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Chapter 3

A MODEL COMPREHENSIVE INCOME TAX

1. Overview

This chapter presents a model income tax system based, as nearly as possible, upon a consistent definition of standard-of-living income as set forth in the previous chapter. Certain deviations from that definition have been allowed when considerations of efficiency or simplicity have seemed to recommend. Sections 2-11 of this chapter present a set of specific recommendations regarding income measurement issues. These recommendations constitute the proposed model comprehensive tax base.

2. The Filing Unit

Among the most difficult problems of translating an income definition into a tax accounting system is to determine what social or economic unit should be required (or allowed) to file a tax return. Consider, for example, the following potential criteria:

1. Families of equal size with equal incomes should pay equal taxes.
2. The total tax liability of two individuals should not change when they marry.

Both of these appear to be reasonable standards. Yet, there is no progressive tax system that will simultaneously

satisfy them. This is readily illustrated by the following hypothetical case. Both partners of married couple A work, and each has taxable earnings of $15,000. Married couple B has $20,000 of taxable earnings from the labor of one partner, $10,000 from the other.

If individual filing were mandatory, with no income splitting, couple A would pay less than couple B. This is a consequence of applying progressive rates separately to the earnings of each partner. Suppose marginal rates were 10 percent on the first $15,000 of taxable income, 20 percent on any additional income. In this example, couple A would owe $1,500 on each partner's income, or a total of $3,000. Couple B would owe $2,500 on the larger income and $1,000 on the smaller--a total of $3,500. This violates criterion one.

Now compare a system of family filing where all income within the family is aggregated and the tax calculated without regard to relative earnings of each partner. In this case, the two couples would pay the same tax on their total income of $30,000. However, both couples would be worse off married than unmarried, with the same earnings. Each couple now pays a tax on the total of $30,000, or $4,500. As compared with the case of separate filing, more income is taxed at the higher marginal rate. This is sometimes referred to as the "marriage tax"--a violation of criterion 2.

Further, the high marginal rates faced by married couples cause an efficiency loss from the point of view of society; namely, labor force participation by second workers is discouraged. If a partner not in the labor force is thinking of entering it the tax rate that person faces is the marginal rate applying to the prospective total family income. This rate may be much higher than that for a single wage earner. This consequence of family filing is sometimes referred to as the "wife tax."

Direct appeal to the principles of income definition discussed in the preceding chapter does not settle these issues, because those principles presuppose the definition of an accounting unit. There are legal, administrative, and even sociological factors involved in the choice. The major arguments in favor of mandatory <u>individual</u> filing can be summarized as follows: (1) no marriage tax; (2) no discrimination against secondary workers; and (3) the administrative ease of identifying individuals without the requirement of a definition of families. The arguments in favor of <u>family</u> filing are: (1) families with equal incomes will pay equal taxes; (2) families typically make joint decisions about the use of their resources and supply of their labor services; and (3) family filing makes it unnecessary to allocate property rights, as in the case of community property laws, and to trace intrafamily gifts.

This last point is critical. A uses definition of income implies that each individual's ability to pay includes consumption and net worth changes financed by transfers from other family members. Carried to extreme, this would require assessment of tax even to minor children. Chiefly because of this problem, <u>it is recommended that the family be made the primary tax unit</u>.

The definition of a family is, of necessity, somewhat arbitrary, as is the application of progressive rate schedules to families of different types. The following definition of a family is adopted here [1/]: The family unit consists of husband and wife and their children. The children are included until the earliest date on which one of the following events occurs:

- They reach 18 years of age and they are not then attending school; or
- They receive their baccalaureate degree or;
- They attain age 26; or
- They marry.

Single persons are separately taxable. Persons not currently married and their children living with them are treated as family units.

As defined, families will still not be regarded as equally circumstanced on the definition of income alone.

The taxability of families will also vary by the number of adults, the number of wage earners, and the number of children. Compare the circumstances of three three-person families of equal incomes -- X has two adult wage earners, Y has two adults, only one of whom is a wage earner, and Z has only one adult, who is a wage earner.

Family Y alone receives the full-time household and child care services of one adult member and may be regarded as better off on this account. Family X alone bears the "wife tax" associated with second wage earners, while family Z has the additional child care responsibility but also the smaller subsistence outlays associated with two children in place of an adult and one child. Differences of the type illustrated by these three families are to be recognized in the model tax by two special adjustments to taxable income, and by means of separate rate schedules for families with one adult and those with two adults.

The first adjustment is that less than 100 percent, perhaps 75 percent, of the wage income of secondary earners is to be included in family income. This lower rate of inclusion would apply only to a limited amount of secondary earnings, say $10,000. Secondary earnings means the income of all family wage earners, except that of the member with

the largest wage income. This provision reduces the "wife tax" on families with more than one wage earner. Second, a child care deduction equal to a percentage, perhaps half, of child care costs is allowed (up to a dollar limit) as a deduction from the earnings of a secondary worker spouse and from earnings of an unmarried head of household. This adjustment provides some allowance for the reduced standard of living associated with the absence of full-time household services of a parent.

The model tax has separate rate schedules, as in present law, for single individuals, families with a married couple, and families with a single head of household. Single individuals would calculate tax liability according to a schedule that has marginal tax rate brackets that are somewhat more than half as wide as those for families. Rates applicable to individuals are set so that a two adult family would pay slightly higher tax than two unmarried individuals whose equal taxable incomes sum to the same taxable income as the family. This is consistent with the idea that two separate households with a sum of, say, $20,000 of income have less total taxpaying ability than a single $20,000 family. A single individual will, of course, owe more tax than a family with the same amount of taxable income. The schedule of rates for a family with a single head of household is

designed so that tax liability is the sum of (1) half the tax calculated from the single rate schedule and (2) half the tax from the rate schedule for couples.

In special circumstances, requirement of joint filing by all married couples may present a hardship for one or both parties. Consequently, the option of separate filing is continued in the model plan, with no attempt to reallocate reported income within the family. To assure that this option does not invite tax avoidance, married individuals filing separately would be required, as now, to calculate liability on a schedule that has marginal tax brackets exactly half as wide as those for joint returns. In this case, tax liability will always be at least as large as (and usually larger than) that determined by the family schedule.

3. Adjusting for Family Size

Most observers agree that the circumstances that determine the taxability of a family include family size, as well as marital status and the number of wage earners.

Under present law, taxable income for a filing unit is reduced by $750 for each family member, either adult or child. This personal exemption system has been criticized in two respects. The first criticism is that the dollar

value of an exemption increases with the family's marginal tax rate so that it is worth more for rich families than for poor. This observation has led to suggestions of either a vanishing exemption, which diminishes as income increases, or a tax credit for each family member in place of the exemption. The latter approach has been adopted, in a limited way, in the "personal exemption credit" provision of the 1975 Tax Reduction Act, which has been extended temporarily by the 1976 Tax Reform Act. A tax credit reduces tax liability by the same amount for each additional family member regardless of family income.

The argument for vanishing exemption or family credit often derives from a misunderstanding of the relationship of these devices to the overall progressivity of the income tax. It is true that trading an exemption for a credit without changing rates will alter the pattern of progressivity, making the tax more progressive for large families, less for small families and single persons. But it is similarly true that for any given level of exemption or credit, any degree of progression, among families of equal size, may be obtained by altering the rate schedule. The issue of exemptions vs. credits is wholly a question of the relative treatment of equal income families at various points of the income distribution.

If the family size adjustment is made by means of a credit of, say, $200 per member, the difference in tax liability between $10,000 families of four members and those of five members is $200. The same would be true if their incomes were $50,000. In contrast, if the marginal tax rate on $10,000 were 15 percent and that on $50,000 were 40 percent, a tax <u>exemption</u> of $1,000 per member would widen the difference in tax liability between families of different income according to each family's accustomed standard of living. The tax difference between four- and five-member families would be $150 for $10,000 families and $400 for $50,000 families. Once again, the issue here is <u>not</u> progressivity; that is determined by the choice of rates. The issue is whether the dollar value of the family size adjustment among families of similar income should vary according to income class.

A separate type of criticism of exemptions is that they provide a socially undesirable (or, at least, unnecessary) incentive for reproduction. According to this view, tax exemptions for children may be regarded as a violation of the principle of horizontal equity because families with identical opportunities but different tastes regarding family size are treated unequally. However, the horizontal

equity argument is invoked on both sides of this issue -- to compare the opportunities of parents, on the one hand, and to compare the relative well being of children in families of different sizes, on the other. Because there are real differences in standard of living among families of similar income but differing size, the equity case is judged to be on the side of continuing a tax adjustment. The reproduction incentive argument requires more evidence of any response of procreation to changes in the cost of rearing children.

The proposition that the dollar value of the reduction in living standard brought about by the addition of a family member is of greater magnitude among high income than low income families is intuitively appealing. Consequently, the per-member exemption is adopted as the method of adjustment for family size, assuming that a desirable pattern of tax progressivity among families of the same size is achievable.

4. Personal Deductions

Whether an item is a deduction from income or an adjustment to determine income is not clear under the present tax law. The distinction does not follow from principles of income definition or measurement, but depends upon whether

Congress decides to extend deductibility of an item to taxpayers who choose the standard deduction. Among present itemized deductions are many that represent refinements in the measurement of income. These include employee travel expenses, moving expenses, and other outlays required by one's occupation. This type of deduction and the deduction of interest payments will be discussed later in connection with the measurement of business income. Other presently allowable deductions are less clearly related to the concept of income. Four of these--medical expenses, charitable contributions, and State and local taxes and casualty losses--are considered here.

A. Medical Expenses

The principal argument for the deductibility of medical expenses is that, above some normal level, they represent extraordinary outlays that are of a different character than voluntary consumption. According to this view, such expenditures should not be included among the uses of resources by which income is defined. Many who would argue the case for deductibility would, however, agree that there is a normal amount of medical expenses each year that is part of ordinary consumption. But even extraordinary medical

expenses are insurable, and with sufficient insurance, the deductibility argument loses its force.

Indeed, the present system of deductibility of medical expenses, in excess of a floor, and partial deduction for insurance premiums may be regarded as a type of insurance program. For those who itemize deductions, medical expenses in excess of three percent of adjusted gross income (AGI) are partially reimbursed by "tax insurance" equal to the deductible expenses multiplied by the taxpayer's marginal tax rate, e.g., 25 percent. The taxpayer pays only the coinsurance rate, in this example 75 percent, times the medical expenses. Therefore, itemizers are uninsured (by the tax system) for medical expenses up to an amount that varies in proportion to their income, and above that amount they pay a coinsurance rate that decreases as marginal tax rates increase. Low income taxpayers are more likely to exceed the floor on deductibility (three percent of AGI), but higher income taxpayers receive a higher rate of insurance subsidy.

Under present law a family with $10,000 of salary receipts might be at the 19 percent marginal tax rate, and thus have a "tax insurance" policy that requires that family to pay 81 percent of medical expenses in excess of $300 per

year. A family with $50,000 of salary at the 48 percent marginal rate has a policy that requires payment of 52 percent of expenses above $1,500 per year. The same type of tax insurance is provided for medicines and drugs to the extent that they exceed 1 percent of AGI. In addition, present law allows deduction of half of private insurance premiums (up to a deduction of $150), while insurance proceeds in excess of expenses are fully taxable. In the case of insured expenses, the result is the same as including all insurance proceeds in income and allowing deduction of all outlays without floor.

Viewed as a mandatory government insurance program, the present tax treatment of medical expenses has little to recommend it. Instead, consider an alternative policy that would provide a <u>complete</u> subsidy -- a refundable tax credit -- for "very" large expenses. Under such a scheme the floor for the deduction would be raised but the "coinsurance" feature would be eliminated. For the level of medical expenses prevailing in 1975, elimination of the present deduction for premiums and expenses would finance complete reimbursement of all medical expenditures that exceed 10 percent of AGI. That is, the revenue costs of the present and proposed systems would be the same, about $6 billion.

Under such a "catastrophe insurance" proposal eliminating deductions for premiums and direct medical expenses and providing a full tax credit for medical expenses in excess of 10 percent of AGI, about 12 percent of all returns would experience a decrease in taxes and 63 percent would experience an increase in taxes. Most of the tax decrease that would result from the proposal would be experienced by the lowest income bracket, while all other income brackets would show an increase.

B. Charitable Contributions

Charitable contributions may be regarded as transfers between donor and beneficiary, in which a philanthropic organization serves as an intermediary or conduit. These organizations usually convert cash contributions into goods and services, such as hospital care, education, or opera performances, which are subsidized or completely free to the beneficiary. In many cases, e.g., cancer research, the benefits are diffused very broadly throughout society. The value of these services is a form of income-in-kind to the beneficiary, but under present law there is no attempt to tax their beneficiaries on that income.

The logic of the tax treatment of charitable contributions is much the same as that for gifts or bequests to individuals. A gift does not add to the standard of living

of the donor, although it does so for the beneficiary. If the taxpayer's standard of living is the appropriate criterion for taxability, proper treatment would be to allow deduction of the gift as at present, with full taxation to the recipient.

However, there is no generally satisfactory way to value or allocate the benefit-in-kind resulting from charitable donations. While total benefits might be measured by their cost, a large input to benefits-in-kind is voluntary effort that is not carried as a financial item in organizational budgets.

Even if it were practical to tax benefits-in-kind, it could still be argued that the benefits should not be taxed because the benefits flow to society generally as well as to the individual recipient. Such activities as education and basic research benefit society at large, and many other philanthropic activities support such public goods and services. Deductibility of contributions to such activities provides an incentive for this provision without direct government control.

On the other hand, many would argue that this kind of hidden public finance should not be given to programs that are under private, perhaps even individual, control. Moreover, it is held to be inequitable for some beneficiaries to

receive untaxed benefits if others must pay the full cost for similar benefits (education, health care, etc.).

If it is considered logical to tax benefits to the beneficiary but impractical to do so, an alternative approximation is to tax the donor by denial of deductibility. The charitable contribution is easily measurable and taxable in a practical sense. If the donor reduces his contributions by the amount of the additional tax he pays, the donor indirectly shifts the tax burden to the beneficiary. Denial of deductibility, therefore, may be viewed as a proxy for taxing the beneficiary. This describes the present treatment of transfers between individuals. As in that case, an ability-to-pay element could be added by including all contributions in the estate and gift tax payable by the donor.

Another dimension of the treatment of charity in the tax system concerns the philanthropic institution that serves as an intermediary between the donor and the beneficiary. These institutions perform activities that may be broadly beneficial to society or that may be targeted for rather narrowly defined beneficiaries. These institutions include, for example, churches, private schools, symphony

orchestras, youth organizations, drama theatres, research institutes, hospitals, etc. Under present tax law, these institutions are recognized as tax exempt on endowment earnings and excess operating income if their activities are organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or education purposes, or for the prevention of cruelty to children or animals. The usual rationale for such treatment is that these activities provide a common or public good that cannot be provided by government or that the existence of parallel public and private institutions is essential in a pluralistic society. In opposition, it is argued that these organizations lack the broad public representation necessary to assure public purposes and, conversely that tax exemption leads to public policies to restrict and regulate their activities.

Tax exemption of the endowment earnings is not the only issue. Philanthropic institutions might be taxed on all their accretion, from gifts and earnings, as a means of approximating the taxation of recipients. Alternatively, their earnings may be taxed, in addition to taxation of the donor, as a means of subjecting the full value of gifts to taxation. Either of these treatments would contradict the idea of the philanthropic organization as merely a conduit

between donor and beneficiary, but both approaches may be regarded as expedient means for valuing income in kind on the side of the recipient or for attributing earnings from a pool of receipts to donors.

Subjecting charitable institutions to taxation would have major effects. On the one hand, for example, the loss of tax exemption would tend to discourage retention and accumulation of earnings by philanthropic institutions. This may be viewed as inappropriate because it limits the extent of activity and the life of the institution. But it may be viewed as appropriate by those who believe that grant-making institutions, such as private foundations, should have a limited life. Taxation of these organizations would force them to compete with proprietary organizations where such are engaged in the same activity and would have the advantage of creating greater efficiency.

The rationale for tax exemption of income of charitable institutions comes down to providing a tax incentive to encourage their activities -- the same argument that has also been given for deductibility to the donor. The tax equity case might suggest taxation of the full value of the charitable contributions on at least one side of the transfer, whether one invokes a standard of living or an ability to pay criterion of equity. But the tax relief as incentive

argument presents an additional policy option--the replacement of deductibility with a tax credit. A flat credit (percentage of contribution) could be provided at a level that would just balance the revenue gain from denial of deductibility. Assume that the credit is 25 percent. The effect would be to provide additional tax savings to those with marginal tax rates below 25 percent and impose more taxes on those with marginal rates in excess of 25 percent. In addition to this redistributive effect, this alternative tax incentive may result in certain activities, such as education, hospitals and the arts, bearing the burden imposed on the higher incomes. Other activities, such as religion and welfare, may benefit from the tax savings given to lower incomes.

The myriad of potential tax policy options that have been discussed for the treatment of charities are summarized in Chart A. Note, in addition, that taxation to the donor may be via the income tax or a separate gift and estate tax; and, similarly, recipients may be taxed under either the income tax or an accessions tax. Partial taxation (in place of nontaxation) may also be achieved in each case by the credit option.

<u>In view of the strong support for a tax incentive for philanthropy, continuation of current donor deductibility</u>

Chart A

Treatment of Charitable Contributions: Options (Accretion-Type Tax)

Item	A	B	C-1	C-2	C-3
Contribution	Nontaxable to donor	Taxable to donor	Nontaxable to donor	Nontaxable to donor	Nontaxable to donor
Benefits	Taxable to beneficiary	Nontaxable to beneficiary	Nontaxable to beneficiary	Nontaxable to beneficiary	Nontaxable to beneficiary
Charitable Organization:					
Current receipt and distribution of contributions	Nontaxable	Nontaxable	Nontaxable	Nontaxable	Nontaxable
Accumulated contributions, appreciation, investment income	Taxable to donor	Taxable to organization (appreciation and investment income only)	Taxable to donor	Taxable to organization	Nontaxable

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and tax exemption of philanthropic organizations (Option C-3 of Chart A) is included as an option in the model plan.

C. State and Local Taxes

Appealing once again to the definition of income as the sum of certain uses of resources available to the household, there is no clear category for most State and local taxes. Only those fees and charges that are directly tied to particular public services are unambiguously includable in consumption, and the remainder are neither voluntary transfers nor changes in the net value of assets (although changes in asset values may sometimes be a consequence of State-local tax policy). Neither are these taxes extraordinary outlays in the sense that medical expenses are. The certainty of taxes is widely noted. Taxes that cannot be regarded as the price of consumption, then, are not subsumed within our income definition and, therefore, should, on equity grounds, be deductible from household receipts.

Of course, some State and local output is financed by benefit taxes rather closely proportioned to individual family use of the services. Some sensible classification of taxes for deductibility is possible. Benefit taxes, such as gasoline taxes, that are reasonably well proportioned to use should not be deductible. In addition, there is little

logic for providing the incentive of Federal deductibility to items of consumption (such as gambling, alcoholic beverages, and tobacco) that are subject to excise taxes.

The recommended model tax base would allow deduction for those broad-based State and local taxes that are levied on individuals to provide general purpose revenues. These taxes are general sales taxes, income taxes, and payroll taxes. The two special cases of property taxes on owner-occupied homes and on personal property will be discussed below, as will the subject of deductibility of taxes on business activities.

D. Casualty Losses

Of all the major personal deductions that are currently allowable, the case for casualty losses is the most clear cut. A certain normal amount of accidental damage to a household's property may be regarded as a component of consumption. Extraordinary losses due to accident or natural disaster are clearly reductions in net worth. According to this logic, it is recommended that uninsured losses in excess of an annual dollar amount, perhaps $1,000, be fully deductible from otherwise taxable receipts. The provision of a floor serves both to define normal losses and to reduce the necessity for detailed recordkeeping for small occurrences.

The case of casualty losses that are reimbursed by insurance is somewhat more complex. Casualty insurance premiums are currently not deductible, and the proceeds are fully included in income. Yet, the share of premiums that insures against extraordinary losses represents current outlays approximately equal to the expected value of reimbursement for such losses. Viewed in the aggregate, these losses are, therefore, made fully subject to tax. This is so because income receipts used to pay the premiums are subject to tax, which fully taxes the expected insured losses, and reimbursements cancel the deduction of losses that occur. According to the logic of the proposed model tax treatment, such losses are reductions in income, which should not be subject to tax. This outcome can be achieved, in terms of expectations, either by excluding the insurance proceeds from taxable income while disallowing the deduction for premiums or by allowing deduction of the premiums and inclusion of the proceeds. In either case, the loss itself would be deductible. Because payoffs from insurance are inherently random in nature, exclusion of the proceeds would result in large tax reductions for those with actual, but reimbursed, casualties. Meanwhile, those who were "unfortunate" enough to avoid casualties would have, in effect,

the present law treatment. In the model tax a deduction is allowed for those casualty insurance premiums that insure against extraordinary losses, with all proceeds included in taxable income.

5. Employer-Paid Insurance Benefits, Social Security, and Private Insurance

A substantial share of employee compensation is in the form of employer-paid contributions to pension plans and health and disability insurance on behalf of the employee. These contributions or the payments to which they lead, are clearly included in our income defintion.

Consider first, contributions to retirement income plans. Employer-provided pension plans come in two forms -- defined-contribution and defined-benefit. The first form is essentially a mutual fund to which the employer deposits contributions on behalf of his employees. Each employee owns a stated percentage of the assets, which are used to purchase an annuity upon his retirement. The income of any individual from such a plan is simply his share of the total earnings as they accrue. After retirement, an annuity table is required to distinguish earnings from principal repayments, a familiar problem for the Internal Revenue Service.

Most pensions are of the second type, defined-benefit pensions. This is a misnomer because the benefit is not really defined until retirement. It usually depends on the employee's average wage over the years of employment, outcome of contract negotiations, etc. The employee's benefits may not vest for a number of years, at which time a sharp jump in the value to him of participation in the plan occurs. By strict income definition it is the annual change in the present value of expected future benefits that constitutes income from the plan. In general, it is not possible to determine the accrued value of future benefits in such a plan without many arbitrary assumptions about the employee's future employment prospects, marital status at retirement, and similar issues.

As an alternative to estimating pension benefits as accrued, it is possible to approximate such treatment through the taxation of plan earnings and actual benefits. If done correctly this is equivalent to the taxation of accrued benefits. Of course, actual benefits can be allocated easily enough to actual recipients, but investment earnings will have ambiguous ownership for the reasons mentioned above.

Under present law, if an employer-provided pension plan is legally "qualified," retirement benefits are taxable to the employee only when received, not as accrued, even though contributions are deductible to the employer as they are made. The plan's investment income is tax exempt. Certain individuals are allowed tax benefits similar to qualified pension plans under separate laws. These laws allow a limited amount of retirement saving to be deducted from income, its yield to be tax free, and its withdrawals taxable as personal income. This treatment allows an interest-free postponement of tax liability. The result is to introduce nonneutral tax treatment among forms of saving and investment, and, in a growing economy, a reduction in the available tax base.

The model comprehensive income tax would continue to exclude contributions to pension plans from the tax base and to tax benefits when received, as at present. In addition, however, the earnings of pension plans would be taxed as they accrue, either to the employer, if no assignment of rights were made to employees, or to the employee to whom these earnings are allocated by the plan. The employee-paid portion of these pension plans would be treated in exactly the same way.

Social security retirement benefits (OASI) present other problems. They are financed by a payroll tax on the first $15,000 of annual earnings, half of which is paid by the employer and half, by the employee. The half paid by the employee is fully taxed under the current income tax; the tax paid by the employer is not considered income to the employee, and is a deductible expense to the employer. Social security benefits are tax free when paid.

For an individual employee, the amount of annual accrual of prospective social security benefits is ambiguous, at best. Actual benefits, by contrast, are readily measurable and certain. Furthermore, because participation in social security is mandatory, failure to tax accruals does not present the same tax neutrality problem encountered with private pensions, that is, the incentive to convert savings to tax-deferred forms. Consequently, the proposed model tax base would allow deduction of employee contributions by the individual and employer contributions by the employer, but OASI payments would be subject to tax.

The treatment of health and casualty insurance has already been discussed in the context of personal deductions. The recommended treatment -- taxation of the premiums for health insurance and the proceeds of casualty insurance -- is the same when premiums are paid by the employer. The

same arguments and recommended treatment apply to the health insurance (Medicare) component of Social Security.

Disability income insurance and life insurance present somewhat different problems, however. Under present law, employees are not required to include in income employer-paid disability insurance premiums, and, subject to a number of limitations, disability grants do not have to be included in the individual's income tax base. Under the proposed system, premiums paid into such disability plans by employers would not be taxable, but the benefits would be taxable. Undoubtedly, the premiums paid by the employer do increase the net worth of the employee, and to that extent income is accruing that will escape tax. However, evaluating the worth of the future interests would pose insurmountable administrative difficulties. Exactly the same treatment is proposed for the disability insurance portion of Social Security (DI), because the annual value of accruing DI benefits is, if anything, less certain than for private plans.

There is no similar difficulty of evaluation in the case of employer provision of term life insurance. The annual value to the employee is equal to the premium on his behalf. Therefore, the premium payment should be included in income to the employee. This parallels the present treatment of an individual's own purchase of term insurance that is to be continued.

Whole life insurance involves some additional considerations. A whole life policy represents a combination of insurance plus option to buy further insurance. When one buys a whole life policy, or it is purchased on his behalf, at a certain prescribed annual premium, that policy may be viewed as one year's insurance plus an option to buy insurance for the next and subsequent years <u>at the premium level appropriate for this year</u>. That option value is recognized in the form of the "cash surrender value" of the policy. It represents the value as determined by the company's actuaries of buying back from the insured his option to continue to purchase on attractive terms. Naturally, this option value tends to increase over time, and it is this growth in value taht represents the income associated with the policy. Dividends paid on life insurance are a case of income arising from price reductions.

The total annual income associated with a whole life insurance policy is equal to the increase in its cash surrender value plus the value of the term insurance for that year (the term insurance premium) less the net whole life premium, after dividend. <u>Under the model tax, insurance companies would annually inform each policyholder of this income, which would be included in his income subject to tax</u>. This treatment is recommended whether the premium is paid by the individual or by his employer.

Under present law, both the Federal Unemployment Tax Act (FUTA) taxes to finance the public unemployment compensation system and the unemployment compensation benefits are excluded from the income of covered employees. Following the recommended treatment of disability insurance, which has similar characteristics, the payroll taxes would continue to be excluded, but unemployment compensation benefits would be included in taxable income.

6. State and Local Bond Interest

The annual receipt or accrual of interest on State and local obligations unquestionably increases the taxpayer's opportunity to consume, add to wealth, or make gifts. It is, therefore, properly regarded as a source of income. However, such interest is not included in income under current law. This is not to say that owners of such bonds bear no consequence of the existing income tax. Long-term tax-exempt bonds yield approximately 30 percent less than fully taxable bonds of equal risk. This lower interest return may be regarded as an implicit tax, but this foregone interest does not substitute for full taxation on either efficiency or equity grounds.

The difference in interest costs that the State or local government would have to pay on taxable bonds and that which they actually pay on tax-exempt bonds is borne by the Federal Government. The subsidy is inefficient in that the

total cost to the Federal Government exceeds the value of the subsidy to the State and local governments in the form of lower interest payments. Estimates of the fraction of the total Federal revenue loss that is not received by the State and local governments vary widely, but the best estimates seem to be in the 25-30 percent range.

A further inefficiency of the interest exclusion is that capital formation is encouraged in the State and local government sector at the expense of other sectors, such as private business. A corollary is that the subsidy provides a short-run incentive to shift to more capital-intensive activities. Relatively labor-intensive local governments receive less aid, than capital-intensive jurisdictions. Furthermore, the tax subsidy has caused these governments to rely disproportionately on the tax-exempt market for debt finance. To a large extent, tax exempts are held by commercial banks. The municipal bond market is highly volatile. Thus, some economists have suggested that the reliance on the tax-exempt market has made State and local governments especially vulnerable to changes in economic conditions.

total cost to the Federal Government exceeds the value of the subsidy to the State and local governments in the form of lower interest payments. Estimates of the fraction of the total Federal revenue loss that is not received by the State and local governments vary widely, but the best estimates seem to be in the 25-30 percent range.

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The subsidy may also be regarded as inequitable. The value of the tax exemption depends on the investor's marginal tax rate. Thus, higher income taxpayers are willing to pay more for tax exempts securities than lower income individuals. The concentration of the tax savings among the relatively well of reduces the progressivity of the Federal income tax relative to what it would be without this tax exemption. As pointed out previously, tax-exempt securities yield about 30 percent less than otherwise comparable taxable investments. This has the effect of butting a ceailing of 30 percent on the marginal rate effectively confronting investors inclined toward this type of security, while those with income from personal ssources must pay higher rates.

Interest on State and local bonds would be fully taxable under the model income tax. Many policy alternatives have been suggested to replace the tax exemption. These include replacement with a direct cash subsidy, replacement with a direct subsidy of interest on taxable bonds issued by State and local governments at their option, or a federally sponsored bank that would buy tax exempt bonds and issue its own taxable bonds.

7. Owner-Occupied Housing

Under present law, homeowners are allowed personal deductions for mortgage interest paid and for State and local property taxes assessed against their homes. What is

more significant quantitatively, however, is that there is no attempt to assess to owner-occupiers the income implied by ownership of housing equity. In the aggregate, this untaxed income is estimated in the national income and product accounts at $____ per year. Yet many homeowners would deny that any such income exists.

Any dwelling, whether owner-occupied or rented, is a capital asset that yields a flow of services over its economic lifetime. The most inclusive measure of the value of this service flow for any time period is the market rental value of the dwelling. For rental housing, this usually takes the form of a monthly contractual payment from tenant to landlord for the services of the dwelling. In an equilibrium market, this monthly (or annual) rental amount must be sufficient to pay for maintenance expenses, related taxes, and depreciation, if any. The difference between these continuing costs and the market rental is <u>net income</u>, which is divided between the mortgage holder and the owner, depending upon the terms of the mortgage. Since a potential owner-occupier faces an array of investment opportunities, including housing for rental, homeownership is worthwhile only if the return to his equity--potential net rental income less mortage interest--is at least the equal of other investments. This is the sense in which a homeowner is said to have income which, because he need not declare it, presently escapes tax.

It is useful, therefore, to think of an owner-occupier as a landlord who rents to himself and who does so because it is normally profitable. But any attempt to tax this profit under a personal income tax, however desirable it may be from the standpoint of tax equity, would severely complicate tax compliance and administration. Because the owner-occupier does not explicitly make a rental payment to himself the market price for each dwelling is not revealed. Even if market rental were estimated, using methods similar to property tax assessments, the taxpayer would face the difficulties of accounting for annual maintenance and depreciation. In addition, it may be argued that the incentive to owner-occupancy provided by the prospect of tax-free income serves worthwhile public purposes. Homeownership may contribute to community stability, increased citizen responsibility, and greater attention to home maintenance and neighborhood amenities. For these purposes, and for the sake of simplification, no imputation of income to owner-occupied housing is included in the proposed tax base.

The proper tax treatment of presently deductible property taxes and mortgage interest are separate issues, however. Consider first the property tax. Over time, housing supplies within a market area will be adjusted so

that all current costs are met and a normal return accrues to all claimants to housing income, i.e., owners of equity and housing-secured debt. When the local property tax is increased throughout a market area, current cost of supplying rental housing increases by the amount of the tax increase, and, accordingly, rents must rise dollar-for-dollar. (Note that deductibility of the local tax against Federal income tax does not result in reduced Federal liability for landlords, because gross receipts increase by an equal amount.) Consequently, tenants experience an increase in rent and no change in the income tax liability.

Owner-occupiers provide the same service as landlords. Consequently, they would receive the same rental for a dwelling of equal quality. Hence, market rentals for their homes will also rise by the amount of any general property tax increase. If owner-occupiers are allowed to deduct the tax increase from taxable income, while not reporting the increased imputed rent, they enjoy a reduction in income tax that is not available either to tenants or to landlords.

To summarize the effect of the property tax, the landlord has the same net income and no change in income tax; the tenant has no change in income tax and higher rent; the owner-occupier has higher (imputed) rent as a "tenant", but as a "landlord" finds his income tax reduced. He is

first favored relative to the renter by receiving income from assets free of tax, and, in addition, his advantage over the tenant and landlord increases according to the rate of local property tax. This latter advantage would not be present if the property tax deduction were denied to the owner-occupier. He would be treated as the tenant/landlord that he is--paying higher rent to himself to cover the property tax while his net income and income tax are unchanged.

Both simplicity and equity are served by denying the deduction of property taxes on owner-occupied homes, and the homeownership incentive of tax-free income remains. This treatment is, therefore, adopted in the model tax.

The mortgage interest deduction for owner-occupiers is often discussed in the same terms as the foregoing property tax argument. There are, however, some significant differences. Mortgage interest is that portion of the net income from a housing asset that is paid to the suppliers of debt financing secured by those assets. The prospective owner of equity in housing will choose, within the limits of his resources, the shares of equity and debt in the financing and, simultaneously, the share of his total assets that are in housing. This presents an element of tax incentive that is not present in the tax treatment of the property tax. If the

mortgage interest deduction were denied to owner-occupiers, the income tax would distort the financing choice in favor of equity. Increasing the share of equity finance by trading taxable assets for housing will reduce the homeowner's tax liability; increasing the mortgage to purchase other assets (of equal before-tax profitability) will increase it. This is a substantial violation of tax neutrality.

There is a corollary vertical equity problem also. Prospective homeowners of little wealth are obliged to offer the house as security to obtain debt financing. By contrast, an individual of greater wealth may simply borrow against some other securities, use the proceeds to purchase housing equity, and take the normal interest deduction. In other words, a mortgage is not the only way to finance housing, and it is impossible to trace the proceeds of any other loan to the acquisition of a house. Consequently, for wealthy taxpayers, both the equity and debt portions of net income from owner-occupied housing may be tax free, while only the equity-financed portion escapes tax for the less wealthy.

Once it is decided that taxable income is not to be imputed for owner-occupied homes, the only way to avoid these violations of tax neutrality and equity is to allow

all net income from such assets to be tax free, regardless of the relative shares of equity and debt. This is accomplished by allowing mortgage interest the same deductibility as any interest payment. This treatment is adopted. To reiterate, the model income tax would disallow the deduction for property taxes on owner-occupied homes, but deduction for mortgage interest would be allowed, and there would be no imputation of rental income to owner-occupiers.

Precisely the same arguments apply to other consumer durables, such as automobiles, boats, and mobile homes, that may be subject to State and local personal property taxes. The same treatment is recommended.

8. Integration of the Corporate and Personal Taxes

Strictly speaking, it is impossible to tax a corporation on its income, because corporations do not consume nor can they be said to have a "standard of living." The terms of the standard income definition are attributes of individuals or families. The term "corporate income" is usually shorthand for the contribution of the corporate entity to the income of its stockholders.

Under existing law, income earned in corporations is taxed differently from other income. All corporate earnings are subject to the corporate income tax, and dividend

distributions are taxed separately as income to shareholders. Undistributed earnings are taxed to shareholders only as they raise the value of the common stock and only when it is subsequently sold. Such capital gains are taxed under special tax provisions of the individual income tax. Thus, the tax on retained earnings generally is not closely related to the shareholder's individual tax bracket.

An exception to these general rules exists for corporations that are taxed under subchapter S. If a corporation has ten (in some cases fifteen) or fewer shareholders and meets certain other requirements, it may elect to be taxed as a partnership, so that there is no corporate income tax and retained earnings are subject to the individual income tax. For earnings of these corporations, then, complete integration of the corporate and individual income taxes already exists.

The separate taxation of income earned in corporations is responsible for a number of serious economic distortions. It raises the overall rate of tax against capital income and so produces a bias against saving and investment. It inhibits the flow of saving to corporate equities relative to other forms of investment. Finally, the separate corporate tax encourages the use of debt, relative to equity, for corporate finance.

The existing differential treatment of dividends and undistributed earnings results in distortions. Distribution of earnings is discouraged, thus keeping corporate investment decisions from the direct test of the capital market and discouraging lower bracket taxpayers from ownership of stock.

In the model tax system the corporate income tax is completely eliminated and the effect of subchapter S corporation treatment be extended to all corporations.

The treatment of corporate profits might be summed up in the form of the following three rules:

1. Each shareholder annually adds his proportional share of the corporation's income to his income subject to tax, or subtracts his share of losses.
2. A shareholder's basis in his stock is increased by his share of income and decreased by his share of loss.
3. A shareholder's basis in his stock is reduced, but not to below zero, by cash dividends or by the fair market value of property distributed to him. Once the shareholder's basis has been reduced to zero, the value of any further distributions is included in income. A distribution after the

basis has been reduced to zero indicates that the corporation and, therefore, the shareholder have experienced a capital gain.

For large corporations with publicly traded stock, certain rules would be necessary to allocate income and losses to those who buy and sell shares during an accounting year. These rules are designed to avoid recordkeeping problems associated with transfers of stock ownership within the tax year and to avoid the "trafficking" in losses between taxpayers with different marginal rates.

It is proposed that the first day of the taxable year be designated the "record date" for ownership of corporate shares. All income or loss of the corporation would be attributed to shareholders as of that date, regardless of subsequent sale within the year. Similarly, the shareholder of record would make the full adjustment of basis resulting from earnings or loss over that year. Basis adjustments due to distributions would be made by whoever receives the distribution.

A shareholder who holds his stock for the entire taxable year would be taxed on the full amount of income for the year (or would deduct the full amount of loss). Any future taxable gains from sale of the stock would be reduced

by the amount of undistributed earnings upon which he is currently subject to tax. His corporation would simply provide him at the end of the taxable year with a statement of his share of corporate earnings and the required adjustments of basis.

A shareholder of record who sells his stock before the end of the tax year will receive exactly the same statement of earnings as the full year shareholder. He also will increase his basis by the full amount of earnings less any distributions he receives before the sale. The effect of basis adjustment is that he will only be taxed on the year's earnings of the corporation to the extent that he receives dividends and to the extent that earnings are reflected in the gain on the sale of his stock.

Conversely, he will actually take into account a year's loss only to the extent of the loss on his sale of stock. This is because the adjustment to the basis of the shareholder's stock (which is the amount of income or loss attributable to the shareholder for the corporate taxable year) will neutralize or "wash out" the amount of corporate income or loss attributable to the shareholder.

This can be illustrated by the following example. Suppose that as of the record date (January 1) shareholder (X) has a basis of $100 in his one share of stock. By

June 20, the corporation has earned $10 per share and X sells his stock for $110 to Y. The corporation earns $25 per share for the year and this amount is attributed in full to X. X will include the $25 in income, but will also increase his basis by this amount. The increase in basis (from $100 to $125) gives X a $15 loss on the sale of his stock, not a $10 gain. This $15 loss offsets $15 of the $25 of income attributable to X, resulting in a net income of $10, or the amount of gain on the sale. The practical effect would be that X need only report the gain on his sale of stock. In the event there was a dividend distribution to X of the $10 of earnings before he sold his stock, the amount the dividend would be reflected in the year's income attributable to X. The amount of the dividend, however, would reduce the basis of the stock and thus would not be offset by an artificial loss on the sale of the stock.

This proposed full integration system is quite simple. It would make it possible to tax income according to the circumstances of families who earn it, regardless of whether income derives from labor or capital services, regardless of the legal form in which capital is employed, and regardless of whether income earned in corporations is retained or distributed. To the extent that retained earnings result in

increases in the value of corporate stock, this system has the effect of taxing capital gains from ownership of corporate stock as they accrue, thereby eliminating a major source of controversy and complexity in the present law.

There would, however, be some remaining problems of administration with the proposed system. First, there may be some deferral of tax on the remainder of the income earned in a year in which shares are sold. Income earned by the corporation between the date of sale of the stock and the end of the taxable year would not be taxed until the purchaser sells the stock, unless that income were already reflected in the sale value.

Second, it would be very difficult to incorporate withholding of tax at the corporate level into this proposal. In the event of a sale of the stock, a credit for taxes withheld would have to be apportioned between the buyer and seller, since each would be taxable on the portion of the income reflected in the gain on his respective sale of the stock. Such an apportionment appears to be administratively impossible. Thus, despite the desirabilty of withholding as a means to avoid problems of cash flow for the taxpayer and the government, a system of quarterly declarations such as that now employed for partnerships would be employed.

Finally, it should be noted that audit adjustments to corporate income may extend well beyond the taxable year and, thus, potentially reopen individual accounts (perhaps long after one's shares have been sold). However, since an adjustment in income is accompanied by an equal change in basis, it may be safe to ignore the adjustment for all stockholders of record for the year in question who have subsequently sold their shares. The amount of the adjustment would still not escape tax, because it presumably would have been reflected in the price the buyer paid the seller for the stock, and taxable as gain on a future transaction.

None of these administrative problems would appear to be so substantial as to offset the significant economic and simplification advantages of full corporate integration.

9. Capital Gains

Capital gains appear to be different from most other forms of income because realization of gains involves two distinct transactions--the acquisition and the disposition of the property--and each transaction occurs at a different time. This difference raises several issues of income measurement and taxation under an income tax.

The first issue is whether income (or loss) ought to be reported annually on the basis of changes in market value of assets--the accrual concept--or only when realized. Clearly,

the annual change in market value of one's assets constitutes a change in net worth and is, therefore, income under the "uses" definition. If tax consequences may be postponed until later disposition of an asset, there is a deferral of taxes, which represents a loss to the government and a gain to the taxpayer. The value of this gain is the amount of interest on the deferred taxes for the period of deferral. Distinct from, but closely related to, the issue of deferral is the issue of the appropriate marginal tax rate to be applied to capital gains. If capital gains are to be subject to tax only when realized, there may be a substantial difference between the applicable marginal tax rate during the period of accrual and that faced by the taxpayer upon realization. Finally, the extent to which an adjustment for general price inflation over the holding period of an asset should be made must be considered.

The range of possible tax treatments for capital gains can be summarized in an array that ranges from the taxation of accrued gains at ordinary rates to the complete exclusion of capital gains from income subject to taxation. This range may be illustrated by five different alternatives.

1. Tax gains (and deduct losses) as they accrue at the same rates applicable to other types of income;
2. Tax gains only when realized, but charge interest on the deferred taxes;
3. Tax gains at ordinary rates, but only when realized;
4. Tax gains only when realized, at preferential rates, and without any charge for deferral; and
5. Exclude capital gains from income subject to tax.

Of course, each alternative can be modified to allow for (a) income averaging to minimize extra taxes due to the bunching of capital gains and (b) adjustments to reflect changes in the general price level.

Present treatment for individuals is nearest to alternative 4, with a number of special provisions. When capital assets have been held for 6 months or more,[2/] gains from their realization are considered "long-term" and receive special tax treatment in two respects: one-half of capital gains are excluded from taxable income, and individuals have the option of calculating the tax at the rate of 25 percent on the first $50,000 of capital gains. There are complex restrictions on the netting out of short-and long-term gains and losses, and a ceiling of $1,000[3/] is imposed on the amount of net capital losses that may be used to offset ordinary income in any one year, with unlimited carryforward

of such losses. Also, there are provisions in the minimum tax for tax preferences that limit the extent to which the capital gains provisions can be used to reduce taxes below ordinary rates. Limited averaging over a 5-year period is allowed for capital gains as well as most other types of income.

There are many other capital gains provisions in the tax law that (1) define what items may be considered capital assets, (2) specify when they are to be considered realized, (3) provide for recapture of artificial accounting gains, and (4) make special provisions for timber and certain agricultural receipts. There are also the special provisions that allow deferral of capital gains tax on the sale or exchange of personal residences. Much of the complexity of the tax code derives from the necessity of spelling out just when income can and cannot receive capital gains treatment. If individual income taxes are fully integrated into a single tax and shareholders are taxed on the entire amount of corporate profits as recommended above, a large portion of capital gains, the changes in value of common stock that reflect retention of corporate earnings, will be subject to tax as accrued. Corporate tax integration thus would eliminate this problem of taxing capital gains. The remainder of gains would very likely be more volatile over time.

Changes in the value of common stocks depend upon expectations about future earnings in addition to current retentions, and other assets, such as bonds and real estate, also will produce capital gains and losses.

As long as capital gains realizations are taxed instead of accruals, the tax benefits of deferral can be substantial. Even if capital gains were taxed as ordinary income (no exclusion, no alternative rate) the <u>effective</u> tax rate on gains held for long periods of time would be much lower than the nominal or statutory rate. This is shown in Table 1 for an assumed before-tax rate of return of 12 percent on alternative assets yielding an annually taxable income.

Table 1

Effective Tax Rates on Capital Gains

	Holding Period			
	1 year	5 years	25 years	50 years
Statutory rate of 50 percent	50%	44%	23%	13%
Statutory rate of 25 percent	25%	21%	10%	5%

There are, however, three problems with accrual taxation of capital gains: (1) the administrative burden of annual reporting; (2) the difficulty and cost of determining

asset values annually; and (3) obtaining the funds to pay taxes on accrued but unrealized gains. Under accrual taxation the taxpayer would have to compute the gain or loss on each of his assets annually. For common stock and other publicly traded securities, there is little cost or difficulty associated with obtaining year-end valuations. But for other assets, the costs and problems are formidable, and the enforcement and crediting problems would be substantial: Quite apart from intentional misrepresentation, it is very difficult and expensive to valuate assets by appraisal; there are distinct advantages to the valuation by concrete transactions that taxing realizations provides.

For taxpayers with little cash or low money incomes relative to the size of their accrued but unrealized capital gains, accrual taxation may pose cash flow problems. However, as a last resort, certain taxpayers could be allowed to pay a later tax on capital gains, with interest, at the time a gain is realized.

In fact, this treatment--taxation on relization with interest charge for deferral--might be extended to all taxpayers(method 2 above). This method attempts to achieve the same economic effect as accrual taxation, including the elimination of the incentive to convert ordinary income into

capital gains. But taxation on the basis of realization introduces some problems of its own. The present complex rules defining realizations could not be eliminated. However, the main difficulty with this method is the computation of interest on the deferred taxes. What rate of interest is appropriate and what pattern of accruals is to be assumed? In order to eliminate economic inefficiency, the interest rate on the deferral should be the individual taxpayer's rate of return on his investments, but becuase it is impossible to administer a program based on each investor's marginal rate of return, the government would have to charge a single interest rate. The single interest rate, however, would tend to move alternatives away from neutrality. Moreover, for simplicity, it would have to be assumed that the gain occurred equally over the period or that the asset's value changed at a constant rate. Because these patterns will actually reflect reality in very few cases, additional distortions will be introduced. To the extent that gains occur early in the holding period, capital gains will be undertaxed; when gains occur late in the period, capital-gains will be overtaxed.

Under a progressive income tax system, the tax rate on a marginal amount of income will differ depending on the person's other income. Generally, the higher the income

level, the higher the tax rate. Similarly, under a progressive tax system, people with fluctuating incomes pay a higher average tax rate over time on the same amount of total income than do those persons who have more nearly uniform incomes over time.

Under an accrual system, these questions do not arise; they are only relevant under a realization system of taxation. Clearly, if a taxpayer's income (apart from any capital gains) is rising over time, the longer he delays realization, the higher his tax rate will be. Similarly, if he only realizes gains occasionally, his gains will tend to be larger, and the average tax rate on the gains will be increased. The lumpiness problem could be solved by spreading the gain, via "income averaging," over the holding period of the asset. This flexibility would involve great complexity, and the result could be approximated reasonably well by a fixed-period averaging system, similar to the general 5-year averaging system or the special 10-year averaging for lump sum distributions, both of which are in present law.

The problem of higher tax rates from increased income levels is more difficult. One solution would be to calculate an average marginal tax rate over the extra holding period (or, as in the averaging case, over a fixed number of years) and to modify the amount of gain included in the tax

base for the year of realization to reflect the ratio of the average marginal rate over the period to the marginal rate in the current year. Thus, if the current rate were higher, less than all of the gain would be included in income; if the current rate were lower, more than 100 percent of the gain would be included. As with charges of interest for deferral, however, such systems add significantly to the complexity of the tax law, and represent inexact adjustments besides.

The proper tax treatment of capital gains is further complicated by general price inflation. Capital gains that merely reflect increases in the general price level are illusory. Suppose an individual's capital assets increase in value, but at a rate precisely equal to the rise in the cost of living. His net worth will not have increased in real terms, and neither, therefore, will his standard of living. If no adjustment is made in his basis for inflation, the change in capital value of an asset held over a period of time will be largely in terms of past prices. This contrasts with other income flows, such as salaries. which are always accounted for in current dollars. Accounting for other transactions that are affected by inflation, such as borrowing and lending, is largely corrected for anticipated inflation by market adjustments. For example, a lender

will insist on a higher interest rate to compensate for taxes against the depreciating value of the principal. Therefore, an adjustment of basis for inflation is necessary in the case of ownership of capital assets to avoid relative overtaxation of capital gains.

Under the model income tax, <u>it is recommended that capital gains be subject to full taxation upon realization at ordinary rates after (1) adjustment to basis of corporate stock for retained earnings (as explained in the integration proposal) and (2) adjustment to basis for general price inflation</u>. The inflation adjustment is accomplished by multiplying the cost basis of the asset by the ratio of the consumer price index in the year of purchase to the same index in the year of sale. These ratios would be provided in the form of a table accompanying the capital gains schedule. Table 2 is an example of such a table. (Note that for the last 3 years, the ratios are given monthly. This is to discourage December 31 purchases coupled with January 1 sales.) No inflation adjustment is allowed for intra-year purchases and sales.

Table 2

Inflation Adjustment Factors
(Base-December, 1975-1.663)

Year	Factor	Year	Factor	Year	Factor	Year	Factor	Year	Factor
1930	3.326	1940	3.960	1950	2.307	1960	1.875	1970	1.430
1931	3.647	1941	3.771	1951	2.138	1961	1.856	1971	1.371
1932	4.066	1942	3.408	1952	2.092	1962	1.836	1972	1.327
1933	4.286	1943	3.210	1953	2.076	1963	1.814		
1934	4.147	1944	3.156	1954	2.066	1964	1.790		
1935	4.046	1945	3.085	1955	2.074	1965	1.760		
1936	4.007	1946	2.843	1956	2.043	1966	1.711		
1937	3.867	1947	2.486	1957	1.973	1967	1.663		
1938	3.941	1948	2.307	1958	1.920	1968	1.596		
1939	3.998	1949	2.329	1959	1.905	1969	1.515		

	1973	1974	1975
January	1.302	1.190	1.065
February	1.293	1.175	1.058
March	1.281	1.162	1.054
April	1.272	1.156	1.049
May	1.265	1.143	1.044
June	1.256	1.133	1.035
July	1.253	1.124	1.025
August	1.231	1.109	1.021
September	1.227	1.096	1.017
October	1.217	1.087	1.101
November	1.209	1.078	1.004
December	1.201	1.070	1.000

Source:
Office of the Secretary of the Treasury
Office of Tax Analysis, September 28, 1976

10. <u>Business Income Accounting</u>

What is meant here by the phrase "business income" is that part of the annual accretion to a taxpayer's standard of living which derives from the <u>ownership of property</u> employed in private sector production. In the ordinary language of income sources, this income includes those elements called interest, rent, dividends, corporate retained earnings, proprietorship and partnership profits and capital gains each appropriately adjusted for costs. Unfortunately, there exists no generally accepted set of accounting definitions for all of these ordinary terms. An important object of the model income tax is to specify the outlines of an accounting system for property income that is at once administerable and in close conformance with the standard definition of income.

As argued previously, income is an attribute of families and individuals, not of business organizations; and income is best defined in terms of uses of resources, rather than receipts of claims. Nonetheless, accounting for income is most easily approached by beginning with receipts of individual business activities (or firms), then specifying adjustments for costs, and, finally, allocating income earned in each business among its claimants. The sum of

such claims for all activities in which a taxpaying unit has an interest is that taxpayer's business income subject to tax.

In broad outline, accounting for business income proceeds as follows. Begin with <u>gross receipts</u> from the sale of goods and services during the accounting year and <u>subtract purchases</u> of goods and services <u>from other firms</u>. This first step separates out those transactions which represent a swap of assets rather than income-producing production activity. Next <u>subtract</u> the share of income from the activity that is owed to suppliers of labor services, generically called <u>wages</u>. Next <u>subtract</u> a <u>capital consumption allowance</u>, which estimates the loss in value during the year of capital assets employed in production. The <u>remainder</u> is <u>net capital income</u>, or simply business income. Finally, <u>subtract interest</u> paid or accruing to suppliers of debt finance. The <u>remainder</u> is income to suppliers of equity finance, or <u>profit</u>. A business activity generates three elements of income subject to tax--wages, interest and profits.

Major problems in defining rules of income measurement for tax purposes include (1) issues of timing associated with a fixed accounting period, such as inventory valuation;

(2) estimation of capital consumption, i.e., depreciation and depletion rules; and (3) imputations for non-market transactions, e.g., self constructed capital assets. In each of these cases, there are no explicit market transactions within the accounting period which provide the appropriate valuations. Rules for constructing such valuations are necessarily somewhat arbitrary, but the rules described here are intended to be as faithful as possible to the concept of income within limits of administrability. In cases of substantial market uncertainty, these rules should err on the side of tax reduction or deferral to avoid penalizing the undertaking of risks.

Rules for capital consumption allowances should not be regarded as arbitrary allowances for the "recovery of capital costs." Rather, they are a measure of one aspect of annual capital cost, namely the reduction in value of productive capital occasioned by use, deterioration, or obsolescence. Rules for estimating this cost should be based upon experience and subject to continuous revision as a result of new evidence and to adjust for changing technology. <u>For machinery and equipment, it is recommended that depreciation estimated by means of a system similar to the existing ADR system, and that use of that system be made mandatory</u>. The essential features of this system are (1) classification

of all assets by type of activity, (2) mandatory vintage accounting, (3) a guideline annual repair allowance, (4) a specified annual depreciation rate (or permissible range) to be applied to the undepreciated balance together with a date at which remaining basis may be deducted. Notice that this recommendation would establish a constant relative rate of depreciation as the "normal" depreciation method instead of straight line; and it would disallow all others.

Depreciation of structures would be treated in a similar way, except that prescribed depreciation rates may be variable over the life of a structure. For example, depreciation of x percent per year may be allowed for the first 5 years of an apartment building, y percent for the next 5years, and so on. In addition, gains and losses would be recognized when exchanges or demolitions occur. However, depreciation and repair allowance rates of exchanged properties will always be determined by the age of the structure, not by time in the hands of the new owner.

For minerals, all expenditures for minerals properties prior to the onset of production, and all post-production expenditures not subject to depreciation, must be capitalized and depletion allowances computed on the basis of initial production rates combined with guideline decline rates. Depletion allowances will be scaled to recover no more than

the capitalized expenditures. Immediate deduction will be permitted for "dry holes". After 5 years' experience, the size of the mineral deposit will be reestimated and corrections made to the original allowance; the corrected allowance would only apply to subsequent tax years.

A problem analogous to that of owner occupied homes occurs with regard to capital assets, such as buildings, that are constructed by their prospective user for "rental" to himself. In the case of commercial properties, however, the potential economic biases from allowing the income from such assets to escape tax is more serious than in the case of housing, and the same social-benefit argument does not exist. Consequently, it is recommended that all payments for goods and services associated with construction of goods not for sale (including property taxes and other fees to government, depreciation of own equipment, but not interest paid) be segregated into a special account. During the construction period, a guideline rate of return would be imputed to the average value of this account and reported as income. When such assets are placed in service they would be depreciated according to the regular rules.

These recommendations are illustrative of the type of rules that would also be recommended in other special problem areas such as the treatment of bad debt reserves in financial institutions, evaluation of farm inventories, and the treatment of patent rights.

11. <u>International Considerations</u>

There are two prototype approaches to the taxation of international flows of income, once the corporate income tax is merged with the individual income tax. Under the <u>residence</u> principle all income wherever earned would be taxed according to the rates applied by the taxpayer's own country of residence. According to the <u>source principle</u>, the taxpayer would pay tax at the rate applicable in the source country regardless of his residence. The residence principle is more consistent with the concept of income as a measure of resouces use (which is to take place primarily within the country of residence). Income taxation under the residence principle also invites less economic distortion in the international allocation of resources. This is true because factor <u>services</u> are generally more mobile than factor <u>owners</u>. Therefore, as a long-term objective, coupled with the integration of corporate and individual income taxes, the United States should seek a worldwide system of residence principle taxation.

The first step in establishing the residence principle of taxation is to define a unique tax residence for each individual. These definitions would be initially established by national statute, and ultimately settled by international tax treaty.

The second step in establishing residence principle taxation is to devise national tax systems which discourage the taxation of income by non-resident countries. This fundamental change in tax jurisdiction will take time, and it is important that international flows of labor, capital, and technology not be hampered by double taxation during the transition period. Accordingly, the model U.S. tax system should be designed to bring about a slow but steady movement towards residence principle taxation.

As a practical matter, however, it would not be feasible to exempt foreign shareholders from U.S. taxation until such time as the residence principle received broad political acceptance in the United States and abroad. Initially, therefore, foreign shareholders might be subject to a withholding tax of perhaps 30 percent on their share of corporate income (whether or not distributed), with the rate of tax subject to reduction by treaty. Other forms of income paid to foreign residents would continue to be subject to withholding tax at current statutory or treaty rates. These rates could also be reduced by treaty.

Eventually a deduction, not a credit, should be allowed for foreign income taxes, on the argument that they are not significantly different from State and local taxes, for which a deduction is also allowed. This approach will

encourage foreign overnments to provide U.S. firms operating abroad with benefits approximately equal to the amount of taxes. Oterwise, U.S. firms will gradually withdraw their investment.

It will take time for foreign governments to accept the residence principle, just as the United States is not immediately willing to forego withholding taxes on U.S. source income paid to foreign residents. Therefore, for reasons of international comity, and in order not to interrupt international flows of factor services, the United States would continue to allow a foreign tax credit to the extent of its own withholding tax on foreign income. In the case of corporate source income, the initial credit limitation rate would be 30 percent (and the remainder of foreign taxes would be allowed as a deduction). In the case of other income, the credit limitation would be determined by the U.S. statutory or treaty withholding rate on the particular type of income.

In keeping with the model income tax definition of income, the earnings of a controlled foreign corporation would "flow through" to the domestic parent company and then to the shareholders of the domestic parent. The U.S. parent corporation would be deemed to receive the before-foreign-tax income of the subsidiary even if no dividends were paid,

thus eliminating deferral. A foreign tax credit would be allowed for the foreign country's corporate income tax and withholding tax to the extent of the 30 percent limit. Excess foreign taxes would be deductible.

The earnings of foreign corporations which are not controlled foreign corporations would be taxable in the hands of U.S. shareholders only when distributed as dividends and therefore a deduction rather than a credit would be allowed for the underlying corporate income tax. A foreign tax credit would be allowed only to the extent of foreign withholding taxes, limited by the U.S. withholding rate on dividends paid to foreign residents (the remainder of foreign withholding taxes would be allowed as a deduction).

Other types of foreign income paid to U.S. residents would be similarly eligible for a foreign tax credit, again limited by the U.S. tax imposed on comparable types of income paid to foreigners. Thus, a U.S. citizen working and earning salary income abroad, who retains his U.S. tax residence, could claim a foreign tax credit up to the limit of U.S. withholding taxes on salary income paid to foreign residents.

The objective of tax treaty negotiations would be to reduce U.S. withholding taxes on income paid to foreign residents, and correspondingly to reduce foreign taxation of

income paid to U.S. residents and the foreign tax credit allowed on foreign source income. Ultimately, this approach would bring about taxation on the basis of the residence of individual taxpayers.

12. Incentives for Capital Accumulation

In the previous chapter it was pointed out that one of the disadvantages of any income tax is that it penalizes saving and investment for future consumption relative to present consumption. Accordingly, it is often argued that broad tax incentives for capital formation are a desirable feature of an otherwise-comprehensive income tax.

The required rate of return from capital sources is composed of (1) the return required by investors who purchase the firm's stocks and bonds, (2) the taxes levied by government, and (3) the physical depreciation of the capital. If a change in tax rules lowers the requiried rate of return on investment, it makes additional investment opportunities worthwhile at prevailing interest rates. People will invest more and interest rates will rise until all investment opportunities that yield the required rate of return are exhausted.

If the required rate of return varies for different types of investments, then the country's capital stock will be deployed inefficiently. For example, if investment in

computers requires a 12 percent rate of return when investment in trees requires only 4 percent, then the pattern of investment chosen by investors will have the property that a million dollars withdrawn from investment in trees and devoted to investment in computers will provide an additional $80,000 per year in income. Tax rules can generate incentives that will motivate investors to maintain an inefficient pattern of investment. This is presently the consequence, for example, of the relatively light taxation of income from real estate, the heavy taxation of corporate relative to noncorporate income, and the higher taxation of dividends relative to interest. From the perspective of promoting employment and a high level of income, a badly allocated capital stock is no better than a smaller capital stock that is efficiently allocated. Thus, removing misallocative elements in the tax rules as proposed in the previous section, is an important part of a program to promote investment.

Once distortions associated with inconsistent definition of income are removed, any additional investment incentive must take the form of general tax reductions or reduction in tax on the income from new capital. Several such schemes are considered here.

Investment may be stimulated by lowering personal tax rates, which would increase the net returns to investors and lower the pre-tax returns that they would require of firms. There is some controversy among economists about whether higher returns to investors will actually stimulate more saving. But a recent study sponsored by the Treasury has concluded that saving will indeed respond positively to higher interest rates. There are also possibilities for promoting saving, and hence investment, by expanding the possibilities of tax-sheltered savings. However, it should be remembered that this is basically inconsistent with an accretion type income tax.

Another tax reduction that might be considered is a more generous tax treatment of capital gains. This is not recommended, however, because there is already an inefficient incentive for investors to seek opportunities whose returns will come in the form of capital gains. An efficient tax incentive does not further promote the search for capital gain opportunities, it instead promotes all investment opportunities in an even-handed manner.

An objection that might be raised to general tax rate reductions of any sort is that they do not provide as much stimulus for investment, for a given revenue reduction, as is possible. They provide reduced taxes on all the capital

already in existence as well as new capital. If a tax change provides instead that only new investment will receive the benefit of lower taxes, then there is a much smaller revenue loss for a given investment stimulus. There is no problem with the feasibility of a tax reduction for new capital. One fact that mitigates the possible unfairness of capital only; the investment tax credit and liberalization of depreciation allowances will achieve the purpose. However, there are reservations that should be expressed about whether they are just and equitable.

When a tax reduction is provided only for new capital, the rate of return available to investors rises temporarily, and investment is expanded. But with more capital available, the price of the services of capital falls, and interest rates are likely to rise. When a new equilibrium is established, the price that preexisting capital will be able to command for its services will be no greater than what the new capital earns. Therefore, the old capital will fall in price. The introduction of an investment tax credit provides a clear example of this.

If one person buys a $1 million machine the day before a 10 percent investment tax credit is enacted, and a second period buys a similar machine two days later, the government will give the second $100,000. There upon both machines have a market value of $900,000. The financial result is no different from what would occur if the government were to finance a tax reduction by confiscating 10 percent of all existing capital. One fact that mitigates the possible unfairness of a tax break for new investment is that, for the most part, the owners of the old capital that will fall in value are the same persons who will receive the benefits of the tax breaks for new investment.

If, despite such reservations, tax policies that favor new investment are desired, there are some policies that are better than others.

Liberalized depreciation allowances could be used, but it would be quite complicated to administer them in such a way that no investments were favored over others. It is hard enough to establish a tax depreciation policy that conforms closely to economic depreciation. The investment tax credit indicated, <u>can</u> be administered in such a way as to provide a uniform incentive for all types of investments, though it does nto have that caracteristic at present. Working through the investment tax credit has the advantage

of providing a possibility of being used to offset other distortions, such as the lack of inflation adjustments, but it has the disadvantage of requiring lawmakers to leave their hands off the details and trust experts to make the right calculations about the way that the credit should vary with the durability of equipment.

There is one tax cincentiveetive for new capital that can be applied in a manner that is both simple and neutral among different investments. That incentive is to allow firms to write off some fixed fraction of their investments at the time of purchase, anpreciate the remainder over the scheduled life, in the pattern of economic depreciation. If there are no other distortions in the system, all required rates of return will be lowered by the same amount. An initial write-off of 25 percent of the purchase price would provide about the same revenue cost and average incentive as the present 10 percent investment tax credit. There would be some administrative complications, in that recapture provisions would be needed for assets that were sold before their tax lives were ended, but these complications would not be severe.

In summary, there are three basic ways that tax policy can be used to augment the nation's capital stock. The first is by removing distortions that have become imbedded

in the tax structure. The second way of stimulating investments is by general tax reductions and the third way of promoting investment is by special tax advantages for new investment. Accelerated depreciation and the investment tax credit can be used for this purpose, but it is complicated to use these instruments in a neutral manner. The simplest neutral stimulus for new investment is a uniform partial write-off of investments at purchase, with the remainder of the investment amortized in the pattern of economic depreciation . However, before a decision is made to rely on tax reductions for new investment alone, consideration should be given to the question of whether such incentives are just, and to the possible destabilizing effect of using investment incentives to cure macroeconomic problems.

13. Information on Sample Tax Form for the Comprehensive Income Tax

Filing Status

1. Check Applicable Status

   a. Single individual

   b. Married filing joint return

   c. Unmarried Head of Household

   d. Married Filing Separately

Family Size

2. Enter one on each applicable line

   a. Yourself

   b. Spouse

3. Number of dependent children

4. Total Family Size (Add lines 2a, 2b, 3)

Household Receipts

8a. Wages, Salaries, and Tips of Primary Wage Earner (attach forms W-2)

b. Wages, Salaries, and Tips of all other Wage Earners (attach forms W-2)

c. Multiply line 8b by .75

d. Wages Subject to Tax. Add lines 8a and 8c

9. Pensions, Annuities, Disability, Unemployment Compensation, Workmans Compensation and Sick Pay (includes Social Security benefits except Medicare)

10. Employer contributions to Health Insurance (includes Medicare) (attach form W-w)

11. Employer contributions to Life Insurance (attach form W-w)

12. Other employee compensation (list)

13. Interest received (attach forms 1099)

14. Dividends (attach forms 1099)

15. Rents, Royalties, Estate and Trust Income (attach Schedule E)

16. Unincorporated Business Income (attach Schedule C)

17. Net Gain or Loss from the Sale, Exchange or Distribution of Capital Assets (attach Schedule D)

18. Allocated Share of Corporate Retained Earnings (Attach forms W-x)

19. Public Assistance Payments, Veterans Compensation, Fellowships, Scholarships, Stipends (attach forms W-y)

20. Total (add lines 8-19)

<u>Deductions</u>

21. Employee Business Expense (includes qualified travel, union and professional association dues, tools, materials, and educational expenses)

22. Nonbusiness Interest Expense (attach statement)

23. Charitable Contributions

    a. Total contributions to qualified charities (attach statement)

    b. Enter $W

24. Deduction for Charitable Contributions. Subtract line 23b from 23a (if less than zero, enter zero)

25. State and Local Income Tax (attach forms W-z)

26. State and Local Sales Tax (from Table)

27. Casualty and Theft Losses

    a. Total of Qualified Losses (attach statement)

    b. Enter $X

28. Subtract line 27b from 27a (if less than zero, enter zero)

29a. Casualty and Theft Insurance Reimbursement

b. Casualty Loss Deduction. Subtract 29a from line 28 (if less than zero, enter zero)

30a. Child Care and Household Expenses. If line 8b is positive or box 1c is checked, and line 3 is not zero, enter total child care and household expenses

b. Multiply line 30a by .375

c. Enter smaller of line 30b or $3.750

d. Child Care Deduction. Enter smaller of line 30c or line 8b

31. Total Deductions (add lines 21, 22, 24, 25, 26, 29b, and 29d)

<u>Tax Calculation</u>

32. Income Subject to Tax. Subtract 31 from line 20 (if less than zero, enter zero)

33. Family Size Allowance. Multiply line 4 by $Z

34. Taxable Income. Subtract line 32 from line 31

35. Tentative Tax (from appropriate table)

36. Catastrophic Medical Expense Credit

    a. Enter total qualified medical and dental expense

    b. Subtract $M from line 35a (if less than zero, enter zero)

c. Multiply line 36b by .8

37. Tax Liability. Subtract 36b from 35 (if less than zero, enter zero and precede to line 38)

38. Credit Refund. If line 37 is zero, subtract line 35 from line 36c

Notice that there would be only two supplementary schedules, one for calculating unincorporated business net income (Schedule C) and the other for capital gains (Schedule D) but they would be much simpler. No separate schedules would be required for itemized deductions, and there would be no corporation tax return.

1/ This definition is based upon that of Galvin and Willis, "Reforming the Federal Tax Structure", p. 19.

2/ Increased in increments to 12 months by the Tax Reform Act of 1976.

3/ Increased in increments to $3,000 by the Tax Reform Act of 1976.

Chapter 4. A Model Cash Flow Tax

1. Introduction
2. Elements in Common with the Comprehensive Income Tax
3. Differences Between the Cash Flow Tax and the Comprehensive Income Tax
4. Special Problems: Progressivity, Wealth Distribution and Wealth Taxes
5. Information on Sample Tax Form for Cash Flow Tax