

SPECIAL REPORT

May 1995
Number 49

How Will Alternative Tax Reform Plans Affect the Jones Family?

By Arthur P. Hall, Ph.D.
Senior Economist
Tax Foundation

Three alternative tax reform plans have been proposed to replace the current income tax system:

- the flat tax introduced by Rep. Dick Armey (R-Texas) with Richard Shelby (R-Ala.) co-sponsoring the plan in the Senate (presidential candidate Sen. Arlen Specter is offering a similar plan);
- the Unlimited Savings Allowance (USA) Tax System sponsored by Senators Pete Domenici (R-N.M.) and Sam Nunn (D-Ga.);

- and a national retail sales tax advocated by presidential candidate Sen. Richard Lugar (R-Ind.).

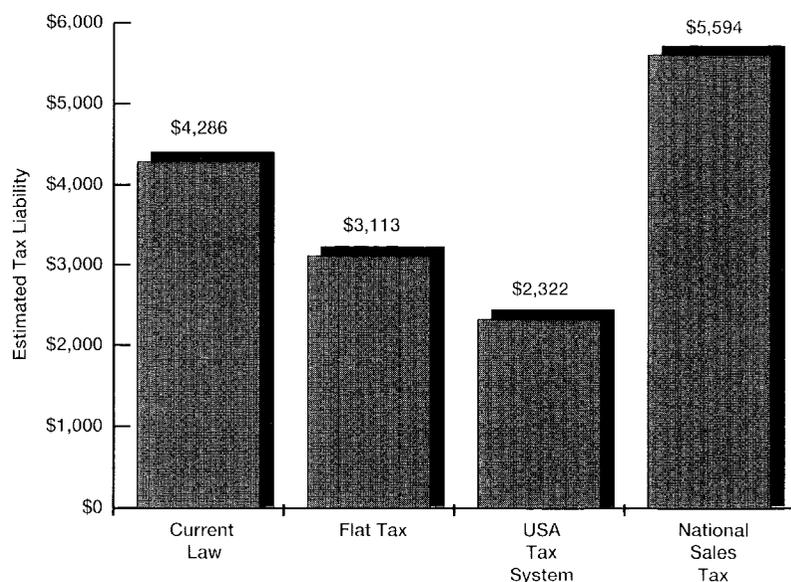
To illustrate the different tax rules and effects for individuals under the alternative plans, the Tax Foundation assisted the Cable News Network (CNN) in calculating an actual family's tax burden — Bob and Susan Jones* of Tennessee — under each of the reform plans and comparing these burdens with the burden under the current income tax system.

The reform plans have identical goals. They seek to eliminate the biased tax treatment of saving and investment and to simplify the process of complying with (and administering) the federal tax system. However, the flat tax and the USA Tax System differ in the approach they take to relieve the tax burden on saving and investment.

Put simply, the flat tax creates for individual taxpayers what is in effect an unlimited, back-ended individual retirement account (IRA). That is, individuals' wage and salary income is taxed when it is earned, while any interest, dividend, and capital gains income that results from either old or new savings is never subject to tax at the individual level. And there are no tax consequences or penalties associated with drawing down one's savings or altering the composition of a savings portfolio.

Under the USA Tax System, individuals must total their wages and salaries (and also any other forms of income), but they are then allowed to deduct their new saving for the year. In effect, then, the USA Tax System operates like an

Figure 1
Estimated Tax Liabilities for the Joneses Under Current System and Alternative Tax Plans



Source: Tax Foundation.

* Their last name has been changed in this report to ensure privacy.

Tax Consequences of the Reform Proposals for the Jones Family

*Table 1
Under Current Law, 1994**

Income:	
Wage/Salary	\$47,066
Interest	67
Capital Gains	(1,960)
Dividends	303
Gross Income	<u>45,476</u>
Less:	
Standard Deduction	6,350
Exemptions	7,350
Taxable Income:	<u>31,776</u>
Tax (15% bracket)	5,736
Child Care Credit	480
Tax Liability	\$4,286

*Calculations based on 1994 rates, exemption levels and deductions.

*Table 2
Armedy-Shelby Flat Tax*

Income:	
Wage/Salary	\$47,066
Less:	
Personal Allowances	26,200
Dependent Exemption	5,300
Taxable Income:	<u>15,566</u>
Tax Liability	\$3,113

(20% rate)

*Table 3
USA Tax System*

Income:	
Wage/Salary	\$47,066
Interest	67
Capital Gains	*
Dividends	303
Gross Income	<u>47,436</u>
Less:	
Family Allowance	7,400
Exemptions	7,650
Previously Taxed	653
Savings*	
Mortgage Interest	4,250
Charity	240
Savings Allowance	<u>3,600</u>
Taxable Income:	<u>23,643</u>
Tax (19% on first \$5,400; 27% on difference)	5,952
Refundable Credit for Payroll Tax**	3,630
Tax Liability	\$2,322

* Under the USA Tax transition rules, most taxpayers will be able to amortize over a three-year period previously taxed basis of savings assets acquired prior to the USA Tax. The \$653 (one-third of \$1,960) previously tax savings deduction assumes that the Jones family had previously taxed savings basis of \$1,960 — the value of their capital losses for the year. Since the Jones family appears to have a history of saving, their deduction for previously taxed savings is probably understated in this example.

** Both the Social Security and the Medicare portion of the payroll tax are included in the tax credit for wages up to the Social Security wage cap. No credit is available on the payroll taxes levied on wages above this cap.

*Table 4
National Retail Sales Tax*

Income:	
Wage/Salary	\$47,066
Interest	67
Capital Gains	(1,960)
Dividends	303
Gross Income	<u>45,476</u>
Less:	
Payroll Taxes	3,630
Property Tax	698
Mortgage Interest	4,250
Charity	240
Savings	3,600
Other Gov. Fees	<u>150</u>
Estimated Nontaxable "Expenditures"	12,568
Estimated Taxable Expenditures*	32,908
Tax Liability	\$5,594

* Assumes the broadest possible tax base. No goods and services are excluded.

unlimited, front-ended IRA. There are no tax consequences or penalties associated with altering the composition of a savings portfolio and there are no penalties associated with drawing down one's savings. However, any new pre-tax savings that is drawn down to pay for consumption expenditures must be added to the taxpayer's taxable income. Draw-downs of after-tax savings already accumulated under current law are not included in taxable income.

A national retail sales tax differs from the other plans in that it is collected at the point of sale. Analytically, it is similar to the USA Tax except that all expenditures are subject to tax under a sales tax—including draw-downs of existing after-tax savings and purchases with debt.

Fundamental Rules of Each Tax Reform Plan

Because the alternative tax overhaul plans differ in their approaches to the tax treatment of income from saving and investment, their basic rules of operation differ. The flat tax and the USA Tax System also differ in fundamental respects with regard to the taxation of business income.

A. Individual Tax Rules

Figure 1 reports the "bottom line" for our typical family, the Joneses, under each tax system. *Tables 1* through *4* provide the line-by-line calculation of tax liability under each of the reform plans and the current income tax system. *Figures 2* and *3* provide a more graphic visual of these calculations for the flat tax and the USA Tax System. It is assumed that each reform plan would be in its first year of enactment to capture any pertinent transition rules.

The analysis shows that, while the Joneses owe \$4,286 under the current federal income tax system, the family would have a tax liability of \$3,113 under the Armey-Shelby flat tax proposal, at the initial 20 percent tax rate. Under the USA Tax, the Joneses would owe \$2,322 at the higher, initial tax rates. The national sales tax, set at a 17 percent rate, would result in a tax liability of \$5,594.

The mechanics of a retail sales tax are familiar. The generic rules for individuals under the Armey-Shelby flat tax and the USA Tax are summarized below.

Flat Tax Rules for Individuals

Income: Wages, salaries, and pension/retirement distributions (excluding Social Security benefits).

Exemptions: \$26,200 for married filing jointly, \$13,100 for single filer, \$17,200 for head of household filer, \$5,300 per dependent. Each item would be adjusted for inflation each tax year.

Deductions: None. (Sen. Arlen Specter's plan would retain the deduction for home mortgage interest and charitable contributions in exchange for a permanent 20 percent tax rate.)

Tax Rate: 17 percent (two year phase-in rate of 20 percent)

Tax Credits: None.

USA Tax Rules for Individuals

Income: Wages, salaries, interest, dividends, capital gains, distribution from a business to an owner and income distributions from a pension, trust, or estate. Same as current law for Social Security benefits.

Exemptions: \$2,550 for personal and each dependent (which will be adjusted for inflation).

Deductions: Family Allowance deduction (which will be adjusted for inflation): \$7,400 for married filing jointly, \$4,440 for single filers, \$5,400 for head of household filers, all net savings (including reinvested interest, dividend and capital gains income), qualified education expenses, charitable contributions, home mortgage interest, alimony payments.

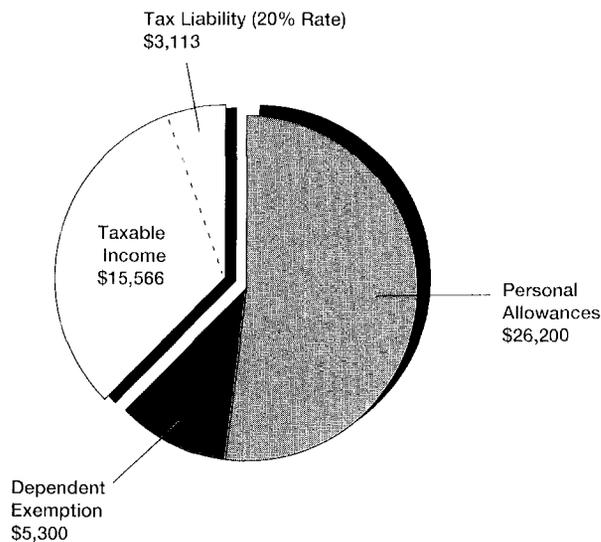
Tax Rates: Joint return brackets (levels will be adjusted for inflation): 8 percent on first \$5,400, 19 percent on \$5,401 through \$24,000, and 40 percent on taxable income over \$24,000. (The two lower rates begin at 19 and 27 percent and decrease annually over the four year phase-in period.) The rate structure is identical for all filers. The bracket levels for single filers are set at \$0, \$3,200, and \$14,400; for head of household filers they are set at \$0, \$4,750, and \$21,100.

Tax Credits: Payroll tax credit equal to the employee portion of Social Security and Medicare payroll taxes paid on wages up to the Social Security wage cap under current law (the 1995 cap is \$61,200). The current law's Earned Income Tax Credit for taxpayers with children will be retained and expanded.

B. Business Tax Rules

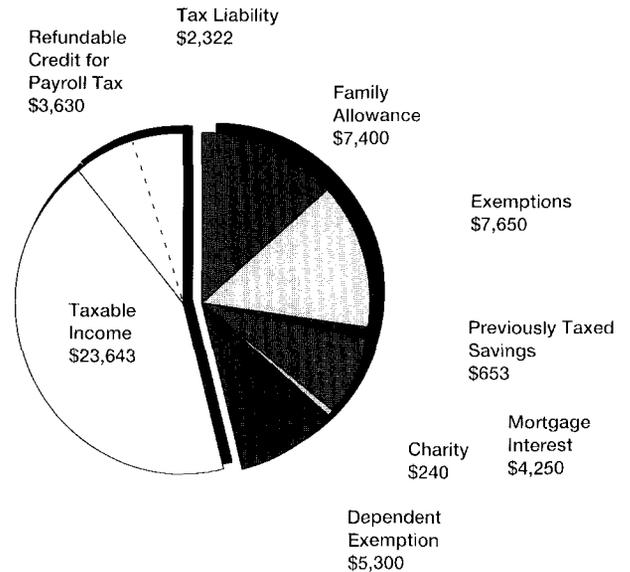
For businesses, there are four key similarities between the flat tax and the USA Tax System. First, each tax treats all business organizations identically. Tax distinctions among corporations, partnerships, and sole proprietorships would disappear. Second, each tax allows for the immediate "expensing" of all capital investments. Third, each tax is "territorial."

Figure 2
Tax Consequences of Jones Family's \$47,066 Income under the Flat Tax



Source: Tax Foundation.

Figure 3
Tax Consequences of Jones Family's \$47,436 Income under the USA Tax System



Source: Tax Foundation.

SPECIAL REPORT
(ISSN 1068-0306) is published at least 10 times yearly by the Tax Foundation, an independent 501(c)(3) organization chartered in the District of Columbia.

4-12 pp.
Annual subscription: \$25.00
Individual issues \$5.

The Tax Foundation, a nonprofit, nonpartisan research and public education organization, has monitored tax and fiscal activities at all levels of government since 1937.

©1995 Tax Foundation

Editor and Communications Director
Stephen Gold

Tax Foundation
1250 H Street, NW
Suite 750
Washington, DC 20005
(202) 783-2760

That is, businesses will not report the net income generated by their foreign-based operations. Fourth, each tax allows businesses to carry business losses forward as offsets against future profits.

Despite these broad similarities, there are several important differences between the Arney-Shelby flat tax and the USA Tax which are highlighted below. (As with state-level retail sales taxes, businesses will be largely unaffected by a national retail sales tax.)

Flat Tax Rules for Businesses:

Business Income: Gross revenue from sales of goods and services.

Deductions: Purchases of goods, services, and materials; Wages, salaries, and retirement benefits; Purchases of capital equipment and land.

Tax Rate: 17 percent (two year 20 percent phase-in rate).

Tax Credits: None.

USA Tax Rules for Businesses:

Business Income: Gross revenue from sales of goods and services.

Deductions: Purchases of goods, services, materials, capital equipment, and land; Revenue received from the sale of exported goods and services.

Tax Rate: 11 percent.

Tax Credits: Employer portion

of the Social Security and Medicare payroll tax.

Special Note: The USA Tax places a levy, set at a rate equal to the business tax rate (11 percent), on foreign businesses that operate outside the United States but sell goods or services in the U.S. market.

Transition Issues

A major consideration of any tax overhaul plan is how to transition from the current tax system to the proposed tax system. These issues are important for the equitable treatment of taxpayers who made financial decisions and business decisions based on prevailing tax law. They are also important for the stability of the government's revenue stream.

Of the three tax overhaul alternatives, only the USA Tax System has attempted to deal with transition issues in a comprehensive way. The relevant transition issues for both individuals and businesses are many and varied. A given tax overhaul plan will likely succeed only when taxpayers at large become convinced of the coherence and equity of the plan's transition rules.