNCs can raise debt capital in U.S. markets, deduct the interest expense at the 35 percent U.S. rate against taxable U.S. earnings, and invest the proceeds abroad, and the earnings from that investment can be deferred and can avoid U.S. taxation indefinitely.

Some other countries impose limits on the deductibility of interest expense. For example, Germany imposes a limit on net interest expense. Interest expense generally is allowed up to the level of interest income received. Above that, interest expense in excess of 30 percent of earnings is disallowed subject to a number of exceptions including a "small business" exception.

The introduction of a limit on the deductibility of net interest expense would require consideration of the treatment of small firms, which rely more heavily on debt financing; one option would be to impose the limitation on the deductibility of interest expense only above some threshold—like the $5 million threshold in the example above. (If the interest rate were 5 percent, a $5 million threshold would exempt a business with as much as $100 million in debt.) Furthermore, policymakers would need to decide whether to apply an interest limit on all business entities or only on corporations. The advantages of applying the limit to all businesses are similar to those for corporations—such as a lower reliance on debt, reduced risk of bankruptcy, and higher revenues. In addition, applying the same rules to all businesses would reduce the options for tax avoidance or tax arbitrage, and harmonized rules would be simpler to enforce. Other types of limits on interest deductions sometimes proposed include denying the interest deduction for the inflationary component of the interest rate and limiting the interest deduction to the interest rate on Treasury securities on the grounds that higher interest rates represent a higher risk premium that is more like an equity return. The effects of different kinds of limits on interest deductions would have to be studied more carefully for their possible economic consequences.

Disadvantages:

Limiting the deductibility of net interest would have different effects on different sectors, raising taxes more for some than for others. For example, limitations on net interest would yield higher tax burdens on manufacturers and utilities, which are firms with significant investments in physical capital that are frequently debt financed. An abrupt change that disallowed some or all interest expense would have significant short-term impacts on the profitability of firms relying on debt financing. Thus the transition from the current system to a system with limitations on net interest deductions would be difficult for firms with debt in their capital structure, and transitional relief and a period of time for firms to adapt their capital structure could be appropriate. Small businesses also rely heavily on debt financing, and limiting interest expense deductions could reduce their access to capital and discourage the formation of new firms. All else equal, like other base-broadening measures, limiting the deductibility of net interest would increase the effective tax rate on capital investments unless offset by a lower corporate tax rate. Finally, limiting deductions for interest expense would create incentives for firms to replace interest expense with other expenses like leasing arrangements, which achieve the same effect but which would remain deductible expenses.

ii. Option 2: Review the Boundary Between Corporate and Non-Corporate Taxation

Another factor that has contributed to the erosion of the corporate income tax base has been the growth of non-corporate businesses (non-C corporations) including partnerships, LLCs, S corporations, and other pass-through entities. Such businesses pay no separate corporate income tax, and their income is taxed at the owner level. Many of these entities provide the legal benefits of limited liability, but their earnings are generally taxed only once—on the tax returns of their owners.[12] Indeed, pass-through entities now account for nearly half of business income in the U.S. and about

12 Corporations can be and often are partners in partnerships, thus partnership income may be subject to the corporate tax. When all partners are C corporations, such as in a joint venture, all of the partnership income is subject to the corporate tax. Overall, as much as 15 to 20 percent of the pass-through income may ultimately be subject to the corporate tax.

one-third of receipts (see Table 8).[13] Changes at the federal and state level have allowed more businesses to operate in pass-through form.[14] We are now in a situation in which the corporate income tax bill is paid predominantly by the largest corporations: in 2006, 85 percent of corporate income taxes were paid by less than 0.5 percent of all C corporations—fewer than 10,000 firms.

Table 8: Shares of Total Business Returns, Receipts and Net Income, 1980-2007

	1980	1990	2000	2007
S Corporations				
Returns	4%	8%	11%	12%
Total Receipts	3%	13%	15%	18%
Net Income (less Deficit)	1%	8%	14%	14%
Partnerships[a]				
Returns	11%	8%	8%	10%
Total Receipts	4%	4%	9%	12%
Net Income (less Deficit)	3%	3%	18%	23%
Sole Proprietorships				
Returns	69%	74%	72%	72%
Total Receipts	6%	6%	4%	4%
Net Income (less Deficit)	17%	26%	15%	10%
C Corporations[b]				
Returns	17%	11%	9%	6%
Total Receipts	87%	78%	72%	66%
Net Income (less Deficit)	80%	62%	53%	53%

a. Includes LLCs & LLPs.

b. Includes 1120-RIC and 1120-REIT.

Source: Internal Revenue Service, Statistics of Income, www.irs.gov/taxstats.

A goal of reform in this area is tax neutrality with respect to organizational form. Many individuals with whom we met suggested that it was neither fair nor good tax policy for businesses of similar size and engaged in similar activities to face different tax regimes and different tax rates. Steps toward neutrality—harmonizing the rules and effective tax rates—for corporate and non-corporate businesses could be taken in a number of ways.

The proposals and their advantages:

One option would be to require firms with certain "corporate" characteristics—publicly traded businesses, businesses satisfying certain income or asset thresholds, or businesses with a large number of shareholders—to pay the corporate income tax. In effect, this would broaden the corporate tax base by applying the corporate tax to more businesses.

Since a primary distinction in determining whether a business is treated as a corporation for federal tax purposes has been access to public capital markets, the conditions under which firms can access public capital markets without being subject to the corporate tax could be reconsidered. A

13 These figures do not remove the double-counting that can result from tiered partnerships or S corporations owning partnership interests.

14 These include the Tax Reform Act of 1986, the adoption of limited liability company legislation by all states by the end of the 1990s, the expansion of eligibility for S corporation status in 1996, and the adoption of "check-the-box" by the IRS in 1997.

straightforward approach would end the current law exemptions for entities with certain types of income (natural resource or portfolio-type income) from the requirement that publicly traded entities be taxed as corporations. A more limited version of this, as reflected in several bills introduced in Congress, would remove the publicly traded partnership (PTP) exception for partnerships with passive-type income derived from providing investment adviser and related asset management services. This change would eliminate the distortions that result from different tax treatment for PTPs and from businesses that provide similar services and operate in similar ways.

Alternatively, company size or the number of shareholders could be considered as a basis for corporate taxation, with the corporate tax rate applied to firms above a certain size or with more than a specified number of shareholders. There may also be some industry or sector situations in which imposing the corporate tax might be appropriate, such as for very large S corporation banks or credit unions.

An alternative option would eliminate the double taxation of corporate income and harmonize tax rates on corporate and non-corporate income through "integration" with the individual income tax. In one example of such a system, individual investors would be credited for all or part of the tax paid at the corporate level against their individual taxes. A number of OECD countries—the U.K., Canada, and Mexico for example—have used such a system. In such a system, the effective tax burden on corporate businesses would be reduced relative to the tax burden on non-corporate businesses and the lost corporate revenues could be recouped at the individual level through higher rates on dividends or higher marginal rates. If the credit was not available for foreign shareholders, a higher corporate rate would not raise the tax on U.S. shareholders.

Disadvantages:

Achieving neutrality between corporate and non-corporate businesses by subjecting more businesses to the corporate tax would increase the cost of capital and thus decrease investment in those businesses. In particular, imposing an additional level of tax on PTPs would likely discourage the flow of equity into such investments. If corporate tax status were based on an income or asset threshold, complexities would be numerous. For instance, if a firm's activities fluctuated above and below such thresholds, rules would be needed to address frequent conversions. Also, rules would be needed to prevent businesses from avoiding size thresholds by splitting into parts—for example, a single partnership splitting into two or more partnerships. Depending on how the new rules were defined and applied, they could add complexity for existing non-corporate pass-throughs that would be required to follow corporate tax rules and file corporate tax returns. However, this could reduce the compliance burden for large non-corporate businesses with many shareholders or partners, each of whom must currently report the business-related income and deductions on their individual returns. The shift of business activity from the corporate into the non-corporate sector has resulted in market efficiencies (e.g., the formation of partnerships that are joint ventures involving the assets of two or more entities). The taxation of such partnerships as corporations might prevent the formation of these productive ventures.

Finally, eliminating the differences between the tax treatment of corporate and non-corporate businesses by integrating the corporate income tax system with the individual income tax system would carry a revenue cost to the extent that credits for corporate taxes paid reduced revenues from individual taxes. However, the lost revenues could be offset by taxing corporate income at a higher rate at the individual level.

iii. Option 3: Eliminate or Reduce Tax Expenditures

A number of provisions in the tax system narrow the tax base for certain businesses, with the result that higher statutory rates are needed to achieve the same revenue. Some of the largest of these expenditures are provided in Table 9, which shows the 10-year revenue losses due to each provision. The estimates date from 2007, and thus provide revenue numbers that are not affected by the recession.

Table 9: Special Tax Provisions Substantially Narrow the Business Tax Base

	Revenue, 2008-2017 (FY, $ billions)		
Major Special Business Tax Provisions	**Corporate**	**Non-Corporate**	**Total**
Deduction for U.S. production/manufacturing activities	210	48	258
Research and experimentation (R&E) tax credit	132	1	133
Low-income housing tax credit	55	6	61
Exclusion of interest on life insurance savings	30	0	30
Inventory property sales source rules	29	0	29
Deductibility of charitable contributions	28	0	28
Special ESOP rules	23	4	27
Exemption of credit union income	19	0	19
New technology credit	8	1	9
Special Blue Cross/Blue Shield deduction	8	0	8
Excess of percentage over cost depletion, fuels	7	0	7
Other business preferences[a]	27	28	55
Total	**576**	**88**	**664**
Accelerated depreciation/expensing provisions	356	306	662
Total Revenue from Business Preferences	**932**	**394**	**1,326**

a. None of the special business tax provisions in this category exceed $5 billion over the 10-year budget window.

Source: U.S. Department of the Treasury, Office of Tax Analysis.

Many of these provisions distort economic activity, increase the complexity of the tax code, and violate principles that businesses with similar characteristics should be treated equally. Eliminating specific expenditures would thus improve efficiency while simplifying the tax code. Many of the disadvantages of elimination are specific to the proposals; elimination will disadvantage those who benefit from the tax expenditure.

A discussion of the largest of these provisions follows.

1. Eliminating the Domestic Production Deduction

In 2004, the U.S. began allowing businesses (both corporations and pass-through entities) to deduct part of their earnings from certain kinds of domestic production from their taxable income. This deduction is called the domestic production deduction and it was introduced as a substitute for the Foreign Sales Corporation (FSC) law that was ruled illegal by the WTO in 2000. The purpose of the domestic production deduction was to encourage manufacturing production in the United States. However, the scope of the definition of "production" is sufficiently broad—encompassing activities like the writing of computer software and even the production of fast food hamburgers—that many sectors benefit from the deduction.

The proposal and its advantages:

We estimate that eliminating this provision would raise corporate revenues by enough to allow a reduction in the corporate tax rate of about 1.1 percentage points. The corporate rate could be reduced by about 1.4 percentage points if the provision was repealed for all businesses and the revenue used to reduce the corporate rate.

Eliminating the deduction would also result in considerable tax simplification because the definition of qualifying production is complex and raises compliance and administrative costs. Moreover, the deduction does not apply to all domestic production so this provision distorts economic decisions. Since the deduction is similar in effect to a rate reduction, it would make the tax system simpler and more transparent to simply reduce rates.

Disadvantages:

A concern is that this would raise the effective corporate tax rate on manufacturing industries by about 3 percentage points if the statutory corporate tax rate is not reduced. It would be revenue neutral for the corporate sector only if the corporate rate was reduced. Additionally, non-corporate businesses receive about 20 percent of the benefit from the deduction, so that eliminating the provision and using the revenue to reduce the corporate rate would result in winners and losers by organizational form.

2. Eliminate or Reduce Accelerated Depreciation

As discussed above, accelerated depreciation and expensing provisions are the largest single tax expenditure (measured relative to straight line economic depreciation) for businesses (both pass-through entities and corporations). Accelerated depreciation provides a lower rate to new investment, similar to expensing or bonus depreciation. It also reduces the penalty on investing in plant and equipment and commercial real estate relative to investing in research or advertising, or in owner-occupied housing.

The proposal and its advantages:

Eliminating accelerated depreciation would raise significant revenues from corporations—enough to reduce the corporate rate by around 3 percentage points. (Almost as much revenue would be raised by eliminating accelerated depreciation for the non-corporate sector; complete elimination of accelerated depreciation would raise enough revenue to lower the corporate rate approximately 5 percentage points.) A more limited option that would raise proportionately less revenue would be to reduce the degree of acceleration in the depreciation formulas.

In general, the advantages (and disadvantages) of curtailing accelerated depreciation are the same as those discussed in Option Group A above.

Disadvantages:

Eliminating accelerated depreciation would raise taxes for new investments, reducing investment in the aggregate. It would exacerbate the differential treatment of plant and equipment investments relative to other corporate investments, like advertising or research. Some firms would see their taxes rise more than others—for example, newer firms or firms in capital-intensive industries; in effect this would reward existing capital at the cost of new investments.

3. Eliminate Other Tax Expenditures

Table 9 also enumerates a number of additional, smaller tax expenditures that experts have mentioned as possible base-broadeners in a business tax reform. A few specific provisions are discussed below.

A. Special Employee Stock Ownership Plan (ESOP) Rules

ESOP plans are employer-sponsored retirement plans that typically invest entirely in stock of the employer. Special rules allow employers to deduct dividends paid to stock in ESOPs and allow employees to defer paying capital gains taxes on certain employer-stock transactions. Some argue that the special treatment given to ESOPs, which is even more favorable than other employer-sponsored retirement accounts, results in a lack of diversification in employees' retirement savings that can and, historically has, sometimes resulted in outsized losses to retirement wealth. Eliminating these special provisions and treating ESOP plans like other employer-sponsored retirement plans would raise revenues and harmonize tax incentives with other retirement plans.

B. Exemption of Credit Union Income from Tax

Unlike other financial institutions like banks and thrifts, credit unions do not pay corporate taxes on their income. This puts them at a competitive advantage relative to other financial institutions for tax reasons. Eliminating this exemption would raise revenue and level the playing field, but would clearly raise taxes on credit unions.

C. Low-Income Housing Credit

The low-income housing credit encourages the construction, rehabilitation, and purchase of low-income rental housing. Some experts suggest that other federal aid (like housing vouchers) would assist low-income households at a lower cost. Proponents of the credit argue that it encourages investment in rental properties in low-income areas and helps to revitalize those neighborhoods.

V. ADDRESSING INTERNATIONAL CORPORATE TAX ISSUES

As noted above, the U.S. has one of the highest statutory corporate tax rates among developed economies, and the difference between the U.S. tax rate and the tax rates imposed by other developed countries has increased over time as other countries have lowered their rates. The relatively high U.S. tax rate is particularly important for U.S. MNCs because they are subject to the U.S. corporate tax on their worldwide income, regardless of where it is earned. As a result, U.S. MNCs operating in lower-tax jurisdictions face higher statutory tax rates than their competitors. Tempering this burden is the fact that the U.S. corporate tax is paid only if and when a corporation repatriates its foreign-earned income, for example as a dividend to its parent corporation. In contrast, the income earned by U.S. corporations domestically is subject to the U.S. corporate income tax at the time it is earned. In practice, most MNCs take advantage of deferral and defer the repatriation of a significant fraction of their foreign-earned income for long periods of time, often indefinitely. Deferral therefore reduces the effective tax rate on foreign-earned income, mitigating the tax disadvantages U.S. MNCs face when operating in foreign jurisdictions compared to their foreign competitors. Another consequence is that U.S. MNCs face lower effective tax rates on their foreign-earned profits than on domestically-earned corporate income.

Many experts and business representatives argued that the high effective corporate tax rate in the U.S. discourages MNCs from choosing the U.S. as a site for the production of goods and services or as a headquarters for their global activities. Moreover, we heard concerns that the U.S. system places U.S. MNCs operating in other countries at a cost disadvantage relative to their business competitors in those jurisdictions. Both of these concerns are exacerbated by the fact that in addition to having lower statutory tax rates, most other developed countries also exempt from corporate taxation all or most of the overseas income earned by their corporations. In contrast, the U.S. exempts such income from taxation only as long as it remains abroad.

Other experts argued that the difference in the effective tax rates between income earned at home and income earned overseas provides U.S.-headquartered MNCs incentives to shift taxable profits to their foreign subsidiaries to delay taxation, and encourages costly and wasteful tax planning measures to do so. As corporate tax rates in other countries have declined and as global markets have grown, the incentives and opportunities for U.S. MNCs to shift profits abroad have increased, straining the already complicated system of laws and enforcement that attempts to regulate these activities. Experts also cautioned that such tax avoidance efforts reduce the domestic tax base and reduce corporate tax revenues.

Most experts emphasized the need for changes to the current rules for taxing the foreign income of U.S. corporations to address the above concerns. But experts differed on what changes should be made because of their evaluation of how changes would affect the following, sometimes competing, policy goals: increasing the attractiveness of the U.S. as a production location for U.S. and foreign companies; reducing the tax disadvantages of U.S. MNCs operating in low-tax jurisdictions compared to their foreign competitors; reducing the incentives for U.S. MNCs to shift activities and reported profits abroad to avoid paying U.S. corporate tax; reducing the costs of administration and compliance; and reducing the erosion of the U.S. tax base and the loss of corporate tax revenues that result from tax avoidance measures.

a. The Current U.S. Approach to International Corporate Taxation

As noted above, the U.S. uses a worldwide approach to the taxation of corporate income earned by U.S. companies overseas. The basic principle of this approach is that all of the income earned by U.S. companies anyplace in the world should be subject to the U.S. corporate income tax. But the current U.S. system also allows U.S. companies to defer payment of the tax on most of the overseas active income earned by their foreign subsidiaries until it is repatriated, for example as dividends to the parent corporation. U.S. tax is not deferred on passive investment income (such as portfolio interest) earned abroad or on other easily moveable income of foreign subsidiaries under the so-called "subpart F" anti-deferral rules. Profits or losses of foreign branches of U.S. corporations (rather than subsidiaries) are subject to immediate U.S. tax just as if the profits or losses accrued domestically.

To prevent the double taxation of income earned by a U.S. company by both the government of a foreign country in which the U.S. company is operating and by the U.S. government, current U.S. tax law includes provisions to allow a credit for foreign income taxes. Under these rules, a U.S. company is allowed a foreign tax credit for foreign income taxes paid by it and by its foreign subsidiaries on earnings repatriated to the United States. The foreign tax credit is claimed by the U.S. company on its U.S. tax return and reduces its U.S. tax liability on foreign source income. (See Box 1 for a discussion of the foreign tax credit.)

As a result of deferral and foreign tax credits, the U.S. corporate tax paid by U.S. MNCs on foreign source income in 2004 was only $18.4 billion. A relatively small part of that revenue was derived from dividends paid by foreign subsidiaries to their U.S. parents. Foreign source royalties, as well as foreign source interest and income from foreign subsidiaries not eligible for deferral under the current system, represent a much more important source of tax revenue than dividends. Even with foreign tax credits, U.S. multinationals have a strong incentive to keep their overseas earnings outside the U.S. as a result of the interplay between the high U.S. statutory corporate tax rate and deferral. In 2004, when Congress allowed companies to repatriate overseas income for a limited amount of time at a reduced corporate effective tax rate of 5.25 percent, the amount of repatriated income jumped from an average of about $60 billion per year from 2000-2004 to about $360 billion in 2005. In 2004, U.S. multinationals had over $900 billion in unrepatriated overseas income. Even after repatriating over $360 billion in 2005, U.S. companies reported over $1 trillion of permanently reinvested earnings on 2008 financial statements. Most of the business people we spoke with predicted that a significant portion of this income would be repatriated to the U.S. if there was another temporary tax holiday with a reduced rate or if there was a reduction in the corporate tax rate.

b. Box 1: The Foreign Tax Credit

The foreign tax credit rules are complicated and include several significant limitations. In particular, the foreign tax credit is applied separately to different categories of foreign income (generally distinguishing between "active" and "passive" income). The total amount of foreign taxes within each category that can be credited against U.S. income tax cannot exceed the amount of U.S. income tax that is due on that category of net foreign income after deductions. In calculating the foreign tax credit limitation, the U.S. parent's expenses (such as interest) are allocated to each category of income to determine the net foreign income on which the credit can be claimed. The allocation of expenses to foreign income is intended to assure that credits for foreign taxes do not offset U.S. tax on domestic source income. The portion of expenses allocated to foreign income therefore reduces the amount of foreign tax that can be credited that year.

This foreign tax credit limitation, however, allows active income subject to high foreign taxes (usually active earnings of foreign subsidiaries distributed to U.S. parent corporations as dividends) to be mixed with active income subject to low foreign taxes (including royalties or interest from affiliates). Thus, if earnings repatriated by a foreign subsidiary have been taxed by the foreign country in excess of the U.S. rate, the resulting "excess" foreign tax (i.e., the amount of foreign tax on the earnings that exceeds the U.S. tax that would be owed on the dividend) may be used to offset U.S. tax on other, lower-taxed foreign source income in the appropriate category. This method of using foreign tax credits arising from high-taxed foreign source income to offset U.S. tax on low-taxed foreign source income is known as "cross crediting." One consequence of cross-crediting is that if a U.S. parent corporation develops an intangible asset, such as a patent or trademark, and licenses the rights to its subsidiaries operating in foreign countries, the royalty income generally would be considered active and the U.S. tax on that income may be offset by excess foreign tax credits on other active income subject to high foreign taxes.

If a U.S. parent does not have or expect to have excess foreign tax credits from earnings in a high-tax country, it may have an incentive to structure its affairs so that the rights to such an intangible are owned for tax purposes by a foreign subsidiary in a low-tax country. This may be accomplished through use of an R&D expense cost sharing arrangement, which allows the U.S. parent corporation to retain legal ownership of the intangible rights for intellectual property law purposes but for tax purposes allows the foreign subsidiary to be treated as owning an undivided interest in the intangible. It is not necessary to pay a royalty to the U.S. parent for an intangible whose costs have been shared; however, the U.S. parent loses its U.S. deduction for the portion of R&D expense that is shared. The foreign subsidiary may use the intangible or sub-license the rights to affiliates that make use of the intangible and earn returns attributable to the cost shared intangible. It generally is possible to achieve a deduction in the country of operation and income in the lower-taxed country, while avoiding any U.S. tax under the "subpart F" anti-deferral rules.

Proper allocation of earnings between a U.S. parent corporation and a foreign subsidiary necessarily requires putting appropriate fair market prices on services, products and transfers of intangible rights exchanged between the two. If these "transfer prices" are too high or too low, earnings may be incorrectly allocated and U.S. tax may be avoided by shifting earnings to a lower-tax country. This is the so-called transfer pricing issue. The incentive to manipulate transfer prices is related to the difference in effective tax rates between countries involved in a transaction. In the cost sharing arrangement described above, if rights to an intangible are cost shared after the intangible has significant value, the party receiving the benefit should pay for pre-existing value (a "buy-in payment"). This is one of the most difficult transfer pricing issues to administer and enforce, and highlights the challenges facing governments in applying national tax systems to cross-border transactions.

The United States is the only major developed country economy that uses a worldwide (with deferral) approach to the taxation of corporate income. Other developed countries use a "territorial" or "dividend exemption" approach that taxes only the domestic income of their corporations and exempts all or a significant portion (e.g., 95 percent) of their overseas income from domestic taxes. (Both the U.K. and Japan recently switched from a worldwide approach to a territorial approach.) Additionally, all of the developed countries with the exception of Japan have a lower statutory corporate tax rate than the United States. In contrast to the worldwide system used in the U.S., in territorial systems there is no (or very little) additional domestic tax imposed on exempt overseas income when it is repatriated. A territorial system therefore provides an even greater incentive and opportunity for a company to reduce its domestic corporate taxes by reporting profits abroad and deductible costs at home than the U.S. approach. However, the magnitude of the additional incentive is subject to debate, with some arguing that it is actually quite small because the current U.S. system already provides territorial-like treatment for unrepatriated earnings. Others point to the willingness of U.S. corporations to repatriate substantial foreign earnings in 2005 in response to a temporary 5.25 percent effective rate as evidence that the implicit costs of deferral are more sizable.

A simple example shows the difference between the worldwide approach used by the United States and a territorial approach. A U.S. company with a subsidiary in Ireland, where the corporate tax rate is 12.5 percent — among the lowest in the OECD — pays U.S. tax on the profits earned from active business operations in Ireland, adjusted by a foreign tax credits for foreign taxes paid in Ireland (to ensure the earnings are not double taxed), when the profits are repatriated into the United States. Thus, if the income earned by the Irish subsidiary is repatriated, the tax rate, adjusted for applicable foreign tax credits, is increased from 12.5 percent to the statutory U.S. corporate rate of 35 percent. A French company with an Irish subsidiary also pays the Irish tax of 12.5 percent on income from active business operations of its Irish subsidiary. In contrast with the United States, if the income earned by the Irish subsidiary is repatriated, the French company only pays French tax on 5 percent of the repatriated profits when these profits are repatriated to France. In such a case, the tax rate on the French subsidiary is the Irish rate of 12.5 percent plus a small additional French tax.

As the preceding example indicates, the after-tax result of the U.S. worldwide with deferral system and a territorial system is similar if foreign earnings are not repatriated. Indeed, some experts suggested that with deferral the U.S. system is very similar to some territorial systems used elsewhere. Financial accounting rules preserve this pattern in that they do not require accrual of the U.S. tax on repatriation of earnings if the company makes an election to treat the earnings as permanently reinvested, but that similarity disappears if the U.S. company wants to pay dividends from the foreign subsidiary to the parent in order to finance investment in the U.S. or pay dividends to shareholders.

c. Economic Effects of the Current U.S. Approach

i. Effects on the Location of the Economic Activities of U.S. Multinationals

There are two contrasting views about how U.S. international corporate tax rules affect the production and employment of U.S. MNCs at home. One view rests on the belief that the foreign operations of U.S. multinationals are a substitute for their domestic operations, in the sense that increases in foreign operations come at the expense of domestic operations. According to this view, factors that reduce the cost of foreign operations, including lower taxes on foreign source income, increase the incentive for American companies to shift production, investment and employment to lower-cost foreign locations. Under this view, reducing the relative tax burden on the foreign source income of U.S. MNCs increases the relative cost advantage of their overseas activity and encourages them to move investment—and jobs—abroad, reducing employment and production at home. By this logic, increasing the relative tax burden on the foreign source income of U.S. multinationals would encourage them to relocate production and jobs back to the U.S.

There is evidence that supports the view that cost differences are sometimes a significant factor behind MNC decisions to substitute overseas employment for domestic employment. Studies have found that U.S. employment correlates positively with foreign country wages, indicating that domestic and foreign labor are substitutes, and that higher foreign costs increase employment at home. Other studies find that the sign of the relationship varies by country and likely depends on the type of foreign activity being undertaken by the U.S. company.

A contrasting view is that the foreign operations of U.S. multinationals are a complement to their domestic operations—that is, that employment and other economic activity at foreign subsidiaries correlate positively with domestic employment and activity. According to this view, the foreign subsidiaries of U.S. multinationals increase employment, output, investment and R&D in the U.S. both by enhancing the efficiency and cost competitiveness of U.S. multinationals and by increasing their sales in foreign markets, many of which are growing much more rapidly than the U.S. market. In this view, the foreign operations of U.S. companies generate jobs and activity at their domestic operations. According to this view, factors that increase the attractiveness of foreign operations, including lower taxes on foreign source income, will increase the economic activity of U.S. MNCs both overseas and at home, and also increase the use of equipment and inputs produced by U.S. suppliers.

There is also evidence that supports the view that the foreign operations of U.S. MNCs complement their domestic activities. Recent studies have found positive relationships between both the domestic and foreign employment of U.S. MNCs and between their domestic and foreign investment levels.

On a firm-by-firm and industry-by-industry basis, there is likely to be significant heterogeneity in the relationship between domestic and foreign activity. For many businesses, the ability to substitute domestic activities for foreign activities in order to serve foreign markets is limited by what they produce. For example, firms that require a local presence to exploit U.S. innovation or expertise to serve foreign markets, firms whose business revolves around natural resources located abroad, firms that require a retail presence or whose business requires face-to-face relationships with consumers, and firms that produce goods that are costly to transport are often unable to serve foreign markets from their domestic locations and to substitute domestic employment and investment for overseas employment and investment. Indeed, in 2007, 19 percent of U.S. exports of goods were intra-company exports from a U.S. parent to a foreign affiliate. Firms in such sectors and carrying on such activities often have significant administration and R&D activities in the U.S. to support or complement their foreign operations. In contrast, firms that produce high value-to-weight goods and goods that are easy to transport are better able to serve foreign markets through exports from U.S. locations. For such companies, the relative cost of investing abroad (including taxes) is likely to be a more important determinant of decisions about whether to locate production and employment in the U.S. or overseas.

ii. Effects on the Costs of U.S. Companies and their Foreign and Domestic Competitors

The combination of lower foreign corporate tax rates and the territorial system of corporate taxation used by other countries reduces the cost of production for foreign firms competing with U.S. companies outside of the U.S.—thus raising the relative cost of U.S. MNCs operating in lower-tax foreign jurisdictions. Although deferral reduces national differences in effective corporate tax rates, such differences may still place U.S. MNCs at a relative disadvantage in international markets and may be influencing company shares in global markets and preventing global production from being allocated to the most efficient companies.

The U.S. worldwide/deferral approach to corporate taxation favors foreign firms operating in their own country compared to U.S. firms in that country. Foreign and U.S. firms both pay corporate taxes in that country—on average at lower rates than in the U.S.—but U.S. firms pay an additional tax on repatriation of those profits. The same is true when U.S. and foreign companies compete in a low-tax third country; foreign firms operating in such a country (e.g., a French firm in Ireland) pay the third country rate, but the U.S. firm pays an additional tax when it repatriates its earnings to the U.S. Overall, the territorial system lowers the cost of doing business by foreign firms in low-tax third countries compared to U.S. firms. However, because U.S. MNCs have been successful in reinvesting their income abroad and deferring U.S. taxes, this tax disadvantage may be small. Nevertheless, U.S. companies that do not remit foreign earnings due to the U.S. repatriation tax bear costs that arise from tax-induced inefficiencies in their financial structure—costs that their competitors based in territorial countries do not bear.

The U.S. worldwide/deferral tax approach also puts U.S. MNCs at a disadvantage in the acquisition and ownership of businesses in other countries compared to foreign companies that operate under a territorial approach. For example, a foreign company can pay more than a U.S. company to acquire a firm in Europe or in a low-tax third country because the net-of-tax profits resulting from the acquisition will be higher for the foreign company than for its U.S. competitor.

In domestic markets, however, both U.S. MNCs and their foreign counterparts benefit from the lower effective rates applied to their foreign-source income and a lower cost of capital, and can spread their overhead costs over a broader base of sales than can purely domestic firms. Moreover, multinational firms may also benefit from reduced domestic taxes through tax planning and transfer pricing to shift domestically-earned profits to lower-tax foreign jurisdictions. Such tax avoidance opportunities are not available to purely domestic firms.

iii. Erosion of the Business Tax Base through Transfer Pricing and Expense Location

Because of the relatively high U.S. corporate tax rate and the ability to defer foreign-earned income indefinitely, U.S. companies have a strong incentive to shift profits abroad to delay payment of their corporate taxes, and to deduct the domestic business expenses incurred in support of their foreign operations against their current domestic earnings. For example, two of the most important methods that U.S. MNCs use to avoid taxes relate to the location of debt and to the location of valuable intangible property. In the first example, a corporation issues debt in a high-tax location (e.g. the U.S.) and uses the capital to generate active income abroad, which is then deferred. This practice allows businesses to reduce taxable income from their domestic operations immediately while deferring the payment of taxes on their foreign profits. In the second example, a corporation transfers a valuable intangible asset, like a patent or copyright, to a subsidiary in a low-tax jurisdiction without appropriate compensation. The company then exploits the intangible asset through the subsidiary without appropriate royalty payments to the domestic parent. The company benefits from deducting the costs of developing the intangible in the U.S., the high-tax country, and reporting profits from exploiting the intangible in the low-tax country. U.S. MNCs also have a strong incentive to classify passive income earned overseas as active income because deferral applies to the latter form of income and not to the former. Furthermore, the current system of foreign tax credits allows firms to use foreign tax credits received for profits earned in high-tax countries to offset taxes due on profits earned in low-tax countries or to offset taxes due on other kinds of income, like royalties. This system provides additional incentives to manipulate the location of profits (and the type of earnings) attained abroad to qualify for foreign tax credits.

Policing transfer pricing is challenging both because of the intrinsic difficulty of assigning prices to intra-firm sales that are not observed the way arm's length transactions can be and because of the complexity and number of related-party transactions that occur within MNCs. Thus, changes in the tax system motivated by the goal of improving the "competitiveness" of the foreign subsidiaries of U.S. multinationals with respect to their foreign competitors may also have the effect of increasing the incentive for U.S. MNCs to reduce the taxes they pay on the income they earn in the U.S. Indeed, a part of the tax expenditure for maintaining deferral in the current system or for shifting to a territorial system is the reduction in taxes paid by U.S. MNCs on their domestically-earned income.

iv. The Costs of Administering and Complying with the Current U.S. System

Most experts agree that the current hybrid U.S. system that combines a worldwide approach with deferral embodies the worst features of both a pure worldwide system and a pure territorial system from the perspective of simplicity, enforcement and compliance. In a pure worldwide system, all income is subject to the same tax rate, eliminating the necessity of distinguishing active from passive income (and the complexity of subpart F) and of distinguishing domestic and foreign sources of profits (and therefore the need to police transfer pricing). Hence, costly tax planning to shift income to low-tax havens or to re-characterize passive income as active income is significantly reduced. And so is the need for enforcement. However, even in a pure worldwide system, a foreign tax credit system is still required to ensure that companies are not subject to double taxation. (And the foreign tax credit system is complicated.) Moreover, in a pure worldwide system without deferral there would be a greater incentive for U.S. multinationals to shift their headquarters abroad and reorganize as foreign companies to avoid the high U.S. corporate tax rate on foreign income.

In a territorial system, foreign active income is generally not subject to domestic tax but foreign passive income is. The location of profits and the source of income are very important because some income is taxed at the full domestic rate (35 percent in the U.S.) and some income is taxed potentially at zero. Thus, in a territorial system, there typically are rules to differentiate active from passive income (like subpart F under present law), and rules to differentiate profits earned at home from profits abroad (including transfer pricing rules). A foreign tax credit system is required, but only for passive income and other foreign income not eligible for exemption (e.g., royalties). In a pure territorial system, depending on the difference in effective tax rates on domestic income and foreign income eligible for dividend exemption, firms have strong incentives for tax planning, and spend time and money doing it.

The U.S. hybrid approach, like a pure worldwide approach, requires a broad foreign tax credit system to avoid double taxation. But deferral effectively provides territorial-like treatment to active earnings until repatriated, generating the same incentives for tax planning and transfer pricing as a territorial system. Plus, only active income may be deferred while passive income may not. Therefore, the current U.S. system requires a complete foreign tax credit system (including expense allocation rules), subpart F anti-deferral rules for passive income, and onerous transfer pricing enforcement, while generating strong incentives for tax planning and avoidance by businesses. In short, the current U.S. system combines some of the more disadvantageous features from both pure worldwide and pure territorial systems.

The incentives generated by the current system encourage a great deal of costly tax planning by firms and necessitate a significant amount of costly enforcement and compliance activities by the IRS. Moreover, the provisions to address problems created by deferral, foreign tax credits and expense allocation rules, and to differentiate passive and active income contribute significantly to the complexity of the corporate tax code. According to one study, large companies reported that 40 percent of their tax compliance burden arises from the taxation of foreign source income. And the IRS maintains that the international provisions for taxation of corporate income are among the hardest to administer and enforce.

Most experts agree that the current rules for taxing the foreign income of U.S. corporations should be reformed, but there is disagreement about how. In the remainder of this section, we summarize the pros and cons of three basic kinds of reforms that we discussed with experts during our work on international corporate taxation: moving to a territorial system similar to those of other developed countries; maintaining a worldwide approach but at a lower corporate rate and without deferral; and tightening or ending deferral with no change in the corporate rate. We also discuss the implications of maintaining the current system with deferral and a lower corporate tax rate.

v. Option 1: Move to a Territorial System

The proposal and its advantages:

The United States could adopt a territorial approach similar to those used by most other developed economies and exempt from U.S. taxation the active foreign income earned by foreign subsidiaries or by the direct foreign operations of U.S. companies. (Transition rules might be imposed to limit the potential windfall from eliminating the tax that would have been paid when and if accumulated and deferred profits currently held abroad are repatriated.)

Moving to a territorial system would eliminate the incentives of U.S. MNCs to keep income earned from foreign operations abroad rather than repatriating this income to the U.S., reducing the implicit costs companies incur to avoid repatriation. Moving to a territorial system would therefore improve the efficiency of corporate finance decisions.

Adopting a territorial system would mean that the foreign subsidiaries of U.S. MNCs would face similar effective tax rates to those faced by their foreign competitors headquartered in countries with territorial systems. This would reduce the cost of doing business in countries that have lower tax rates for U.S. multinationals relative to their foreign competitors in those foreign markets.

A territorial system would also enhance the ability of U.S. multinationals to acquire foreign firms and would eliminate the incentives for U.S. multinationals to merge with or sell their foreign operations to foreign companies for tax reasons. Elimination of these distortions to the ownership of capital assets would help ensure that those assets were managed by the most productive businesses.

To the extent that foreign operations complement the domestic operations of U.S. MNCs, moving to a territorial system that reduces their costs and increases their shares in foreign markets would boost their production, investment, and employment in the U.S.

Moving to a territorial system could also provide some simplification benefits by eliminating the need for foreign tax credit provisions (except those that apply to passive income and other non-exempt income).

Disadvantages:

The principal disadvantages of adopting a territorial system derive from the fact that in such a system the differences in tax rates applied to repatriated foreign earnings versus domestic earnings and active versus passive income would increase, strengthening the incentives for firms to shift income offshore through transfer pricing and expense shifting, and encouraging active tax planning (as long as the U.S. corporate tax rate remains significantly higher than the rates imposed by other countries). As noted above, however, the incremental effect of these increased incentives compared to the current system with deferral may be modest. Addressing these disadvantages of a territorial system in order to protect the U.S. domestic tax base and maintain tax revenues would place pressure on the current tax administration and compliance regime and could require rules and regulations that differed significantly from those of other countries.

In particular, to maintain corporate tax revenues (from both domestic and international profits) under a territorial system, critical (and technical) details would need to be resolved, including: the share of foreign corporate income exempted from U.S. taxes; the U.S. tax treatment of U.S. business expenses incurred by U.S. companies to support their foreign operations; and the U.S. tax treatment of royalty or passive income earned abroad by U.S. corporations.

The revenue consequences of these design decisions are material. According to rough estimates from the Treasury, a simplified territorial system without full expense allocation rules would lose approximately $130 billion over the 10-year budget window. In contrast, a territorial system with full application of expense allocation rules could be revenue neutral or could raise revenue depending on the behavioral responses of corporations and the ability of the IRS to police transfer pricing and expense allocations. Indeed, earlier studies from the JCT, Treasury, and the Congressional Budget Office (CBO) have scored territorial tax systems with expense allocation rules based on the current rules used for the foreign tax credit as raising between $40 billion and $76 billion over 10 years. Differences in these estimates result from differences in behavioral assumptions, the details of the proposals, and the data used to make these estimates. The wide variation in revenue effects highlights the importance of complex specification details and the incentives created under different regimes.

A reform that maintained the current effective tax rate on the domestically-earned income of U.S. MNCs would require increased attention to transfer pricing enforcement and the rules regarding the location of expenses. For example, to maintain revenue neutrality, tax deductions for interest and other administrative expenses of U.S. MNCs used to finance operations abroad would need to be disallowed so that they could not be used to reduce domestic taxable income. This would limit any simplification benefits of reform. Moreover, a territorial system that included expense allocation rules with rigorous enforcement would remain very different from the territorial systems of other developed countries. Most countries using territorial systems do not "allocate and disallow" domestic business expenses in this way either by design or because their rules are undeveloped. In a system with stringent allocation rules, many U.S. firms could still face higher costs of doing business in foreign jurisdictions than their foreign competitors. Similarly, shifting to a territorial system while retaining the current rules on royalty income without a reduction in the U.S. corporate tax rate would mean that royalty income from foreign sources would be taxed at a higher rate than royalties paid to foreign firms operating from lower-tax jurisdictions.[15]

15 A territorial system would impose a higher effective U.S. tax rate on foreign-source royalty income, providing firms with a greater incentive to reclassify royalty payments (and other non-exempt income) as exempt active income. Currently, royalties are mostly sheltered from tax using "excess" foreign tax credits. Shifting to a territorial system would eliminate these excess foreign tax credits.

A number of foreign governments with territorial systems attempt to recoup revenue by taxing a small portion of the foreign source active income of their corporations (typically by exempting around 95 percent of repatriated earnings from tax). The U.S. could adopt such an approach to recoup some of the lost revenue from moving to a territorial system. This would reduce the administrative and compliance costs of a territorial system compared to one that used a complicated expense allocation system like that currently used for the foreign tax credit. Revenue losses could also be reduced by denying exemption for income earned in a low-tax country (a "tax haven") that does not have a minimum effective corporate tax rate.

A territorial system that resulted in lower effective rates on foreign-earned profits could also affect the location decisions of U.S. multinationals. To the extent that production overseas is a substitute for domestic economic activity (or in industries where this is true), adopting a territorial system could encourage the movement of production, employment and investment out of the U.S. to lower-tax jurisdictions. A territorial system that raised effective rates on royalty income from U.S.-domiciled intangibles could encourage firms to shift intellectual property and research and development abroad.

Finally, a territorial system would retain or exacerbate many of the incentives for inefficient behavior in the current worldwide system with deferral: incentives for shifting income to low-tax locations by distorting transfer prices or paying inadequate royalties; incentives for using related-party transactions (where transfer pricing can be used to reduce taxes) rather than arm's length transactions; and incentives for altering the location of tangible and intangible assets.

vi. Option 2: Move to a Worldwide System with a Lower Corporate Tax Rate

The proposal and its advantages:

This option would impose a pure worldwide tax system and end deferral as part of a larger corporate tax reform that lowered the U.S. corporate tax rate to a level comparable to the average of other developed countries. If the statutory corporate rate were lowered to a rate at which, on average, U.S. MNCs experienced no change in the effective tax rate they currently face on income earned abroad the reform would be "burden neutral" for this category of income (though as discussed below there would probably be individual "winners and losers"). One estimate of the required burden neutral corporate rate for this reform is 28 percent. This option would result in a significant overall revenue loss because the lower corporate rate would apply to both domestic and foreign income and to all U.S. corporations regardless of whether they have foreign operations. To reduce or avoid this revenue loss would require revenue increases elsewhere, for example by broadening the domestic corporate tax base as described above under Option Group B. (Lowering the corporate tax rate would also have efficiency benefits in the domestic context, as described in Option Group A.)

Moving to a worldwide system and ending deferral would have significant benefits for simplification, compliance, enforcement, and efficiency. By eliminating deferral for active foreign income, all income would be taxed at the same rate regardless of where it is earned (domestically or internationally), or whether it is passive or active income. The subpart-F anti-deferral provisions and most rules to differentiate passive and active income could be simplified or eliminated. The system of foreign tax credits would be maintained to avoid the double taxation of foreign-earned income, but it would be possible to simplify the system by eliminating the allocation of expenses.

Moving to a worldwide system without deferral would also reduce many of the incentives for tax planning and tax avoidance, and therefore would require less complex and onerous anti-abuse provisions and less enforcement. Incentives to engage in income shifting, for example through transfer pricing, would be eliminated, reducing planning and compliance costs at businesses and requiring less oversight from the IRS.

Another advantage of this proposal is that it removes incentives for a number of inefficient behaviors. First, because all income is taxed currently, firms would no longer have a U.S. tax incentive to keep cash abroad to avoid repatriation, improving the efficiency of corporate financing decisions. Second, as mentioned, there is no incentive for U.S. multinationals to engage in income shifting through expense location or transfer pricing, and this would reduce the distortions that arise from incentives to use related-party transactions, to locate tangible and intangible assets in alternative locations for tax purposes, or to favor certain financing choices (like domestic debt) over other choices.

Finally to the extent that the foreign economic activities of U.S. MNCs substitute for their domestic economic activities, this option would encourage production, investment and employment in the U.S.

Disadvantages:

A difficulty with this approach is that lowering the tax rate to the required burden-neutral level (around 28 percent) would either necessitate significant base broadening through the elimination of other corporate tax credits and tax deductions, or a substantial loss of corporate tax revenue. Ending deferral would itself permit a revenue-neutral reduction in the corporate rate by about 1.5 percentage points.

Although cutting the corporate rate to the burden-neutral level while ending deferral would result in no change in the average tax rate on foreign income, some firms with such income would face tax increases and others tax reductions. For example, firms operating primarily in low-tax countries benefit more from deferral than companies operating in high-tax countries, so ending deferral would raise taxes more on the former group of firms. Thus, this option would introduce greater country-by-country heterogeneity in the competitiveness of U.S. firms depending on the tax rates of the countries in which they operate, and U.S. MNCs would face greater tax disadvantages in lower-tax countries compared to their competitors headquartered in countries with lower corporate tax rates and/or with territorial systems. Other firms likely to be negatively affected by ending deferral even with a burden-neutral reduction in the corporate tax rate include those able to use transfer pricing to move profits abroad—for example, those transferring hard-to-value intangible assets or services.

Under this option, U.S. MNCs would still face competitive disadvantages on foreign operations in jurisdictions with corporate tax rates below 28 percent. This option would also retain the incentives for foreign firms to acquire U.S. companies or their foreign subsidiaries. Although these incentives would be limited to some extent because the gains from the sales of subsidiaries are subject to U.S. taxation, this option would reduce the ability of U.S. firms to compete in the acquisition of foreign firms that face lower effective tax rates.

Indeed, the incentive for foreign firms to acquire the foreign subsidiaries of U.S. MNCs would likely increase because those foreign subsidiaries would be more valuable in the hands of foreign firms than in the hands of the U.S. MNCs. Further, this proposal would increase incentives for foreign firms to acquire U.S. MNCs outright and then use transfer pricing to shift profits to lower-tax jurisdictions, raising concerns over transfer pricing enforcement of foreign MNCs operating in the U.S. Preventing this outcome would require continued enforcement efforts under the transfer pricing rules. Thus, transfer pricing rules would remain important for these firms and, to a lesser extent, for U.S. tax administrators.

vii. Option 3: Limit or End Deferral with the Current Corporate Tax Rate

Given the high U.S. corporate tax rate, under a pure worldwide tax system without deferral, U.S. MNCs would face a higher effective tax rate compared to foreign MNCs headquartered in countries with lower corporate tax rates, territorial tax systems or both. Deferral offsets much of this disadvantage by approximating the effective rates faced in foreign jurisdictions. With deferral the foreign operations of U.S. corporations are taxed comparably to the foreign operations of their foreign competitors operating in the same foreign tax jurisdictions. As a result of the "time value of money" advantage of postponing tax payments, deferral allows the foreign source income of U.S. corporations to be taxed at a lower effective rate than it would be if it were earned in the U.S. This creates an incentive for U.S. corporations to keep their foreign earnings abroad as long as possible and distorts their investment and business decisions.

The proposal and its advantages:

Maintaining the system of deferral for U.S. MNCs to allow them to enjoy similar tax rates to competitors when operating in foreign jurisdictions comes at a significant revenue cost—approximately $180 billion over ten years. Ending this tax expenditure would raise considerable revenues, enough to reduce the corporate rate by about 1.5 percentage points, relieving the economic distortions of the corporate tax along a number of margins.

For those who see the foreign activities of U.S. MNCs as a substitute for domestic activities, deferral both reduces jobs, production and investment by U.S. companies at home and encourages these activities abroad, as well as allowing U.S. companies to avoid taxes. By this logic, limiting or eliminating deferral would cause U.S. MNCs to substitute domestic for foreign activities, would reduce tax avoidance, and would increase tax revenues.

Like the burden-neutral reform discussed above, this option would simplify the tax system, reduce incentives for income shifting and tax planning and avoidance, and would therefore improve international enforcement and reduce administrative and compliance costs. It would be easier to enforce than the current system because it would leave little incentive for transfer pricing or the use of tax havens.

Disadvantages:

Without a substantial reduction in the U.S. corporate income tax rate, however, this option would impose a significant burden on U.S. multinationals, raising the effective tax rates on income earned at their foreign subsidiaries relative to the rates that apply to their competitors in lower-tax countries, and hampering their ability to bid for and purchase foreign assets in lower-tax jurisdictions. At the same time, ending deferral would make it more attractive for foreign firms to acquire the foreign assets of U.S. companies. To the extent that the foreign activities of U.S. MNCs complement their domestic activities, deferral increases jobs, production and investment at home and limiting or eliminating deferral would reduce the competitiveness of U.S. companies, would decrease jobs, production and investment in the US, and would reduce corporate tax revenues over time.

viii. Option 4: Retain the Current System but Lower the Corporate Tax Rate

The proposal and its advantages:

This option would lower the corporate rate as in Option 2, but within the current tax system, which taxes the active foreign earnings of U.S. MNCs only upon repatriation. The efficiency benefits of a lower corporate tax rate for all U.S. corporations regardless of where they earn their income are discussed in the earlier section of this report on corporate taxation. At the same time, deferral would offset much of the disadvantage U.S. firms face when operating in low-tax countries. Because of the lower corporate rate, the difference in tax rates between income earned domestically versus income earned abroad would be reduced, reducing the incentives for transfer pricing and expense location and the disincentive to repatriate foreign earnings.

Disadvantages:

This option would reduce revenues by lowering the rate and would retain the tax expenditure of deferral (at a lower cost), but would not provide many of the simplification and efficiency benefits of Option 2. Both the complexity of the current system and the incentives to locate profits abroad and defer repatriation for tax avoidance would be retained.

VI. ACKNOWLEDGMENTS

All of us on the President's Economic Recovery Advisory Board would like to express our utmost gratitude to the Board's Tax Reform Subcommittee and staff for their tireless efforts in producing this report. In researching, revising, coordinating, and organizing input from hundreds of people around the country, they applied their admirable diligence and public-spiritedness to this formidable task, and this report is a reflection of their dedication. The members of the subcommittee were Paul Volcker, William Donaldson, Martin Feldstein, Roger Ferguson, and Laura D'Andrea Tyson.

We want to thank the staff that helped assist in the work of the report: Austan Goolsbee, the Staff Director and Chief Economist of the PERAB; Emanuel Pleitez, the Designated Federal Officer; and especially Adam Looney, senior economist at CEA and the PERAB, without whose hard work and diligence this report would never have been possible. Adam's knowledge of the complexities of the tax code was indispensable, and he oversaw a large mountain of work on the project. We owe him a special debt of gratitude. We would also like to thank PERAB staffers: Emily Angulo, Laura Blum, Ronnie Chatterji, Tony Dowd, Wendy Edelberg, Ariel Gold, Joshua Goldman, Max Harris, Brittany Heyd, Meryl Holt, Arik Levinson, Andrew Metrick, Rene Moreno, John Oxtoby, Jesse Rothstein, Paul Smith, Irina Varela, Catherine Vargas, and Jacqueline Yen for their work on the project.

We are also indebted to the support of the Department of the Treasury, the Internal Revenue Service, the Department of Commerce, the Council of Economic Advisers, the Federal Reserve System, and the National Economic Council. The men and women staffing these agencies gracefully loaned us their decades of expertise throughout the process.

Most of all, we would like to thank the public. Those who testified in person, spoke to us on the phone, submitted their ideas in writing, and those who participated in our public meetings online—each contributed in an important way. In the end, we received hundreds and hundreds of ideas and suggestions and to recognize their contributions, we have listed all the direct contributors in the appendix to the report.

VII. APPENDIX

The President's Economic Recovery Advisory Board (PERAB) met with organizations and requested public comments for ideas on tax reform. Upon submission, such comments became part of the public record and subject to public disclosure. We make no representation regarding the nature of the comments as they were self-reported by the public. The publishing of this list does not constitute endorsement, recommendation, or favoring by the PERAB. The states listed for certain individuals were derived from the area codes of the phone numbers that they provided.

Last	First	Organization
Abraham	Terri	Individual from Georgia
Abramson	Steve	Individual from New York
Ackerman	Deena	U.S. Department of the Treasury
Ackman	Sheldon	Fair Tax Organization
Aitken	David	Individual from Colorado
Al-Bakri	Abdel Ilah	None provided
Alfera	Donald	AlfsDogs
Almand	Charles	Georgians for Fair Tax
Altshuler	Rosanne	Urban-Brookings Tax Policy Center
Anderson	Dave	Honeywell
Anderson	Melva	Individual from Missouri
Annee	Carl	Individual from Georgia
Arias	John	Individual from New York
Arnett	Charles	Individual from Georgia
Arnold	Steve	Individual from Georgia
Arnold	Stephen M.	Tax Payer, Citizen, and a FAIRTAX supporter
Arslan	Kristie	National Association for the Self-Employed
Ashbaugh	Margaret	Individual from Missouri
Asnip	Andrew	Individual from Georgia
Atkinson	Larry	Individual from Georgia
Auerbach	Alan	UC Berkeley
Augustine	Alexander	Individual from Pennsylvania

Last	First	Organization
Auten	Gerald	U.S. Department of the Treasury
Avi-Yonah	Reuven S.	University of Michigan Law School
Baehr	Ted	Individual from Louisiana
Bain	Stuart	None provided
Baker	Teal	Podesta Group
Baker	Mary	U.S. Senate Finance Committee
Baldassari	Gene	Baldassari for Assembly 2009
Ballard	Mark	Individual from Illinois
Bankman	Joe	Stanford University
Barba	Chris	Individual from Colorado
Barker, Professor	William	Penn State Law School
Barnes	Scott	Individual from Florida
Barrett	William C.	Applied Materials
Bean	Elise	U.S. Senator Carl Levin
Beard	Bill	None provided
Beaumont	Simon	IBM
Bedford	Daniel	Individual from Virginia
Bedingham	Ann	Individual from Arizona
Beharelle	Lisa	Individual from Georgia
Behler Jr.	George F.	None
Belson Goluboff	Nicole	Individual from New York
Bennett	Jim	Americans for Fair Taxation
Beran	Robin	Caterpillar
Betz	Joseph	Individual from Pennsylvania
Biddison	Bonnie	None provided
Binder	Michael	None provided
Bindner	Michael	Individual from Virginia
Bisson	Joe	Individual from Georgia

Last	First	Organization
Black	Rachel	Bread for the World
Blakley III	David W.	Individual from Missouri
Blanchard	Kimberly S.	Weil, Gotshal & Manges LLP
Bontrager	Jason	Blinn College
Borom	Andrew	Individual from Florida
Bostick	George	U.S. Department of the Treasury
Bouma	Herman B.	Buchanan Ingersoll & Rooney PC
Boyd	Janet	Dow
Bradshaw	Stephen	None provided
Brady Woods	Elizabeth	Individual from California
Brannon	Craig	Individual from Georgia
Brock	Bob	Individual from New Mexico
Brothers	Jeremy	Individual from Ohio
Brown	Fred B.	University of Baltimore School of Law
Brown	Becky	The Information Factory
Brown	Tom	Retired scientist
Brown	Jason	Individual from Arizona
Brown	Ketron	Individual from Florida
Brown	Gerald	Individual from Georgia
Brown	Jim	Individual from Georgia
Bruce	Paul	None provided
Buel	Estelle	Individual from Texas
Burchill	John	FairTax.org
Burger	Frank Jos.	Individual from New York
Burnley	Kristin	Individual from Georgia
Burns	Kevin	Individual from Georgia
Burns	William A.	Individual from South Carolina
Burritt	Dave	Caterpillar

Last	First	Organization
Buttonow	Jim	New River Innovation, Inc.
Calianno	Joseph M.	Georgetown Law School
Callihan	Jesse W.	Individual from Georgia
Campbell Speedy	Bonnie	AARP Tax-Aide
Cannoles, CPA/PFS	Gordon	Individual from Texas
Cardaropoli, Jr	Anthony J.	Individual from California
Carrigg	Daniel	University of Rhode Island
Castro	Juan A.	Individual from Florida
Caswell	Steven	Individual from Georgia
Chambers	Lisa	Individual from Georgia
Chetty	Raj	UC Berkeley
Chew	Thomson	None provided
Chwee	Monica	None provided
Clay	Alex	Individual from California
Clemens	Jeff	Harvard University
Coleman	Dorothy	National Association of Manufacturers
Colgan	Daniel R.	Individual from Minnesota
Colon	Elizabeth	None provided
Comeaux	Kim	Alliance Realty Team
Cooper	Michael	U.S. Department of the Treasury
Coratolo	Giovanni	U.S. Chamber of Commerce
Coussoule	John	Individual from Florida
Crago	Chris	Winston & Cashatt
Crain	Jack L.	Individual from Louisiana
Crandall	Ted	Rockwell Automation
Crider	Oakey	Individual from Indiana
Croft	Charles R.	Individual from Georgia
Cullinan	Ronald	Individual from Texas

Last	First	Organization
Cummings, Jr.	Jasper L.	Alston & Bird
Curtin	Ashley	None provided
Curtiss	Alison	Individual from Florida
Dahl Sr.	Jeffrey T.	Individual from Arizona
Dale	Emily	Macon Organizing for America
D'Arrigo	Emanuele	Individual from the UK
David	Ryan M.	Individual from Texas
David Forte	Sydney	Citizen of the Corporate States of America
Davidson	Charles	Taxpayer Advocacy Panel
Dawson	Shirley	Individual from Missouri
de Grandis	G.	Individual from Pennsylvania
Debes	Harry	None provided
Deck	Christopher	Self Employed Accountant/Governmental Auditor
Desai	Mihir	Harvard Business School
DeTate	Jack	Individual from California
Devlin	Peter	Individual from Mississippi
Dey	Dan	Individual from Missouri
Dickel	Ronald	Alcoa
Dicker	Eli J.	Tax Executives Institute
Dilworth	Robert	McDermott Will & Emery LLP
DiStefano	Theresa	Individual from Georgia
Distefano	Anthony	Fairtax supporter
Dodd	Randall	AARP MEMBER
Dolezal	Uva B.	Individual from Georgia
Dosmann	Todd	Individual from Florida
Driggers	Jacqueline	Individual from Kentucky
Dukes	Rita	Individual from Colorado
Duperon	Theresa	Individual from California

Last	First	Organization
Dwyer	Terence	Individual from Minnesota
Early	Sheila	Individual from Georgia
Earnest	Diane	Individual from Georgia
Earnest	Patrick	Individual from Illinois
Edwards	Chris	Cato Institute
Edwards	Shannon	None provided
Eichner	Jesse M.	JMEArtists.com
Eldridge	Matthew	Individual from Vermont
Elias	Les	Individual from Kansas
Elkins	Stephen	American Chemistry Council
Ellis	George	Individual from Florida
Engle	Kyley	Individual from Washington
Engler	John	National Association of Manufacturers
Engwall	Randy	Individual from Georgia
Ettlinger	Michael	Center for American Progress
Evangelist	Michael	Center for Economic Progress
Fabii	Reno	Individual from Florida
Fairbanks	Steve	None
Fath	Meredith	Tax Analysts
Faust	Ed	None provided
Fearon	Rick	Eaton
Feenberg	Dan	NBER
Feeney	Michael	Marks Building Systems
Femia	Rocco V.	Miller & Chevalier
Feraios	Thomas	Individual from Pennsylvania
Fige	David	Individual from Georgia
Finch	Mike	Individual from Virginia
Finis	Carla J.	Individual from Idaho

Last	First	Organization
Finkelstein	Amy	MIT
Finnell	Stephen C.	Individual from Georgia
Fisher	Carey	Individual from Georgia
Flach	Robert D.	Taxpro Services Corporation
Ford	Fred	fwf inc
Fox	Rockey	Individual from Georgia
Frank	Jeremie	None provided
Freeman	Art	None provided
Friesen	Corey	Individual from Oregon
Froelich	Daniel	Individual from Pennsylvania
Fry	Carol	Individual from Georgia
Fulton	Kathryn	H&R Block
Furman	Jason	NEC
Gailey	Scott	Individual from California
Gale	Bill	Brookings
Galvin	Walt	Emerson
Garcia	James	Individual from New Mexico
Garmon	Andrea	Individual from New Jersey
Gaspard	Michael	Individual from California
Gastler	Shirley	Individual from Missouri
Gavalis	Albert	Individual from NY
Geeting	Jonathan	Individual from Pennsylvania
Gellasch	Tyler	U.S. Senator Carl Levin
Gerardi	Geraldine	U.S. Department of the Treasury
Germann	Christine	Individual from New Jersey
Gibson	L.	None provided
Gilbert	Karl	Individual from Maryland
Gilbert	Frank	Individual from Ohio

Last	First	Organization
Godwin	Robert	Century Homes
Goluboff	Nicole	Individual from New York
Gordon	Roger	UC San Diego
Gordon	Jane	None
Goulder	Robert	Tax Analysts
Graham	John F.	Ansett
Grantham	Doug	Individual from Georgia
Grantham	Douglas	None provided
Granwell	Alan W.	DLA Piper
Gray	Victor E.	Individual from Nevada
Greco	Cal	Individual from Pennsylvania
Green	Bradley	Individual from California
Green	Jason	Individual from Georgia
Greenstein	Robert	Center on Budget and Policy Priorities
Greer	Lisa	Individual from Georgia
Gropper	Adam	Baker Hostetler
Gross	Drew	Individual from North Carolina
Grubert	Harry	U.S. Department of the Treasury
Grumet	Louis	New York State Society of Certified Public Accountants
Guerard	Teresa	Individual from Florida
Gustafson	Susan	Princess House, Inc
Gwyn	Brigitte	Business Roundtable
Hadstate	James	Individual from South Carolina
Hahn	Bruce	American Homeowners Grassroots Alliance/American Homeowners Foundation
Hakim	Joseph B.	Individual from Iowa
Halber	Barry	Individual from Florida
Hamden	Robert	Individual from Florida
Hammett	Eugene	None provided

Last	First	Organization
Hamor	Kathy	The Savings Coalition of America
Harper	Jonathan	Individual from South Carolina
Hasset	Kevin	AEI
Hatano	Daryl	Semiconductor Industry Association
Hausner	Tony	Individual from Maryland
Hay	Christopher	Individual from South Carolina
Hayes	Gregory	United Technologies
Haynes	James	Individual from Ohio
Hazelwood	Dennis	The Gates Corp.
Heil	Mary	Individual from Michigan
Heller	Ken	National Small Business Association
Herzig, Professor	David	Valparaiso University School of Law
Heter	Thomas	Individual from Kansas
Hightower	Mark A.	Mark A. Hightower, CPA, P.C.
Hines Jr.	James R.	University of Michigan Law School
Hodges	James	Individual from Kansas
Holbrook	Anthony	Georgians for Fair Taxation
Holland	Rebecca	Individual from Georgia
Holzer	Harry	Georgetown Center on Poverty, Inequality and Public Policy
Hooper	Jeff	None provided
Hoover	Brandy Leigh	Individual from West Virginia
Horvath	David	Individual from Michigan
Hoxby	Caroline	Stanford University
Hu	Wendy	Individual from Florida
Hu	Jon	Individual from Florida
Hubbard	Frankie	Individual from Georgia
Huckle	Mike	None provided
Huddleston	Joe	Multistate Tax Commission

Last	First	Organization
Huffman	Sam	Individual from Oregon
Hughes	Davis	U.S. Senate Finance Committee
Hughes	Greg	Individual from Georgia
Hume	John	None provided
Hunt	James	Individual from Georgia
Hunt, Jr.	Marshall	Accounting Aid Society
Irons	John	Economic Policy Institute
Iwan	David	Small business owner
Iwry	Mark	U.S. Department of the Treasury
Jacobowitz	Gerald N.	Jacobowitz and Gubits, LLP
Jaeger	Mike	Individual from California
James	Jonathan	Individual from Tennessee
Jens	Dean	Individual from Illinois
Johnson	Calvin H.	Texas Law School and Shelf Project
Johnson	Pamela	Individual from Georgia
Jones	Teresa	None provided
Jones	Robert	Individual from Georgia
Jones	Robert A.	Individual from Georgia
Jones	Trevor	Individual from Utah
Jones	Billie	ACORN
Kaplan	David	Individual from Massachusetts
Kappler	Jim	Community Metrics, LLC
Karas	Matthew	Individual from Connecticut
Karl	Ed	AICPA
Karobonik	Sheri	Individual from Arizona
Kayal	David Nicholas	Individual from California
Kebschull	William David	Individual from Maryland
Keefer	Jeff	DuPont

Last	First	Organization
Keeling	J. Michael	The ESOP Association
Kelley	Paul	FairTax
Kellner	Richard	Individual from New York
Kelly	Barry	Individual from Missouri
Kelly	Kevin	Individual from Virginia
Kesselman, Professor	Jonathan R.	Simon Fraser University, Graduate Public Policy Program, Vancouver, BC, Canada
Kieffer	Mike	Individual from Utah
Kilgallen	Kim	Individual from Georgia
King	Larry	Individual from Georgia
Kinyon	Richard S.	Morrison & Foerster LLP
Kitchen	John	U.S. Department of the Treasury
Kleinbard	Edward	USC Gould School of Law
Klepinger	David	None provided
Klopping	Randall	None provided
Knakmuhs	Sarah	Altria
Knittel	Mathew	U.S. Department of the Treasury
Koch	Cathleen	U.S. Senate Finance Committee
Korth	Christopher M.	Western Michigan University
Koschik	Julie	Individual from Ohio
Koutoulas	Pete	Individual from Kentucky
Krueger	Alan	U.S. Department of the Treasury
Kukreja	Michael	None provided
Kupfer	Jeff	President's Advisory Panel on Federal Tax Reform
Laforme	Bill	Individual from Massachusetts
Laing	David	Individual from Maine
Lane	Shirley	Individual from Georgia
Lang	Helen	Individual from Florida
Lanton	Ron	H. D. Smith

Last	First	Organization
Lara	David	Office of Governor David Paterson
Larson	Paul	None provided
Lau Gibian	Karen	Investment Company Institute
Lee	Marie	TechAmerica
LeMaster, Executive Director	Roger	The Tax Council
Lenard	Thomas M.	Technology Policy Institute
Lenney	Cheryl	Individual from Georgia
Lenzi	Tony	Individual from Virginia
Lerman	Allen	U.S. Department of the Treasury
Levitsky	Brion	Individual from California
Lewis	Claudia	Individual from Ohio
Libin	Jerome B.	Sutherland Asbill & Brennan LLP
Lifson, CPA	David A.	NY State Society of Certified Public Accountants
Linbeck, Jr.	Leo E.	Americans For Fair Taxation
Livingston	Peg	Individual from Oklahoma
Lobel	Martin	Lobel Novins & Lamont, LLP
Loberger	Patrick	None provided
Locke	Jeffrey	Individual from Kansas
Lockwood	David	Strategy Management, Inc.
Lokpez	Midiala	Individual from Florida
Looker, CPA	Michael	Individual from New York
Looney	Steve	Tax Attorney
Lowrey	Lee	Individual from Georgia
Lykken	Matt	SharedEconomicGrowth.org
Lyon	Andrew	PwC
M	David	None provided
Macker	Brian	Individual from New York
Manieri	Marc	AFFT

Last	First	Organization
Manners	Jahmaal	Individual from Maryland
Mansell	Bev	None provided
Marr	Charles	Center on Budget and Policy Priorities
Martin	Riley D.	Individual from Georgia
Martin	Robert	Individual from Wisconsin
Massie	Roy	None provided
Matthews, JD/CPA	Robert (Chip)	Sam Houston State University
Maxwell	Gary	Individual from California
Maydew	Ed	UNC Kenan-Flagler Business School
Maynes	Bruce	Individual from Georgia
Mazur	Mark	U.S. Department of the Treasury
McAdory	Henry	Individual from Georgia
McCarthy	Jim	Procter & Gamble
McConnell	Bill	Individual from Tennessee
McCrady	Howard	Individual from Arizona
McDonald	Rob	Emerson
McDonald	Timothy	Procter & Gamble
McGinnis	Richard	PwC
McGuire	Monica	R&D Credit Coalition
McIntyre	Robert S.	Citizens for Tax Justice
McKay	Bernard	Intuit
McLane	Charles	Alcoa
McMillion	John	None provided
Meier	Ron	Individual from Nebraska
Melancon	Barry	AICPA
Menke	Roger	Individual from Missouri
Merrill	Peter	PwC
Merszei	Geoffrey	Dow

Last	First	Organization
Meyrow	Sarah	National Retail Federation
Michaelson	Robert	Individual from New
Miller	Matthew M.	Financial Executives International
Mioli	Dean	Individual from Pennsylvania
Miran	Steve	Harvard University
Moeller	Jon	Procter & Gamble
Mole	Alan	Individual from Colorado
Molnar	Anna	Individual from Illinois
Mongiello	Stormy	The Inn of the Patriots Bed and Breakfast
Montague	Rachael	Individual from California
Montgomery	James	Individual from Georgia
Moore	Theresa M.	None provided
Moore	Allen	Individual from Illinois
Mullis	Sharon	Individual from Georgia
Mundaca	Michael	U.S. Department of the Treasury
Mundy	Kimbo	Individual from New Mexico
Murray	Fred F.	Georgetown Law School
Nader	Bertte	greensceneshop.com
Najour	Larry	Azar Electric, Inc.
Najour	Judy	Individual from Georgia
Nellen	Annette	San José State University
Nelson	Susan	U.S. Department of the Treasury
Nelson	Suzanne	Individual from Georgia
Netzley	Matthew	Individual from Indiana
Neubig	Thomas	Ernst & Young
Newman	Thomas	None provided
Newman	Dan	Individual from Colorado
Ninovski	Stanimir	None provided

Last	First	Organization
Nissen	Matt	None provided
Nobles	Jerry	Individual from Mississippi
Nowland	Anne	Individual from Massachusetts
Nowland	Ian	Individual from Massachusetts
Noyes	Paul M.	Individual from Georgia
O'Brien	Jim	Fair Tax
Oh-Willeke	Andrew	Individual from Colorado
Olander	David	U.S. House Ways & Means Committee
Olson	Jim	Individual from Georgia
O'Melia	John M.	None provided
Orme	Vickie	Individual from Georgia
Orszag	Peter	OMB
Ozanne	Larry	Congressional Budget Office
Parr	Curtis	Individual from Oklahoma
Patterson	Stephen	None provided
Peacock	Philip J.	ExaTech Solutions, Inc.
Perez	Ruth	IRS
Perez-Fox	Prescott	Starship Design LLC
Perrone	Anthony	Individual from Florida
Peters	Jeremy	Individual from Michigan
Pettingill	Eric	Mental Wellness Center
Petzold	Charles	Individual from New York
Pfost	Bodie	Individual from California
Phillipine	Louis	Individual from New Jersey
Phillips	Richard	INFRADANT LLC
Phillips	John	Phillips & Cohen LLP
Pinkerton	Lorilyne	None provided
Place	Bob	Individual from Georgia

Last	First	Organization
Plattner	Robert	None provided
Ponder	Kendall	Individual from Missouri
Poot	Hu	None provided
Poterba	Jim	MIT
Prater	Mark	U.S. Senate Finance Committee
Putz	Nancy	Individual from Illinois
Quinn	Ronald	Individual from Florida
Radlo	Lee	Individual from Massachusetts
Rakes	Richard	Individual from Colorado
Rauls	Venecia	Individual from Oregon
Ravitch	Richard	Office of Governor David Paterson
Ray	Suzanne	Individual from Georgia
Recob	Joseph	Individual from Missouri
Regalia	Martin	U.S. Chamber of Commerce
Reister	William L.	None provided
Reister	Bill	Individual from Georgia
Rice	Derica	Eli Lilly
Richards	Shan	Individual from California
Rish	Paul	Individual from Georgia
Roach	Robert	U.S. Senator Carl Levin
Robb	Jeremy	Individual from Utah
Roberson	Graham	Individual from North Carolina
Roberts	Bill	AICPA
Rodriguez	Edward	Individual from California
Roesser	Tom	Microsoft
Rosenbloom	H. David	Caplin & Drysdale
Ross	Jeanne	U.S. Department of the Treasury
Ross	Samuel	Individual from New Jersey

Last	First	Organization
Ross	Chip	None provided
Rossotti	Charles	Carlyle Group
Rough	John E.	None provided
Roxx	Kimillion	Robertson Properties
Rutherford	Ken	Individual from Georgia
Rutledge	Jacob	Individual from Georgia
Rys	William	National Federation of Independent Business
Sama	Rob	Individual from Massachusetts
Sammartino	Frank	Congressional Budget Office
Samuel	Randall	Individual from Ohio
Samuels	John	GE
Samwick	Andrew	Dartmouth College
Satagaj	John	Small Business Legislative Council
Savage	Jeffrey	Individual from Missouri
Sawyer	James	Praxair
Sayler	Joy	Individual from Nevada
Schenk	Deborah H.	NYU Law School
Scheppers	John	Individual from Missouri
Schiavo	Pete	Individual from California
Schifferl	Donald	Individual from Indiana
Schilling	Juli	Computer & Communications Industry Association
Schmid	Heinrich O.E.	Individual from Austria
Schoewe	Thomas	Walmart
Sears	Brayden	Individual from Kentucky
Seden	Michael	Individual from Georgia
Sedlak	Sophie	Individual from Georgia
Sepp	Pete	Taxpayers Union
Seto	Theodore	Loyola Law School Los Angeles

Last	First	Organization
Shahi	Hurshbir	None provided
Shannon	Guy	None provided
Sharaf Eldin	Aref Ahmed	BUSINESS
Shaviro	Daniel N.	NYU Law School
Shay	Stephen	U.S. Department of the Treasury
Shear	Anissa M.	Andyrsco & Associates, Inc.
Sherman	Jillian L.	Virginia College Savings Plan
Shimandle	Adie	Fair Tax
Shlaes	Amity	NYU Stern School of Business
Shulin	J.	None
Shulman	Doug	IRS
Shultz	Ronald	Individual from Pennsylvania
Shumans	Diane	Individual from Georgia
Sica	Bob	Individual from Georgia
Silverman	Mark	Steptoe & Johnson LLP
Singer	Paula N.	Vacovec, Mayotte & Singer, LLP
Skipton	F.	Individual from Oregon
Slater	Kim	Individual from Georgia
Slemrod	Joel	University of Michigan
Slot	Bryan G.	Individual from Illinois
Smith	Frederick W.	FedEx Corporation
Smith	Tiffany	U.S. Senate Finance Committee
Smith	Robert	Individual from Florida
Smith	Joshua	Individual from Florida
Smith	Darrel E.	Individual from Indiana
Smith, Jr.	F. Houston	Individual from North Carolina
Sparkman	Don	Individual from Georgia
Spradley	Chip	Individual from Georgia

Last	First	Organization
Spradling	Gregory B.	Individual from Tennessee
Starkman, CPA	Jay	Jay Starkman, PC
Stauffer	John	None provided
Stegner	Bill	Individual from Georgia
Stephens	Terrell	Individual from North Carolina
Steuerle	C. Eugene	Peter G. Peterson Foundation
Stresing	Matthew	None provided
Stretch	Clinton	Deloitte Tax LLP
Strickland	Brent	Yale University
Strier	Robert	Individual from Florida
Suez	Emmanuel	UC Berkeley
Sulcer	Tom	Individual from New Jersey
Summers	Larry	NEC
Sutter	Matthew	Individual from Georgia
Szrejter	Timothy	Individual from Georgia
Taiwo	Olufemi	Indiana University
Talbert	Michael A.	IRS - retired
Talisman	Jonathan	Capital Tax Partners
Taney	Eric	Individual from Texas
Taperman Rolnick	Thala	National Small Business Network
Tauro	Richard	Individual from Ohio
Taylor	Rusty	San Juan Financial
Taylor	Dillon	SBA Office of Advocacy
Taylor	Richard	Individual from Georgia
Taylor	Jim	Individual from Georgia
Taylor	Sharon	Individual from Pennsylvania
Thaxton	James	Individual from Georgia
Thomas	Dawn	Individual from Texas

Last	First	Organization
Thomas	Donald	Individual Taxpayer Advocacy Panel Member
Thompson	Todd	Individual from Florida
Threadgill	Jeremy	Eco Concepts of Mississippi/AMMO
Throckmorton	Charles D.	Voting US Citizen
Thuronyi	Victor	Individual from Maryland
Tiedemann	John	@homecomputers
Tilton	Sandy	9-12 Project
Toder	Eric	Urban Institute
Townsend Jr.	Alvin	Individual from Georgia
Treml	Rudy	Individual from Florida
Trimble	Ray	Individual from Georgia
Tuck	Lee	None provided
Tuszynski	Tyler	Individual from Florida
Vallee	Jean	None provided
Vande Guchte	John	None provided
Vaughn	Latricia	Individual from Missouri
Vazquez	Alex	None provided
Viard	Alan	AEI
Vincent	Joshua	Center for the Study of Economics
Vodanovich	Adam	Individual from Louisiana
Vogelman	Mike	AB Courier
Walker	Robert	None provided
Waller	Alex	Individual from Georgia
Walser	David	None provided
Walter	Robert	Individual from Georgia
Walter	Carolyn	Fair Tax Grassroots
Warlick	Mike and Marian	Americans for Fair Taxation
Warlick, Sr.	Michael D.	Americans for Fair Taxation/Georgians for Fair Taxation

Last	First	Organization
Warren	Mark	Retail Industry Leaders Association
Washington	Dianne	Individual from New York
Waters	Jack	Individual from Pennsylvania
Weaver	Debra	Internal Revenue Service
Weinburg	Mark	Individual from Massachusetts
Weiner	Joann M.	George Washington University
Wells	Kenneth	Individual from Alaska
Wells	Steve	Individual from Georgia
Welsh	Walter	ACLI, AALU, GAMA, NAILBA, and NAIFA
West	Jade	The LIFO Coalition
West	Philip	Steptoe & Johnson LLP
Westover-Kernan	Tiffany	Corporate Voices for Working Families
Whalen	Richard	None provided
Whitehead	Lois	NY State Society of Certified Public Accountants
Whitson	Herb	Individual from Georgia
Wilkerson	Matt	None provided
Wilkerson	Matt	Americans for Fair Taxation
Williams	Michael	North American Equipment Dealers Association
Williams	Lyn	AFFT
Wilson	John	Meredith College
Wilson	Leslie	Wilson & Associates Architects, Inc.
Wilson	Logan	Individual from Arizona
Wilson	Charles	Individual from Ohio
Witt	David	Individual from Ohio
Wolf	Maurice A.	Individual from California
Wrick	Nancy	Individual from Pennsylvania
Wright	Arthur W.	University of Connecticut
Wright	Sam	None provided

Last	First	Organization
Wyden	Ron	U.S. Senator Ron Wyden
Yin	George K.	University of Virginia School of Law
Young	Mary Ann	Fair Tax
Zagaris	Bruce	Berliner, Corcoran & Rowe, LLP
Zieburtz	Wiliam	None provided
Zobel	Kenneth	Individual from New York
Zolt	Eric M.	UCLA
	Beckham	None provided
	Burrton	Individual from Georgia
	Chris	Individual from Georgia
	Colin	Individual from Missouri
	Ed	Individual from Pennsylvania
	Edward	Individual from France
	Froggy	Individual from Colorado
	Glenn	LU 803
	Greg	Illinois State University Graduate Student
	Harry	None provided
	Indigent	Salvation Army
	J	None provided
	Jess	None provided
	Jill	Individual from Utah
	Jim	Individual from Georgia
	John	None provided
	Joy	Individual from Arizona
	Kalanda	Individual from Florida
	Karen	Fair Tax
	Kristina	Individual from Florida
	Nancy	None provided

Last	First	Organization
	Peter	Self-Employed
	Peter	Self-Employed
	Tasha	Individual from Michigan
	Ted	Individual from Florida
		National Tax Association
		IRS Research Conference
		NBER Tax Policy and the Economy Conference