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

James M. Bickley
Specialist in Public Finance

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Summary

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

Proposals for fundamental reform have been made in reports by the National Commission on Fiscal Responsibility and Reform and the Debt Reduction Task Force of the Bipartisan Policy Center. In the 112th Congress, fundamental tax reforms are proposed in two companion bills, H.R. 25 and S. 13, *Fair Tax Act of 2011*; H.R. 99, *Fair and Simple Tax Act of 2011*; H.R. 1125, the *Debt Free America Act*; S. 727, the *Bipartisan Tax Fairness and Simplification Act of 2011*; H.R. 1040, the *Freedom Flat Tax Act*; and S. 820, the *Simplified Manageable, and Responsible Tax Act.* On April 13, 2011, President Obama presented his *Framework for Shared Prosperity and Shared Fiscal Responsibility*, which includes fundamental tax reform. On April 14, 2011, Representative Paul Ryan introduced H.Con.Res. 34. On April 15, 2011, the House passed this FY2012 budget resolution, which includes fundamental changes in the U.S. tax system. An evaluation of these and other proposals would consider the effects on equity, efficiency, and simplicity.

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

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

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

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

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

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Introduction

The President and leading Members of Congress have stated that fundamental tax reform is a major policy objective for the 112th Congress. These policymakers have said that fundamental tax reform is needed in order to raise a large amount of additional revenue, which is necessary to reduce high forecast budget deficits and the sharply rising national debt. Congressional interest has been expressed in both a major overhaul of the U.S. tax system and the feasibility of levying a consumption tax over the existing tax system.[1] Some proponents of reform argue that the tax base should be broadened by reducing or eliminating many tax expenditures. "Tax expenditures are revenue losses resulting from federal tax provisions that grant special tax relief designed to encourage certain kinds of behavior by taxpayers or to aid taxpayers in special circumstances."[2] If tax expenditures are reduced substantially or a consumption tax is levied or both, then the marginal income tax rates could be reduced. An alternative to increasing tax revenues is cutting spending. Thus, Members are faced with considering the best mix of tax increases and spending cuts in order to reduce deficits and slow the growth of the national debt.

In December 2010, The National Commission on Fiscal Responsibility and Reform (the "Commission") issued a report titled *The Moment of Truth*, which proposed extensive broadening of both the individual income tax base and the corporate income tax base by eliminating all business tax expenditures and almost all individual tax expenditures.[3] Marginal individual and corporate income tax rates would be reduced, and the individual alternative minimum tax would be abolished. The taxation of foreign-source income would be changed by moving to a territorial system.[4] On November 17, 2010, the Debt Reduction Task Force of the Bipartisan Policy Center issued a report titled *Restoring America's Future*.[5] This report also recommended that individual and corporate income tax bases be broadened by reducing or eliminating most tax expenditures. Marginal individual and corporate income tax rates would be lowered, and the individual alternative minimum tax would be eliminated. In addition, this report recommended that a 6.5% value-added tax be levied. The recommendations of these two reports may influence the tax reform debate in the 112th Congress.

In the 112th Congress, Members of Congress have introduced numerous bills containing incremental or marginal adjustments in the tax code in an attempt to redistribute income, reallocate resources, change individual behavior, etc. Proposed incremental or small tax adjustments are considered tax changes.[6] In contrast, fundamental tax reform concerns a major proposed overhaul of the U.S. tax system, which affects the entire tax system or a major component of the system.

In the 112th Congress, bills proposing fundamental tax reform have been introduced. Two companion bills, H.R. 25 (introduced by Representative Rob Woodall) and S. 13 (introduced by

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[1] For more information, see CRS Report R41641, *Reducing the Budget Deficit: Tax Policy Options*, by Molly F. Sherlock.

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

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

[4] Ibid., p. 33.

[5] The Debt Reduction Task Force, Bipartisan Policy Center, *Restoring America's Future*, November 17, 2010, 138 p.

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

Senator Saxby Chambliss), *Fair Tax Act of 2011*, would replace the individual income tax, the corporate income tax, all payroll taxes, the self-employment tax, and the estate and gift taxes with a 23% (tax-inclusive) national retail sales tax. Representative David Dreier introduced H.R. 99, *Fair and Simple Tax Act of 2011*, which would establish an alternative determination of tax liability for individuals. Representative Michael Burgess introduced H.R. 1040, *Freedom Flat Tax Act*, which would authorize an individual or a person engaged in business activity to make an irrevocable election to be subject to a flat tax (in lieu of the existing tax provisions). Representative Chaka Fattah introduced H.R. 1125, *Debt Free America Act*, which would impose a transaction fee of 1% on the entire amount of specified intermediate and final transactions. Revenue raised from this fee would be sufficient to eliminate the national debt during a 10-year period and phase out the income tax on individuals. Senator Richard C. Shelby introduced S. 820, the *Simplified, Manageable, and Responsible Tax Act*, which was modeled after the flat tax proposal formulated in 1981 by Hall and Rabushka and would levy a consumption tax as a replacement for individual and corporate income taxes and estate and gift taxes. This proposal would have two components: a wage tax and a cash-flow tax on businesses. On April 14, 2011, Representative Paul Ryan introduced House Continuing Resolution 34, which includes major tax reforms. On April 15, 2011, the House passed this FY2012 budget resolution, which includes fundamental changes in the U.S. tax system.[7]

Two major fiscal reform proposals containing major tax reforms have been introduced or updated during 2011. On April 13, 2011, President Obama presented his *Framework for Shared Prosperity and Shared Fiscal Responsibility*, which proposes to reduce the deficit by $4 trillion over 12 years or less. The President's plan includes comprehensive tax reform. On June 29, 2011, the President's Fiscal Commission published updated estimates of its proposal.[8]

This report primarily covers fundamental tax reform because CRS reports are available online concerning the other three categories of tax reform: tax reform based on the elimination of the individual alternative minimum tax (AMT), proposals for reforming the corporate income tax, and proposals for reforming the U.S. taxation of international business.[9]

Fundamental Tax Reform Options

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

Base-Broadening

Some Members of Congress have expressed concern about the large number and high cost of tax expenditures.[10] Examples of tax expenditures are the deduction for mortgage interest on owner-

[7] House Committee on the Budget, Chairman Paul Ryan, *The Path to Prosperity, Fiscal Year 2012 Budget Resolution*, 63 pp.

[8] National Commission on Fiscal Responsible and Reform, *Updated Estimates of the Fiscal Commission Proposal*, June 29, 2011, 14 pp.

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

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

occupied residences and the deduction for property taxes on owner-occupied residences. Many of these tax expenditures are seen as targets to be reduced or eliminated. Congress may want to consider whether the benefits of a particular tax expenditure exceed the costs of that tax expenditure. Arguably, the current tax reform debate deals with broadening the individual and corporate income tax bases and lowering marginal tax rates.

New Tax

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

Broad-Based Consumption Tax

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

Value-Added Tax

A value-added tax is a tax on the value that a firm adds to a product at each stage of production.[11] The value the firm adds is the difference between a firm's sales and a firm's purchases of inputs from other firms. The VAT is collected by each firm at every stage of production.

There are three alternative methods of calculating VAT: the credit method, the subtraction method, and the addition method. Under the credit method, the firm calculates the VAT to be remitted to the government by a two-step process. First, the firm multiplies its taxable sales by the tax rate to calculate VAT collected on sales. Second, the firm credits VAT paid on inputs against VAT collected on sales and remits this difference to the government. The firm calculates its VAT liability before setting its prices to fully shift the VAT to the buyer. Under the credit-invoice method, a type of credit method, the firm is required to show VAT separately on all sales invoices and to calculate the VAT credit on inputs by adding all VAT shown on purchase invoices.

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

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

[11] For a comprehensive overview of the concept of a U.S. VAT, see CRS Report R41602, *Should the United States Levy a Value-Added Tax for Deficit Reduction?*, by James M. Bickley. For a primer on the VAT, see CRS Report R41708, *Value-Added Tax (VAT) as a Revenue Option: A Primer*, by James M. Bickley.

Retail Sales Tax

A retail sales tax is a consumption tax levied only at a single stage of production, the retail stage. The retailer collects a specific percentage markup in the retail price of a good or service, which is then remitted to the government.[12] As of February 1, 2010, the Tax Foundation reports that 45 states had retail sales taxes.[13]

Flat Tax

A flat tax could be levied based on the proposal formulated by Robert E. Hall and Alvin Rabushka of the Hoover Institution.[14] Their proposal would have two components: a wage tax and a cash-flow tax on businesses. (A wage tax is a tax only on salaries and wages: a cash-flow tax is generally a tax on gross receipts minus all outlays.) It is essentially a modified VAT, with wages and pensions subtracted from the VAT base and taxed at the individual level. Under a standard VAT, a firm would not subtract its wage and pension contributions when calculating its tax base. Under the flat tax, some wage income would not be included in the tax base because of exemptions. Under a standard VAT, all wage income would be included in the tax base.

Environmental Tax

Environmental taxes have been proposed to reduce pollution and raise revenue. The most frequently discussed energy tax is a *carbon tax* that would be levied on the volume of carbon emitted.[15] This tax is frequently recommended by economists, but the Obama Administration is attempting to implement a cap and trade system. Another alternative energy tax would be higher *gasoline taxes*.[16]

Framework of Evaluation

In evaluating any change in tax policy, the prevailing framework is to analyze the tax policy for equity, efficiency, and simplicity. Tradeoffs may exist between these three objectives. For example, if greater income equality is desired, this may conflict with the goal of economic efficiency.

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

[13] *State Sales, Gasoline, Cigarette, and Alcohol Tax Rates by State, 2000-2010*, Tax Foundation. Available at http://www.taxfoundation.org, visited April 18, 2011.

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

[15] For an analysis of the carbon tax, see CRS Report R40242, *Carbon Tax and Greenhouse Gas Control: Options and Considerations for Congress*, by Jonathan L. Ramseur and Larry Parker.

[16] For an analysis of the gasoline tax, see CRS Report R40808, *The Role of Federal Gasoline Excise Taxes in Public Policy*, by Robert Pirog.

Equity

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

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

Efficiency

Tax policy should promote economic efficiency; that is, a tax change should be as neutral as possible by minimizing economic distortions.[17] Low marginal tax rates tend to lessen distortions.

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

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

Simplicity

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

Other Tax Reform Issues

Alternative Minimum Tax for Individuals

In 1969, Congress enacted the individual alternative minimum tax (AMT) to make sure that everyone paid at least a minimum of income taxes and still preserve the economic and social incentives in the tax code. The combined effects of inflation and the legislative reductions in the

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

regular income tax have expanded the number of taxpayers subject to the AMT. Consequently, Congress has passed temporary increases in the basic exemption for the AMT to limit the number of taxpayers subject to the AMT. Most recently, an AMT patch for 2010 and 2011 was included in the *Tax Relief, Unemployment Insurance Authorization, and Job Creation Act of 2010*, which became P.L. 111-312 on December 17, 2010. Some proponents of tax reform argue that the AMT should be repealed or a permanent patch should be passed, but either reform would require a major increase in taxes to offset the large revenue loss.[18]

Business Taxation

Federal taxes on business income have differential effects.[19] For example, non-corporate income is taxed less than corporate income, debt financing is an expense but equity financing is not, and depreciation rules favor machines and equipment over structures and inventory. These differential effects distort investment decisions, lessen economic efficiency, and lower economic welfare. Several options have been proposed to reform federal business taxation.[20]

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

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

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

International Taxation

The rapid growth of the foreign trade sector in the U.S. economy and the expansion of international flows of capital have increased the importance of appropriate U.S. international tax practices.[21] The two alternative principles on which countries can base their international tax systems are residence and territory.

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

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

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

[21] This section of this report summarizes some basic concepts in CRS Report RL34115, *Reform of U.S. International Taxation: Alternatives*, by Jane G. Gravelle. Some excerpts are stated from this report. For a primer on international corporate taxation, see CRS Report R41852, *U.S. International Corporate Taxation: Basic Concepts and Policy Issues*, by Mark P. Keightley.

Under a residence system, a country taxes its own residents (or domestically chartered "resident" corporations) on their worldwide income, regardless of its geographic source. Under a territorial system, a country taxes only income that is earned within its own borders. Currently, the United States has a hybrid system with elements of both a residence system and a territorial system. The United States taxes both income of foreign firms earned within its borders as well as the worldwide income of its U.S.-chartered firms. U.S. taxes, however, do not apply to the foreign income of U.S.-owned corporations chartered abroad. A U.S. firm can indefinitely defer U.S. tax on its foreign income if it conducts its foreign operations through a foreign-chartered subsidiary corporation; U.S. taxes do not apply as long as the foreign subsidiary's income is reinvested overseas. With some exceptions, U.S. taxes apply only when the income is remitted to the U.S.-resident parent as dividends or other intra-firm payments. While the United States taxes worldwide income on either a current or deferred basis, it also allows a foreign tax credit for foreign taxes paid on a dollar-for-dollar basis against U.S. taxes in order to avoid the double-taxation of income.[22]

The current system is complex and difficult to administer. Furthermore, critics argue that the current system is not sufficiently neutral, which results in economic inefficiency. The system provides a tax incentive to invest in countries with low tax rates and a disincentive to invest in countries with high tax rates. Proposals to reform the U.S. international tax system include the replacement of the current hybrid system with either a territorial tax system or a residence-based system.[23]

Fundamental Tax Reform Legislation in the 112th Congress

In the 112th Congress, several bills for fundamental tax reform have been introduced.

Representative David Dreier's Proposal

H.R. 99. The *Fair and Simple Tax Act of 2011* was introduced on January 5, 2011, and referred to the House Ways and Means Committee. This bill would establish an alternative determination of tax liability for individuals. A "simplified taxable income" would be taxed at the rates of 10% on the first $40,000, 15% on the income over $40,000 but under $150,000, and 30% on the income over $150,000. Simplified taxable income would equal gross income less the sum of deductions for personal exemptions, the deduction allowed for the acquisition of indebtedness with respect to the principal residence, the deduction allowed for state and local income taxes, the deduction allowed for charitable giving, and the deduction allowed for medical expenses. The estate and gift taxes would be repealed. The alternative minimum tax exemption amounts would be indexed for inflation. The maximum corporate income tax rate would be reduced to 25%. The 15% rate on dividends and capital gains of individuals would be reduced to 10%. The basis for assets for purposes of determining capital gain or loss would be indexed for inflation. This bill would create tax-free accounts for retirement savings, lifetime savings, and lifetime skills. Examples of qualified life skills include assessments of skill levels, development of an individual employment

[22] Ibid., p. 2.

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

plan, career planning, occupational skills training, on-the-job training, and entrepreneurial training. This bill would repeal the adjusted gross income threshold in the medical care deduction for individuals under age 65 who have no employer health coverage. This bill would make the research credit permanent. This bill would repeal Title IX of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) relating to sunset of provisions. This bill would repeal Section 107 of the Jobs and Growth Tax Relief Reconciliation Act of 2003 relating to application of EGTRRA sunset to this title.

Representative Rob Woodall/Senator Saxby Chambliss Proposal

H.R. 25. The *Fair Tax Act of 2011* was introduced on January 5, 2011, by Representative Rob Woodall and referred to the Committee on Ways and Means. A companion bill, **S. 13**, the *Fair Tax Act of 2011,* was introduced on January 25, 2011, by Senator Saxby Chambliss and referred to the Senate Finance Committee. This proposal would repeal the individual income tax, the corporate income tax, all payroll taxes, the self-employment tax, and the estate and gift taxes and levy a 23% (tax-inclusive) national retail sales tax as a replacement. The tax-inclusive retail sales tax would equal 23% of the sum of the sales price of an item and the amount of the retail sales tax. Every family would receive a rebate of the sales tax on spending amounts up to the federal poverty level (plus an extra amount to prevent any marriage penalty). The Social Security Administration would provide a monthly sales tax rebate to registered qualified families. The 23% national retail sales would not be levied on exports. The sales tax would be separately stated and charged. Social Security and Medicare benefits would remain the same with payroll tax revenue replaced by some of the revenue from the retail sales tax. States could elect to collect the national retail sales tax on behalf of the federal government in exchange for a fee. Taxpayer rights provisions are incorporated into the act. The sales tax would sunset at the end of a seven-year period beginning on the enactment of this act if the Sixteenth Amendment is not repealed. This amendment provided Congress with the “power to lay and collect taxes on incomes.... ”

Representative Chaka Fattah’s Proposal

H.R. 1125. The *Debt Free America Act* was introduced on March 16, 2011, and referred to the Committee on Ways and Means and three other committees. This act states that its purposes are to raise sufficient revenue from a fee on transactions to (1) eliminate the national debt within 10 years and phase out the individual income tax, and (2) provide incentives for private sector investment in capital goods, clean energy generation, and infrastructure development. This act would amend the Internal Revenue Code to impose a transaction fee of 1%, offset by a corresponding nonrefundable income tax credit, on every specialized transaction that uses a payment instrument, including any check, cash, credit card, transfer of stock, bonds, or other financial instrument. This act defines “specified transaction” to (1) exclude any deposit into a personal account of an individual and any transfer between accounts, and (2) include retail and wholesale sales, purchases of intermediate goods, and financial and intangible transactions. The fees would be collected by the seller or financial institution servicing the transaction and would be paid to the U.S. Treasury. This act would establish in the legislative branch the Bipartisan Task Force for Responsible Fiscal Action, which would review the fiscal imbalance of the federal government, identify factors affecting the long-term fiscal imbalance, analyze potential courses of action, and provide recommendations and legislative language to improve the long-term fiscal imbalance. This act would repeal after 2021 the individual income tax, refundable and nonrefundable personal tax credits, and the alternative minimum tax (AMT) on individuals. This act would direct the Secretary of the Treasury to (1) prioritize the repayment of the national debt to protect the fiscal stability of the United States; and (2) study and report to Congress on the implementation of this act.

Senator Ron Wyden's Proposal

S. 727. The *Bipartisan Tax Fairness and Simplification Act of 2011* was introduced on April 5, 2011, and referred to the Senate Finance Committee. This act was also sponsored by Senator Dan Coats and is often referred to as the Wyden-Coats proposal. This proposal would reform the current income tax base rather than changing to a consumption base. This bill has three stated purposes: (1) to make the federal individual income tax system simpler, fairer, and more transparent; (2) to make the federal corporate income tax rate a flat 24%, repeal the corporate alternative minimum tax, and eliminate special tax preferences that favor particular types of businesses or activities; and (3) to partially offset the federal budget deficit through the increased fiscal responsibility resulting from these reforms.

The progressive individual income tax would have three rates: 15%, 25%, and 35%. The individual alternative minimum tax would be eliminated. The standard deduction would almost triple. While most deductions would be eliminated, the bill would include deductions for mortgage interest and charitable contributions. The bill would permanently extend the enhancements of the child tax credit, the earned income tax credit, and the dependent care credit. The bill would consolidate the three existing types of IRAs into a new retirement savings account, and a new lifetime savings account. A married couple would be able to contribute up to $14,000 per year to tax-favored retirement and savings accounts. The corporate tax rate would be 24% of taxable income. The corporate tax base would be broadened by the elimination of numerous tax credits, deductions, and exclusions from income. The growth of small businesses would be encouraged by allowing businesses with gross annual receipts of up to $1 million to permanently expense all equipment and inventory costs in a single year. The bill includes numerous provisions to improve tax compliance.

Representative Michael C. Burgess's Proposal

H.R. 1040. The **Freedom Flat Tax Act** was introduced on March 11, 2011, by Representative Burgess and referred to the House Committee on Ways and Means and the House Committee on Rules.

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

For individuals not engaged in business activity who select the flat tax, their initial tax rate would be 19%, but after two years this rate would decline to 17%. The individual flat tax would be levied on all wages, retirement distributions, and unemployment compensation. An individual's taxable income would also include the taxable income of each dependent child who has not attained age 14 as of the close of such taxable year.

The flat tax would have "standard deductions" that would equal the sum of the "basic standard deduction" and the "additional standard deduction."

The "basic standard deduction" would depend on filing status:

- $30,320 for a married couple filing jointly or a surviving spouse
- $19,350 for a single head of household
- $15,160 for a single person or a married person filing a separate return

The "additional standard deduction" would be an amount equal to $6,530 for each dependent of the taxpayer. All deductions would be indexed for inflation using the consumer price index (CPI).

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

For those employees electing the flat tax, government employers and employers of nonprofit organizations would pay a flat tax on their employees' fringe benefits, except retirement contributions, because activities of government entities and tax-exempt organizations would be exempt from the business tax.

Any congressional action that raises the flat tax rate or reduces the amount of the standard deduction would require a three-fifths (supermajority) vote in both the Senate and the House of Representatives. The effective date of the flat tax would be calendar year 2012.

Senator Richard C. Shelby's Proposal

S. 820. The **Simplified, Manageable, and Responsible Tax Act** was introduced on April 14, 2011, and referred to the Senate Finance Committee. This act is modeled after the flat tax proposal formulated in 1981 by Hall and Rabushka and would levy a consumption tax as a replacement for individual and corporate income taxes and estate and gift taxes. This proposal has two components: a wage tax and a cash-flow tax on businesses.

The individual wage tax would be levied at a 17% rate. The individual wage tax would be levied on all wages, salaries, pension distributions, and unemployment compensation. An individual's taxable income would include taxable income of each dependent child who has not attained age 14 as of the close of the taxable year. The individual wage tax would not be levied on Social Security receipts. Thus, the current partial taxation of Social Security payments to high-income households would be repealed. Social Security contributions would continue to be taxed; that is, they would not be deductible and would be made from after-tax income. Firms would pay the business tax on their Social Security contributions. Individuals would pay the wage tax on their Social Security contributions. The individual wage tax would have "standard deductions" that would equal the sum of the "basic standard deduction" and the "additional standard deduction."

The "basic standard deduction" would depend on filing status. For tax year 2012, the basic standard deduction would have been the following:

- $26,810 for a married couple filing jointly or a surviving spouse
- $17,120 for a single head of household

- $13,410 for a single person
- $13,410 for a married person filing a separate return

The "additional standard deduction" would be an amount equal to $5,780 for each dependent of the taxpayer. All deductions would be indexed for inflation using the consumer price index (CPI).

Businesses would pay a tax of 17% on the difference (if positive) between gross revenue and the sum of purchases from other firms, wage payments, and pension contributions. This business tax would cover corporations, partnerships, and sole proprietorships. Pension contributions would be deductible but there would be no deductions for fringe benefits. State and local taxes (including income taxes) and payroll taxes would not be deductible.

If the business's aggregate deductions exceed gross revenue, then the excess of aggregate deductions can be carried forward to the next year and increased by a percentage equal to the three-month Treasury rate for the last month of the taxable year.

Government employers and employers of nonprofit organizations would pay a 17% tax on their employees' fringe benefits, except retirement contributions, because activities of government entities and tax-exempt organizations would be exempt from the business tax.

This bill would be effective for taxable years beginning after December 31, 2011. A supermajority of three-fifths of the Members of the House or Senate would be required to (1) increase any federal income tax rate; (2) create any additional federal income tax rate; (3) reduce the standard deduction; or (4) provide any exclusion, deduction, credit, or other benefit which results in a reduction in federal revenues.

Other Legislation in the 112th Congress Relevant to Fundamental Tax Reform

H.R. 462. (Sponsor: Representative Bob Goodlatte).

The *Tax Code Termination Act* was introduced on January 26, 2011, and referred to the House Committee on Ways and Means. After December 31, 2015, this bill proposes to terminate the tax code except for self-employment taxes, Federal Insurance Contributions Act taxes, and Railroad Retirement taxes. This proposal declares that any new federal tax system should be a simple and fair system that (1) applies a low rate to all Americans, (2) provides tax relief for working Americans, (3) protects the rights of taxpayers and reduces tax collection abuses, (4) eliminates the bias against savings and investment, (5) promotes economic growth and job creation, and (6) does not penalize marriage or families. This bill would require that the new federal tax system be approved by Congress not later than July 4, 2015.

H.Con.Res. 34. (Sponsor: Representative Paul Ryan).

House Budget Chairman Paul Ryan introduced this continuing resolution on April 14, 2011, "establishing the budget for the United States Government for fiscal year 2012 and setting forth appropriate budgetary levels for fiscal years 2013 through 2021." On April 15, 2011, this bill was passed by the House. This FY2012 budget resolution proposes to reduce future deficits and slow the growth of the national debt. Major reforms in the tax system are proposed. The summary regarding taxes states that the budget resolution

- keeps taxes low so the economy can grow, eliminates roughly $800 billion in tax increases imposed by the President's health care law, and prevents the $1.5 trillion tax increase called for in the President's budget; and
- calls for a simpler, less burdensome tax code for households and small businesses, lowers tax rates for individuals, businesses, and families, sets top rates for individuals and businesses at 25%, and improves incentives for growth, savings, and investment.[24]

Other Major Fiscal Reform Proposals

Two major fiscal reform proposals containing major tax reforms were introduced or updated during 2011. On April 13, 2011, President Obama presented his *Framework for Shared Prosperity and Shared Fiscal Responsibility*, which proposes to reduce the deficit by $4 trillion over 12 years or less. The President's plan includes comprehensive tax reform. On June 29, 2011, the President's Fiscal Commission published updated estimates of its proposal.

President Obama's April 2011 Fiscal Reform Proposal

On April 13, 2011, President Obama gave a speech in which he presented his *Framework for Shared Prosperity and Shared Fiscal Responsibility*. The President set a goal of reducing the deficit by $4 trillion in 12 years or less.[25] Under tax reform, the fact sheet for his proposal states

> The President is calling on Congress to undertake comprehensive tax reform that produces a system which is fairer, has fewer loopholes, less complexity, and is not rigged in favor of those who can afford lawyers and accountants to game it.
>
> He believes we cannot afford to make our deficit problem worse by extending the Bush tax cuts for the wealthiest Americans.
>
> He also supports efforts to build on the Fiscal Commission's goal of reducing tax expenditures so that there is enough savings to both lower rates and lower the deficit. Reform should be designed to ask more of those who can afford it while protecting the middle class and promoting economic growth.
>
> In addition, as he explained in the State of the Union, the President is continuing his effort to reform our outdated corporate tax code to enhance our economic competitiveness and encourage investment in the United States. By eliminating loopholes, reducing distortions and leveling the playing field in our corporate tax code, we can use the savings to lower the corporate tax rate for the first time in 25 years without adding to the deficit.[26]

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[24] House Committee on the Budget, Chairman Paul Ryan, *The Path to Prosperity*, April 5, 2011, p. 5.

[25] The White House, Office of the Press Secretary, *Fact Sheet: The President's Framework for Shared Prosperity and Shared Fiscal Responsibility*, April 13, 2011, p. 1.

[26] Ibid., p. 5.

President's Fiscal Commission Updated Estimates

On June 29, 2011, the President's Fiscal Commission published updated estimates of its proposal.27 Under the Fiscal Commission's plan, deficits were projected to decline as follows: 8.1% of GDP in 2011, 6.4% of GDP in 2012, 2.3% of GDP in 2015, and 1.2% of GDP in 2020.28 Under the Fiscal Commission's updated estimates, deficits are projected to fall from 9.3% of GDP in 2011, 6.8% of GDP in 2012, 2.6% of GDP in 2015, and 1.8% of GDP in 2020.29 The Fiscal Commission's explanation is:

> The deficit … numbers differ from original estimates in the Commission report largely because the increased debt burden created by the 2010 tax cut deal and, more significantly, because of lower economic growth assumptions which have significantly pushed down revenue projections.[30]

The Commission's updated estimates also cover changes in the levels of spending, revenues, and debt.

Author Contact Information

James M. Bickley
Specialist in Public Finance
jbickley@crs.loc.gov, 7-7794

[27] National Commission on Fiscal Responsible and Reform, *Updated Estimates of the Fiscal Commission Proposal*, June 29, 2011, 14 pp.

[28] Ibid., p. 4.

[29] Ibid.

[30] Ibid.