Chapter 3

A MODEL COMPREHENSIVE INCOME TAX

OVERVIEW

This chapter presents a model income tax system based, as nearly as practicable, on a consistent definition of "standard-of-living" income as set forth in the previous chapter. The exceptions to strict conformity with the conceptual income definition are noted. These exceptions occur when rival considerations of efficiency or simplicity have seemed to overrule the underlying principle that all income should be taxed alike. In addition, those cases where the concept of income is not readily translated into explicit rules are noted and discussed. In every case, a specific model tax treatment, sometimes together with optional treatments, is defined and highlighted.

Purpose of the Model Tax

The purpose of the model tax is to provide a concrete basis for the discussion of fundamental tax reform and also to define a standard for the quantitative analysis presented in chapter 5. For each major issue of income tax policy, the model tax reflects a judgment of the preferred treatment. It is not claimed, however, that the model tax provides the unequivocally right answer to all the difficult issues of measurement, definition, and behavioral effects raised. The chapter does not, therefore, only advocate a particular set of provisions; it also presents discussions of alternative treatments.

Base-Broadening Objective

Alternative treatments are suggested when a change from the model tax provision clearly would not violate the basic principle that an income tax should be based on a practical measure of income, consistently defined. In some cases, alternative accounting methods or alternative means of applying tax rates may be used; and there may also be some uncertainties in the interpretation of the income concept itself. Because a low-rate, broad-based tax promises a general imrpovement in incentives, and because there are costs associated with recordkeeping and administration, there is a presumption against deductions, exemptions, and credits throughout the model tax. In particular instances, this presumption may be reversed in favor of an alternative treatment without offending the basic principle of income measurement.

Organization of Chapter 3

The first issues taken up in the chapter concern rules for a definition of income suitable as a tax base. Such rules are derived for three broad sources of household income--employee compensation, government transfer payments, and business income. The first of these is treated in the next section. The third section considers the tax treatment of government transfer payments, and the fourth section deals with problems of accounting for income from businesses. The next four sections of the chapter discuss some specific issues in the taxation of income derived from the ownership of capital. In each of these sections, the model tax is compared with the existing Federal income taxes. Next are three sections that treat issues in the definition of taxable income from all sources. These are the major "personal deductions" under the existing tax. Here, each of these items -- medical expenses, State and local taxes, charitable contributions, and casualty losses -- is considered as an issue of income measurement and economic efficiency. Following these is a brief discussion of the problems and principles of international income tax coordination. Finally, the questions of the proper unit for reporting taxable income and of appropriate adjustments for family size and other circumstances are considered. The chapter concludes with a sample model income tax form that serves as a summary of the model tax provisions.

EMPLOYEE COMPENSATION

The customary starting point for systems of income accounting is to observe the terms under which individuals agree to provide labor services to employers. In the simplest case, described in the previous chapter, the employee is paid an annual wage that is equal to his consumption plus change in net worth. However, in practice, complications usually will arise. On the one hand, the employee may have expenses associated with employment that should not be regarded as consumption. On the other hand, he may receive benefits that have an objective market value, which, in effect, represent an addition to his stated wage.

The model comprehensive income tax attempts to measure the value to the employee of all the financial terms of his employment. In general, the accounting for employee compensation is (1) wage and salary receipts, less (2) necessary employment expenses, plus (3) the value of fringe benefits. The remainder of this section discusses the measurement problems presented by items (2) and (3).

Expenses of Employment

Model Tax Treatment. The model comprehensive income tax would allow deduction from wage and salary receipts for expenses required as a condition of a particular job, such as the purchase of uniforms and tools, union dues, unreimbursed travel, and the like. No deduction would be allowed for expenditures associated with the choice of an occupation, place of employment, or place of residence, even though each of these is related to employment. The latter rule would continue the present treatment of education and commuting expenses, but would disallow moving expenses.

Inevitably, such rules are somewhat arbitrary. For example, whether commuting expenses are deemed costs of employment or consumption expenditures will depend upon whether the work trip is regarded principally as a part of one's choice of residence, i.e., the consumption of housing services, or as a part of the job choice. The guidelines followed here are that expenses should be deductible only if they vary little among individuals with the same job and are specific to the current performance of that job. As at present, regulations would be required to set reasonable limits for those expenses that may be subject to excessive variation, e.g., travel.

A Simplification Option. An option that would simplify individual recordkeeping and tax administration would be to allow deduction for employee business expenses only in excess of a specified amount. If this floor were substantially higher than expenses for the typical taxpayer, most employees would no longer need to keep detailed expense records for tax purposes. The principal disadvantage of this limitation of deductions is that it would tend to discourage somewhat the relative supply of labor to those occupations or activities that have relatively large expenses. Over time, such supply adjustments could be expected to provide compensating increases in wages to those whose taxes are increased by this provision, but the inefficiency of tax-induced occupation changes would remain.

Employer-Provided Pensions

A substantial share of the compensation of employees is in the form of the annual increase in the value of rights to future compensation upon retirement. This increase adds to the net worth of the employee, so that an annual estimate of the accretion of these rights is income under the comprehensive definition. The model tax treatment is intended as a uniform, practical means to estimate the income for tax purposes for different types of private pension plans.

The model comprehensive income tax would continue to exclude employer contributions to pension plans from the employee's tax base and to tax benefits when received. In addition, employee contributions would be deductible in the years paid. However, the earnings of pension plans would be taxed as they accrued. Liability for tax on pension plan earnings would be either upon the employer, if no assignment of rights were made to employees as the earnings accrue, or upon the employee to whom these earnings are allocated by the plan.

Types of Pension 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 percentage of the assets, and each employee's account increases by investment earnings on his share of the assets. Upon retirement, his account balance may be distributed to him as a lump sum payment or may be used to purchase an annuity. The income of any individual from such a plan is simply the contribution made by the employer on his behalf plus his share of the total earnings as they accrue.

Most pensions are of the second type, defined-benefit pensions. This is something of a misnomer because the benefit is not fully defined until retirement. It usually depends on the employee's average wage over the years of employment, the outcome of contract negotiations, etc. The employee's benefits may not vest for a number of years, so that the value to him, and the cost to his employer of his participation are an expectation that depend on the chance of his continued employment. By a strict definition of income, the annual change in the present value of expected future benefits constitutes income from the plan, since this is conceptually an annual increase in the net worth of the employee. 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.

A Practical Measurement System. As an alternative to estimating pension income as an accrual of value to the employee, the model plan would approximate such treatment through the current taxation of plan earnings and full taxation of actual benefits. If done correctly, this would be equivalent to the taxation of the increase in present value of expected future benefit as such increases accrue.

The following example illustrates the equivalence between taxation of accrued pension earnings and taxation of both pension plan earnings and benefits received.

> Mr. Jones' employer contributes $160 to his pension plan at the beginning of this year. Over the year, the contribution will earn 10 percent. Mr. Jones retires at the beginning of next year, taking his pension -- the contribution plus earnings -- in one payment. Mr. Jones' tax rate in both periods is 25 percent.

Method 1. Under a system of taxation of pensions as accrued, Mr. Jones would include the contribution in his taxable income and owe a tax of $40. The earnings of $12 on the remaining $120 would incur an additional tax liability of $3, leaving net earnings of $9. (Note that Mr. Jones could restore the pension fund to $160 only by drawing down his other savings, with a presumably equal rate of return, by the amount of the tax.) Upon retirement, Mr. Jones would receive a tax-prepaid pension distribution of $120 plus $9, or $129.

Method 2. The model tax treatment would subject only the earnings of the fund -- 10 percent of $160 -- to tax in the first year. This tax of $4 would leave net earnings of $12. Mr. Jones would then receive $172 upon retirement, but would owe tax on this full amount. The tax in this case would be $43, so that the remainder [$172 - $43 = $129] would be identical to that resulting from use of method 1, and Mr. Jones should be indifferent between the two treatments.

The method of including actual benefits has the advantage of avoiding the necessity to allocate prospective benefits among nonvested participants. Investment earnings would, however, have ambiguous ownership for the reasons mentioned above. Consequently, it would be necessary to assess a tax on the employer for that share of earnings not assigned to particular employees.

Present Law. 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 also 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 that would not exist under the model tax. Postponement introduces nonneutral tax treatment among forms of saving and investment, encourages a concentration of wealth in pension funds, and reduces the available tax base.

Social Security

Social security retirement benefits (OASI) present other problems. They are financed by a payroll tax on the first $15,300 (in 1976) of annual earnings, half of which is paid by the employer and half by the employee. The half paid by the employee is included in his tax base under the current income tax; the tax paid by the employer is not, although it 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. 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, there is no incentive to convert savings to tax-deferred forms. Consequently, the model tax base would allow deduction of employee contributions by the individual and continue to allow deduction of employer contributions by the employer, but OASI benefit payments would be subject to tax. Very low-income retired persons would be shielded from taxation by provision of a personal exemption and an additional family allowance.

Employer-Paid Health and Casualty Insurance

Issues in the tax treatment of health and casualty insurance are discussed separately below in the sections on medical expenses and casualty losses. In the case of employer-paid premiums for insurance unrelated to occupational hazards, the model tax adopts the same treatment that is recommended for individual purchase. The taxpayer would include as taxable employee compensation the value of the premiums paid on his behalf. Proceeds would not be included in income. The same model tax treatment would apply to the health insurance (Medicare) component of Social Security.

Disability Insurance

Private Plans. Under present law, employees are not required to include employer-paid disability insurance premiums in income, and, subject to a number of conditions, 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 to employers, and employees would be allowed to deduct their own contributions, but the benefits would be taxable.

Conceptually, the premiums paid by the employer do increase the net worth of the employee by the expected value of benefits. Whether benefits are actually paid or not, this increase in net worth is income by a comprehensive definition. However, when benefits are taxable, as they would be under the model plan, the expected value of tax is approximately equal to the tax liability under a current accrual taxation system. The model tax treatment is preferred because valuing the worth of the future interests would pose insurmountable administrative difficulties.

Social Security Disability Insurance. The model tax would provide exactly the same treatment for the disability insurance portion of Social Security (DI), that is given for private plans. Accrual taxation is impractical because the annual value of accruing DI benefits is even less certain than for private plans.

Life Insurance

Term Life Insurance. There is no similar difficulty of valuation in employer provision of term life insurance. The annual value to the employee is equal to the premium paid on his behalf. Therefore, under the model tax, term life insurance premium payments made by the employer would be included in income to the employee; benefits would not be included in income. This parallels the present treatment of an individual's own purchase of term insurance, and that treatment would be continued.

Whole Life Insurance. Whole life insurance involves some additional considerations. A whole life policy represents a combination of insurance plus an option to buy further insurance. When one buys a whole life policy, or when it is purchased on his behalf, that policy may be viewed as 1 year's insurance plus an option to buy insurance for the next and subsequent years at a certain prescribed annual premium. 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, the value of this option tends to increase over time, and it is this growth in value that represents the income associated with the policy. Dividends paid on life insurance are, in effect, only an adjustment in the premium paid -- a price reduction.

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 whole life premium, net of dividend. Under the comprehensive tax, insurance companies would inform each policyholder annually of this income, which would be included in the policyholder's income. This treatment is recommended whether the premium is paid by the individual or by his employer. In addition, the contribution of the employer to the annual payment of the premium would be included in income, as with term insurance.

Unemployment Compensation

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 model comprehensive income tax would exclude payroll taxes from income as at present, but, unlike the present law, unemployment compensation benefits would be included in taxable income.

This treatment has two basic justifications. First, it conforms with the basic equity principle of subjecting all income to the same tax. Employed individuals would not be subject to differentially higher tax than those of equal income who derive their income from unemployment benefits. Second, by taxing earnings and unemployment benefits alike, this treatment would reduce the disincentive to seek alternative or interim employment during the period of eligibility for unemployment benefits. Again, the personal exemption and family allowance would prevent the tax from reaching very low-income persons who are receiving such benefits.

PUBLIC TRANSFER PAYMENTS

A large element of the income of many households is provided by payments or subsidies from government that are not related to contributions by, or on behalf of, the recipients. These transfer payments are presently excluded from the calculation of income for Federal taxes, despite their clear inclusion in a comprehensive definition of income.

Model Tax Treatment

The logic of including transfers in a tax base varies among transfer programs. A distinction may be made between those grants that are unrelated to the current financial circumstances of recipients, e.g., veterans' education benefits, and those that depend upon a stringent test of means, such as aid to families with dependent children. A second useful distinction is between cash grants that are readily measurable in value and publicly provided or subsidized services. The amount of income provided by these "in-kind" benefits, such as public housing, is not readily measurable.

The model income tax would include in income all cash transfer payments from government, whether determined by a test of means or not. Such payments include veterans' disability and survivor benefits, veterans' pensions, aid to families with dependent children, supplemental security income, general assistance, workmen's compensation, black lung benefits, and the subsidy element of food stamps.1/ The model tax would not require reporting the value of government-provided or subsidized services. Hence, there would be no extra tax associated with the benefits of such programs as Medicaid, veterans' health care, and public housing.

Rationale for Taxing Transfer Payments

Horizontal Equity. The principal argument for taxing transfer payments is horizontal equity. Under present law, families that are subject to tax from earnings or from taxable pensions may face the same financial circumstances before tax as others that receive transfer income. If an adequate level of exemption is provided in the design of a tax rate structure, these families would have no tax in either case. But for those whose incomes exceed the exemption level, the present treatment discriminates against the earning family. This is both an inequity and an element of work disincentive.

Those transfer payments that are not contingent on a strict means test are especially likely to supplement family incomes that are above the level of present or proposed exemptions. These programs are the various veterans' benefits, workmen's compensation, and black lung benefits.

The taxation of benefits from any government transfer program would effectively reduce benefits below the level that Congress originally intended, and restoration of these levels may require readjustment of the rates of taxation. However, with a progressive rate tax, the benefits to individuals would be scaled somewhat to family circumstances and, in addition, the tax consequences of earnings and grants would be equalized.

Vertical Equity. The means-tested programs -- Aid to Families with Dependent Children, Supplemental Security Income, general assistance, Food Stamps, Medicaid, and public housing -- have rules to determine eligibility and to scale the value of benefits according to income and wealth of the recipient family. However, these rules may be based on measures of well-being that are different from those appropriate for an income tax. The rules also vary by region, and certain grants may supplement each other or be supplemented by other forms of assistance. Consequently, it is possible that families with similar financial circumstances before transfers will diverge widely after transfer payments are added. To the extent that some recipient households have total incomes that exceed the tax exemption level, inclusion of these grants in the tax base would reduce this divergence. Taxation of grants is no substitute for thorough welfare reform, but it may be regarded as a step toward reducing overlap of the various programs and of reducing regional differences in payment levels.

Valuing In-Kind Subsidies

Those programs of assistance to families that provide particular commodities or services, such as housing and medical care, present difficult administrative problems of income evaluation. One objective approximation of the income to households from these services is the cost of providing them. This is the principle employed to value pension contributions, for example. But in the case of in-kind transfers, costs are not readily allocable to particular beneficiaries. Consider how difficult it would be to allocate costs among patients in veterans' hospitals, for example. Furthermore, because a recipient's choices regarding these services are restricted, the cost of the services may be substantially larger than the consumption (i.e., income) value to the beneficiary. The recipient family would almost certainly prefer an amount in cash equal to the cost of provision. Because of these uncertainties and because of the attendant costs of tax administration and reporting, the in-kind programs might reasonably be excluded from the tax base.

BUSINESS INCOME ACCOUNTING

Basic Accounting for Capital Income

What is meant here by "business income" is that part of the annual consumption or change in net worth of the taxpayer that derives from the ownership of property 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 reduced by costs. Unfortunately, there is no generally accepted set of accounting definitions for all of these ordinary terms. An important objective of the model income tax is to outline an accounting system for property income that is at once administrable and in close conformance with a comprehensive definition of income.

It is apparent from the definition that income is an attribute of families and individuals, not of business organizations. Furthermore, it is useful analytically to think of income 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 for purposes of the model tax.

In broad outline, accounting for business income proceeds as follows. Begin with gross receipts from the sale of goods and services during the accounting year and subtract purchases of goods and services from other firms. Next, subtract the share of income from the activity that is compensation to suppliers of labor services, generically called wages. Next, subtract a capital consumption allowance, which estimates the loss in value during the year of capital assets employed in production. The remainder is net capital income, or, simply, business income. Finally, subtract interest paid or accruing to suppliers of debt finance. The remainder is income to suppliers of equity finance, or profit. A business activity thus generates all three sources of income to households -- wages, interest, and profit.

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 nonmarket transactions, e.g., self-constructed capital assets. In each of these cases, there are no explicit market transactions within the accounting period to 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.

Capital Consumption Allowances

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 subject to continuous revision to reflect new evidence on actual experience and changing technology. For machinery and equipment, the model tax would require that depreciation be estimated by means of a system similar, in some respects, to the existing Asset Depreciation Range (ADR) system but with annual adjustment of basis for increases in the general price level. 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 on which any remaining basis may be deducted) and (5) annual adjustment of basis in each account by a measure of the change in price levels. The inflation adjustment would be a factor equal to the ratio of the price level in the previous year to the current price level, each measured by a general price index. Notice that the recommended depreciation rules would establish a constant relative rate of depreciation as the "normal" depreciation method instead of straight-line depreciation, and it would disallow all other methods.

Depreciation of Structures. Depreciation of structures would be treated in a way similar to that for equipment except that prescribed depreciation rates may be made to vary 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 5 years, and so on. However, in no case would total depreciation deductions be allowed to exceed the original basis, after annual adjustment for inflation. Gains and losses would be recognized when exchanges or demolitions occur. Depreciation and repair allowance rates for exchanged properties always would be determined by the age of the structure, not by time in the hands of the new owner. Expenditures for structural additions and modifications that exceed a guideline repair allowance would be depreciated as new structures.

Depletion of Mineral Property. For mineral property capital assets include the value of the unexploited deposits in addition to depreciable productive equipment. The value of the mineral deposit depends upon its accessibility as well as the amount and quality of the mineral itself. This value may change as development proceeds, and this change in value is a component of income. The value of the deposit will be subsequently reduced, i.e., depleted, as the mineral is extracted. To measure income accurately, a depletion allowance should then be provided that is equal to the annual reduction in the value of the deposit.

Unfortunately, the value of a mineral deposit becomes known with certainty only as the mineral is extracted and sold. Its value at discovery becomes fully known only after the deposit has been fully exploited. Yet, the value on which to base a tax depletion allowance and an annual depletion schedule must be estimated from the beginning of production. Uncertainty about the amount of mineral present, the costs of extraction and marketing, and future prices of the product make estimation of annual capital consumption particularly difficult in the case of minerals. The uncertainties are especially great for fluid minerals.

An objective market estimate of the initial value of a mineral deposit prior to the onset of production is the total of expenditures for acquisition and development, other than for depreciable assets. <u>The model tax would require that all preproduction expenses be capitalized. All such expenditures, except for depreciable assets, would be recovered according to "cost depletion" allowances computed on the basis of initial production rates combined with guideline decline rates derived from average experience.</u> The treatment would be similar to the model tax treatment of depreciation for structures. <u>After each 5 years of experience, or upon exchange of property ownership, the value of the deposit would be reestimated and corrections made to subsequent annual allowances.</u> But, as with depreciation, total deductions are not to exceed the (inflation-adjusted) cost basis. <u>All postproduction expenditures</u>, except for depreciable assets, <u>also must be capitalized and recovered by cost depletion</u> according to the rules in effect for that year.

<u>Self-Constructed Assets</u>

Capital assets that are constructed for use by the builder, rather than for sale, are an example of a case in which a market transaction normally used in the measurement of income is missing. The selling price for a building, machine, or piece of transportation equipment constructed by one firm for sale to another helps to determine the income of the seller and, simultaneously, establishes the basis for estimating future tax depreciation and capital gain of the buyer. Income to the seller will be determined by subtracting his costs from the selling price, so that (with proper accounting for inventories over the construction period) all income generated in the construction process will have been subject to tax as accrued. However, when a construction firm builds an office building, or a shipping company a ship, for its own use or rental, no explicit transfer price is attached to that asset. If any costs associated with construction of the building or ship can be deducted currently for tax purposes, or if any incomes arising from construction can be ignored, current income is understated and a deferral of tax is accomplished.

Unrecognized income is derived from inventories of unfinished buildings, for example. An independent contractor who produces a building for sale must realize sufficient revenue from the proceeds of that sale to compensate suppliers of all capital, including capital in the form of the inventory of unfinished structures during the construction period. But, for self-constructed assets, incomes accruing to suppliers of equity during construction are not recognized for tax purposes because there is no sale. Under current law, certain construction costs, such as taxes and fees paid to governments, may be deducted as current expenses. The result of these lapses of proper income measurement is a tax incentive for self-construction and for vertical integration of production that would otherwise be uneconomic. The present treatment also encourages various arrangements to defer income taxes by providing the legal appearance of integration. These arrangements are popularly known as tax shelters.

To provide tax treatment equivalent to that of assets constructed for sale, <u>the model tax would require that all payments for goods and services associated with construction of capital goods not for sale</u> (including property taxes and other fees to government, depreciation of own equipment, but not interest paid) <u>be segregated into a special account</u>. <u>During the construction period, a guideline rate of return would be imputed to the average value of this account and added to the income tax base of the builder and also to the depreciable basis of the assets</u>.2/ When such assets are placed in service, they would be depreciated according to the regular rules.

<u>Other Business Income Accounting Problems</u>

A number of other problems of inventory valuation must be faced in order to specify a fully operational comprehensive income tax. Also, special rules would be required for several specific industries, in addition to minerals, to improve the measurement of income as compared to the present law. For example, agriculture, banking, and professional sports have presented special difficulties. This section has not spelled out all of these special rules, but has attempted to suggest that improvement of business income measurement for tax purposes is possible and desirable.

INTEGRATION OF THE INDIVIDUAL AND CORPORATION INCOME TAXES

Strictly speaking, the uses concept of income -- consumption plus change in net worth -- is an attribute of individuals or families, not of business organizations. Corporations do not consume, nor do they have a "standard of living." The term "corporate income" is shorthand for the contribution of the corporate entity to the income of its stockholders.

The Corporation Income Tax

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 also 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 the shareholder sells his stock. The resulting gains upon sale are taxed under the special capital gains provisions of the individual income tax. Thus, the tax on retained earnings generally is not at all closely related to the shareholder's individual tax bracket.

Subchapter S Corporations. An exception to these general rules exists for corporations that are taxed under subchapter S of the Internal Revenue Code. If a corporation has 10 (in some cases 15) or fewer shareholders and meets certain other requirements, it may elect to be taxed in a manner similar to a partnership. The income of the entity is attributed directly to the owners, so that there is no corporate income tax and retained earnings are immediately and fully subject to the individual income tax. For earnings of these corporations, then, complete integration of the corporate and individual income taxes already exists.

Inefficiency of the Corporation Income Tax

The separate taxation of income earned in corporations is responsible for a number of serious economic distortions. It raises the overall rate of taxation on earnings from capital 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 also 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.

Owners of closely held corporations are favored relative to those that are publicly held. Owner-managers may avoid the double taxation of dividends by accounting for earnings as salaries rather than as dividends, and they may avoid high personal tax rates by retention of earnings in the corporation with eventual realization as capital gains. Provisions of the law intended to minimize these types of tax avoidance add greatly to the complexity of the law and to costs of administration.

A Model Integration Plan

In the model tax system, the corporate income tax would be eliminated, and the effect of subchapter S corporation treatment would be extended to all corporations. There are alternative methods of approximating this result. Because the direct attribution of corporate income to shareholders most nearly matches the concept of an integrated tax, a particular set of rules for direct attribution is prescribed as the model tax plan. However, there are potential administrative problems with this approach. These problems will be noted and alternative approaches described.

The model tax treatment of corporate profits may be summarized by the following four rules:

1. The holder of each share of stock on the first day of the corporation's accounting year (the "tax record date") would be designated the "shareholder of record."

2. Each shareholder of record would add to his tax base his share of the corporation's income annually. If the corporation had a loss for the year, the shareholder would subtract his share of loss.

3. The basis of the shareholder of record in his stock would be increased by his share of income and decreased by his share of loss.

4. Any shareholder's basis in his stock would be reduced, but not to below zero, by cash dividends paid to him or by the fair market value of property distributed to him. Once the shareholder's basis had been reduced to zero, the value of any further distributions would be included in income. (A distribution after the basis had been reduced to zero would indicate the shareholder had, in the past, income that was not reported.)

Designation of a shareholder of record to whom to allocate income earned in the corporation is necessary for large corporations with publicly traded stock. This treatment is designed to avoid recordkeeping problems associated with transfers of stock ownership within the tax year and to avoid "trafficking" in losses between taxpayers with different marginal rates.

Importance of the Record Date. Suppose that the record date were at the end of the taxable year when reliable estimates of the amount of corporate earnings or losses would be known. Shortly before the record date, shareholders with high marginal rates could bid away shares from shareholders with relatively low marginal rates whose corporations are expected to show a loss.

The losses for the year then would be attributed to the new shareholders for whom the offset of losses against other income results in the greatest reduction in tax liability. Thus, a late-year record date would have the effect of reducing the intended progressivity of the income tax and would bring about stock trading that is solely tax motivated.

The earlier in the tax year that the record date were placed the more the shareholder's expected tax liability would become just another element in the prediction of future returns from ownership of stock in the corporation, as is now the case under the corporation income tax. If the record date were the first day of the tax year, the tax consequences of current or corporate earnings or losses already accrued in the corporation could not be transferred to another taxpayer.

Treatment of the Full-Year Shareholder. Under the model tax scheme, 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 gain from sale of the stock in a future year would be calculated for tax purposes by subtracting from sale proceeds the amount of his original basis plus the undistributed earnings upon which he has been subject to tax. His corporation would provide him with a statement at the end of each taxable year that informed him of his share of corporate earnings. He then could increase his basis by that amount of earnings less the sum of distributions received during the year. For full-year stockholders, then, basis would be increased by their share of taxable earnings and reduced by the amount of any distributions.

It should be noted that, under this treatment, dividends would not be considered income to the shareholder, but would be just a partial liquidation of his portfolio. Income would accrue to him as the corporation earned it, rather than as the corporation distributed it. Hence, dividend distributions would merely reduce the shareholder's basis, so that subsequent gains (or losses) realized on the sale of his stock would be calculated correctly.

Treatment of a Shareholder Who Sells During the Year. A shareholder of record who sells his stock before the end of the tax year would not have to wait to receive an end-of-year statement in order to calculate his tax. He simply would calculate the difference between the sale proceeds and his basis as of the date of sale. The adjustment to basis of the shareholder's stock to which he would be entitled at the time of the corporation's annual accounting would always just offset the amount of corporate income or loss that he would normally have to report as the shareholder of record. Therefore, the income of a shareholder who sold his shares would be determined fully at the time of sale, and he would have no need for the end-of-year statement.

A numerical example may be useful in explaining the equivalence of treatment of whole-year and part-year stockholders. 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 shareholder would thus realize a gain of $10 on the sale, and this would be reported as income.

To illustrate that subsequent corporate earnings would be irrelevant to the former shareholder's calculation of income for taxes, suppose the corporation earns a further $15 after the date of sale, so that as the shareholder of record X receives a report attributing $25 of income to him, entitling him to a $25 basis increase (on shares he no longer owns). One might insist that X take into his tax base the full $25 and recalculate his gain from sale. In this event, the increase in basis from $100 to $125 would convert his gain of $10 from sale to a loss of $15 (adjusted basis = $125; sale price = $110). The $15 loss, netted against $25 of corporate income attributed to him as the shareholder of record, yields $10 as his income to be reported for tax, the same outcome as a simple calculation of his gain at the time of sale. The equivalence between these two approaches may not be complete, however, if the date of sale and the corporate accounting occur in different taxable years. Nonetheless, in the case cited, the model plan appears superior in the simplicity of its calculations, in allowing the taxpayer to know immediately the tax consequences of his transactions, and in its better approximation to taxing income as it is accrued.

In the event there had been a dividend distribution to X of the $10 of earnings before he sold, this distribution would be reflected in the value of the stock, which would now command a market price of $100 on June 20. The amount of the dividend also would reduce his basis to $90, so that his gain for tax purposes would be $10, just as before. The dividend per se has no tax consequences. At the end of the year he again would be allocated $25 of corporation income, but, as before, an offsetting increase in basis. Thus, he will not report any income other than his gain on the sale of the share on June 20.

Note that the same result would obtain in this case if the shareholder included the dividend in income but did not reduce his basis. There would then be $10 attributable to the dividend and no gain on the sale. This treatment of dividends in the income calculation gives correct results for the shareholder who disposes of his shares. However, it would attribute income to a purchaser receiving dividends before the next record date even though such distributions would represent merely a change in portfolio composition. This approach (all distributions are taken into the tax base with only retained earnings allocated to record date shareholders and giving rise to basis adjustments) might, nevertheless be considered an alternative to the treatment of the model plan because it is more familiar and would involve fewer basis adjustments and hence a reduced record-keeping burden. The substance of the full integration proposal would be preserved in this alternative treatment.

The proposed full integration system 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 increase the value of corporate stock, this system would have the effect of taxing capital gains from ownership of corporate stock as they accrued, thereby eliminating a major source of controversy and complexity in the present law.

Administrative Problems of Model Tax Integration

The Liquidity Problem. Some problems of administration of the system just described would remain. One such problem is that income would be attributed to corporate shareholders whether or not it actually was distributed. To the extent the corporation retained its earnings, the shareholders would incur a current tax liability that must be paid in cash, even though their increases in net worth would not be immediately available to them in the form of cash. Taxpayers with relatively small current cash incomes might then be induced to trade for stocks that had higher rates of dividend payout to assure themselves sufficient cash flow to pay the tax.

Imposition of a withholding tax at the corporate level would help to reduce this liquidity problem and perhaps also reduce the cost of enforcement of timely collections of the tax.

One method of withholding that is compatible with the model tax method for assigning tax liabilities is to require corporations to remit an estimated flat-rate withholding tax at regular intervals during the tax year. This tax would be withheld on behalf of stockholders of record. Stockholders of record would report their total incomes, including all attributed earnings, but also would be allowed a credit for their share of taxes withheld. Taxpayers who hold a stock throughout the entire year would receive one additional piece of tax information from the corporation -- the amount of their share of tax withheld throughout the year -- and would subtract the tax withheld as a credit against their individual liability.

This withholding system would complicate somewhat the taxation of part-year stockholders. As explained above, the taxable income of the corporation attributed to stockholders could be determined fully at the time of sale as the sum of dividends received during the year and excess of sale price over basis that existed on the record date. However, if withholding were always attributed to the shareholder of record, he would be required to wait until corporate income for the year had been determined to know the amount of his tax credit for withholding during the full tax year. The selling price of the stock may be expected to reflect the estimated value of this prospective credit in the same way that share prices reflect estimates of future profits. But, in this case, the seller who was a stockholder of record would retain an interest in the future earnings of the corporation, because the earnings would determine tax credit entitlement to the end of the tax year. Despite this apparent drawback, such corporate-level withholding would insure sufficient liquidity to pay the tax, except in cases where the combination of distributions and withheld taxes is less than the amount of tax due from the shareholder of record.

Audit Adjustment Problem. Another administrative problem could arise because of audit adjustments to corporate income, which may extend well beyond the taxable year. This would appear to require reopening the returns of shareholders of earlier record dates, possibly long after shares have been sold. In the present system, changes in corporate income and tax liability arising from the audit process are borne by shareholders at the time of the adjustment. Precisely this principle would apply in the model plan. Changes in income discovered in audit, including possible interest or other penalties, would be treated like all other income and attributed to shareholders in the year the issue is resolved. Naturally, shares exchanged before such resolutions but after the matter is publicly known would reflect the anticipated outcome.

Deferral Problem. There are also some equity considerations. A deferral of tax on a portion of corporate income may occur in a year when shares are purchased. The buyer would not be required to report income earned after the date of purchase but before the end of the taxable year. All earnings in the year of sale that were not reflected in the purchase price would escape tax until the buyer sells the stock.

The 1975 Administration Proposal for Integration

In the context of a thorough revision of the income tax, integration of the corporate and personal tax takes on particular importance. The model tax plan has provisions designed to assure that the various forms of business income bear the same tax, as nearly as possible. If incomes from ownership of corporate equities are subject to greater, or lesser, tax relative to incomes from unincorporated business pension funds, or bonds, the economic distortions would be concentrated on the corporate sector. For this reason, a specific plan for attributing to stockholders the whole earnings of corporations has been presented here in some detail.

A significant movement in the direction of removing the distortions caused by the separate corporation income tax would be accomplished by the dividend integration plan proposed by the Administration in 1975. That proposal may be regarded as both an improvement in the present code, in the absence of comprehensive tax reform, and as a major step in the transition to a full integration of the income taxes, such as the model tax.

CAPITAL GAINS AND LOSSES

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

Accrual Versus Realization

The first issue is whether income (or loss) ought to be reported annually on the basis of changes in market values of assets -- the accrual concept -- or only when realized. The annual change in market value of one's assets constitutes a change in net worth and, therefore, constitutes 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. Also, the extent to which adjustment should be made for general price inflation over the holding period of an asset must be considered. Finally, the desirability of simplicity in the tax system, ease of administration, and public acceptability are important considerations.

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. Alternatives within the range may be modified to allow for (a) income averaging to minimize extra taxes resulting from the bunching of capital gains and (b) adjustments to reflect changes in the general price level.

Present Treatment of Capital Gains

Present treatment for individuals is to tax gains when realized, at preferential rates, with no penalty for deferral. There are a number of special provisions. When those assets defined in the code as "capital assets" have been held for 6 months or more,3/ gains from their realization are considered "long-term" and receive special tax treatment in two respects: one-half of capital gains is 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 $1,0004/ is imposed on the amount of net capital losses that may be used to offset ordinary income in any 1 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 and that deny the use of the 50-percent maximum tax on earned income by the amount of such preferences. Limited averaging over a 5-year period is allowed for capital gains as well as for 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 also are 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.

Model Tax Treatment of Capital Gains

Under the model income tax, capital gains would 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. Capital losses could be subtracted in full from positive elements of income to determine the base of tax, but there would be no refund for losses that reduce taxable incomes below zero. Adjustment for inflation would be 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 1 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 would be allowed for intra-year purchases and sales.

Table 1

Inflation Adjustment Factors
(Consumer Price Index based on December, 1975)

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

Capital Losses

With adequate adjustment for inflation, and for depreciation in the case of physical assets, capital losses under the model tax should measure real reductions in the current income of the taxpayer. There is, consequently, no reason to limit the deduction of such losses, as in current law. A forced postponement of the realization of such losses would be like requiring the taxpayer to make an interest-free loan to the government. Of course, some asymmetry in the treatment of gains relative to losses would remain, because taxpayers could benefit by holding gains to defer taxes but could always take tax-reducing losses immediately.

Taxation of Accruals in the Model Tax

Corporate Stock. As just described, the model tax would continue the present practice of recognizing income from increases in the value of capital assets only upon sale or exchange, but some income sources that presently are treated as capital gains would be put on an annual accrual basis.

If the individual and corporate income taxes were fully integrated into a single tax so that shareholders are currently taxed on retained earnings, a large portion of capital gains -- the changes in value of common stock that reflect retention of earnings -- would be subject to tax as accrued. The remainder of gains would be subject to tax only as realized. These gains would include changes in stock prices that reflect expectations about future earnings, and also changes in the value of other assets, such as bonds, commodities, and land.

Physical Assets. Depreciable assets, such as machinery and buildings, are also subject to price variations, but these variations would be anticipated, as nearly as possible, by the inflation adjustment and the depreciation allowance. If these allowances were perfectly accurate measures of the change in value of such assets, income would be measured correctly as it accrues, and sales prices would always match the remaining basis. Apparent capital gains on physical assets may, therefore, be regarded as evidence of failure to accurately measure past income from ownership of the asset. Consequently, if under the model tax, depreciation would be measured more accurately, the problem of tax deferral due to taxation of capital gains at realization would be further reduced. However, as in the case of corporate stock, some unaccounted-for variation in asset prices undoubtedly will occur despite improvements in rules for adjustments to basis. Sales of depreciable assets will, therefore, continue to give rise to taxable gains and losses. Such gains and losses are the difference between sales price and basis, adjusted for depreciation allowances and inflation.

The taxation of capital gains on a realization basis would produce significantly different results than current taxation of accrual of these gains. Even if capital gains were taxed as ordinary income (no exclusion, no alternative rate), the effective tax rate on gains held for long periods of time but subject to a flat marginal rate would be much lower than the nominal or statutory rate applied to the gains as if they accrued ratably over the period the asset was held. This consequence of deferral of tax is shown in Table 2 for an assumed before-tax rate of return of 12 percent on alternative assets yielding an annually taxable income. Each item in the table is the percent by which the before-tax rate of return is reduced by the imposition of the tax at the time of realization.

Table 2

Effective Tax Rates on Capital Gains

Taxed as Realized at Ordinary Rates

	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%

Accrual Taxation Alternative

Accrual taxation of capital gains poses three problems that, taken together, appear to be insurmountable. These are (1) the administrative burden of annual reporting; (2) the difficulty and cost of determining asset values annually; and (3) the potential hardship of 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 would be little cost or difficulty associated with obtaining year-end valuations. But for other assets, the costs and problems of evaluation would be very formidable, and the enforcement problems would be substantial. It would be very difficult and expensive to valuate assets by appraisal; valuation by concrete transactions, which taxing realizations would provide, has distinct advantages.

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. This circumstance is similar to that encountered with local property taxes assessed on homeowners. There is no cash income associated with the asset in the year that the tax liability is owed. However, in cases of potential hardship certain taxpayers could be allowed to pay a later tax on capital gains, with interest, at the time a gain is realized.

Realization-With-Interest Alternative

An alternative method that attempts to achieve the same economic effect as accrual taxation is taxation of capital gains at realization with an interest charge for deferral. But, in addition to the present complex rules defining realizations that would not be avoided in the model tax plan, rules would be required for the computation of interest on the deferred taxes. An appropriate rate of interest would have to be determined and some assumption made about the "typical" pattern of accruals. In order to eliminate economic inefficiency, the interest rate on the deferral should be the individual taxpayer's rate of return on his investments. However, because 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 would itself 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. This assumption would be particularly inappropriate in those cases where basis was changed frequently by inflation adjustments, depreciation allowances, capital improvements, etc. Because a simple time pattern of value change would reflect reality in very few cases, the deferral charge would introduce additional investment distortions. To the extent that gains occur early in the holding period, capital gains would be undertaxed; when gains occur late in the period, capital gains would be overtaxed.

The Income Averaging Problem

Under a progressive income tax system, the tax rate on a marginal addition to income differs depending on the taxpayer'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 tax at a higher average rate over time on the same amount of total income than do those persons whose incomes are more nearly uniform over time.

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 realizes gains only occasionally, his gains will tend to be larger, and the average tax rate on the gains will be increased. The bunching problem could be solved by spreading the gain, via income averaging, over the holding period of the asset. This flexibility would involve great complexity, but 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 system for lump sum distributions, both of which are in present law.

The problem of postponement of tax to periods of higher marginal rates is a more difficult one. One optional solution would be to calculate an average marginal tax rate 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, some of the gain could be excluded from income; if the current rate were lower, more than 100 percent of the gain would be included. As is the case with charges of interest for deferral, however, such systems would add significantly to the complexity of the tax law, and represent inexact adjustments besides.

Inflation Adjustment

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. For example, 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 basis adjustment is made to account for inflation, the reported capital gain for an asset held over a period of time will largely reflect the level of prices in previous years. This contrasts with other income flows, such as salaries, that 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 desirable in the case of ownership of capital assets to avoid overtaxation of capital gains relative to other income sources, even if general indexing of income sources and/or tax rates is not prescribed.

Inflation adjustment would introduce additional complexity. The basis for each asset would have to be revised annually, whether sold or not. For this reason, it might be desirable to restrict the inflation adjustment to those years in which the inflation rate exceeds some "normal" amount, such as 2 or 3 percent.

Clearly, there are competing objectives of simplicity, equity, and economic efficiency involved in the tax treatment of capital gains. In this case, the model tax treatment would favor simplicity by foregoing accrual treatment that would require annual valuation of all assets, or interest charges for deferral. On the other hand, clear moves in the direction of accrual taxation are taken by introducing current taxation of corporate-retained earnings and more accurate measurement of depreciation. Annual adjustment of basis for general inflation also is judged to be worth the additional administration and compliance cost.

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 present income tax. Long-term tax-exempt bonds yield approximately 30 percent less than fully taxable bonds of equal risk -- a consequence that may be regarded as an implicit tax. However, because problems of equity and inefficiency remain, this lower yield on tax-exempt bonds does not substitute for full taxation. Under the model income tax, interest on State and local bonds would be fully taxable.

Inefficiency of Interest Exclusion

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 in the form of reduced revenues. 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- to 30-percent range.

Inequity of the Exclusion

The subsidy also may be regarded as inequitable. The value of the tax exemption depends on the investor's marginal tax rate. Thus, higher-income taxpayers are more willing than lower-income individuals to pay more for tax-exempt securities. The concentration of the tax savings among the relatively well-off reduces the progressivity of the Federal income tax as compared with the nominal rate structure. The exemption also results in differential rates of taxation among higher-income taxpayers who have incomes from different sources. Investors who would otherwise be subject to marginal rates above 30 percent may avoid these rates by purchasing tax-exempt bonds. Those with equal incomes from salaries or from active management of business must pay higher rates.

Alternatives to Tax-Exempt Bonds

The taxation of interest from State and local bonds would present no special administrative problems, except for transition rules, but alternative means of fiscal assistance to State and local governments may be desirable. Among the alternatives that have been suggested are replacement of the tax exclusion with a direct cash subsidy from the Federal Government (as under revenue sharing), or replacement with a direct interest subsidy on taxable bonds issued by State and local governments at their option. The mechanism for an interest subsidy may be either a direct Federal payment or a federally sponsored bank empowered to buy low-yield State and local bonds and issue its own fully taxable bonds.

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. Furthermore, there is no attempt to attribute to owner-occupiers the income implied by ownership of housing equity. (In the aggregate, this is estimated in the national income and product accounts at $11.1 billion per year, an amount that does not include untaxed increases in housing values.)

Imputed Rental Income

Any dwelling, whether owner-occupied or rented, is an asset that yields a flow of services over its economic lifetime. The value of this service flow for any time period represents a portion of the market rental value of the dwelling. For rental housing, there is a monthly contractual payment (rent) from tenant to landlord for the services of the dwelling. In a market equilibrium, these rental payments must be greater than the maintenance expenses, related taxes, and depreciation, if any. The difference between these continuing costs and the market rental may be referred to as the "net income" generated by the housing unit.

An owner-occupier may be thought of as a landlord who rents to himself. On his books of account will also appear maintenance expenses and taxes, and he will equally experience depreciation in the value of his housing asset. What do not appear are, on the sources side, receipts of rental payment and, on the uses side, net income from the dwelling. Viewed from the sources side, this amount may be regarded as the reward that the owner of the dwelling accepts in-kind, instead of the financial reward he could obtain by renting to someone other than himself. Since a potential owner-occupier faces an array of opportunities for the investment of his funds, including in housing for rental to himself or others, the value of the reward in-kind must be at least the equal of these financial alternatives. Indeed, this fact provides a possible method for approximating the flow of consumption he receives, constituting a portion of the value of his consumption services. Knowing the cost of the asset and its depreciation schedule, one could estimate the reward necessary to induce the owner-occupier to rent to himself.

In practice, to tax this form of imputed income, however desirable it might be from the standpoint of equity or of obtaining neutrality between owning and renting, would severely complicate tax compliance and administration. Because the owner-occupier does not explicitly make a rental payment to himself, the value of the current use of his house is not revealed. Even if market rental were estimated, perhaps as a fixed share of assessed value of the dwelling, 5/ the taxpayer would face the difficulties of accounting for annual maintenance and depreciation to determine his net income.

The present tax system does not attempt to tax the imputed income from housing. This is, perhaps, because there would be extreme administrative difficulties in determining it and because there is a general lack of understanding of its nature. The incentive for home ownership that results from including net income from rental housing in the tax base while excluding it for owner-occupied housing also has strong political support, although the result is clearly a distortion from the pattern of consumer housing choices that would otherwise prevail. Primarily for the sake of simplification, <u>the model plan continues to exclude from the tax base the portion of housing consumption attributable to owner-occupied dwellings. No imputation of the net income arising from these assets is proposed.</u>

<u>Deductibility of Homeowners' Property Tax</u>

Present law allows the homeowner to deduct State and local property taxes assessed against the value of his house as well as interest paid on his mortgage. The appropriateness of each of these deductions is considered next, beginning with the property tax.

The model tax would allow no deduction for the local property tax on owner-occupied homes or on other types of property that also have tax-free rental values, e.g., automobiles. This treatment is based on the proposition that deduction of the property tax results in further understatement of income in the tax base, in addition to the exclusion of net rental income. This cannot be justified, as can the exclusion of net income from the dwelling, on grounds of measurement difficulty. Allowing the deduction of property taxes by owner-occupiers results in unnecessary discrimination against tenants of rental housing. Elimination of the deduction would simplify tax administration and compliance and reduce the tax bias in favor of housing investment in general, and owner-occupancy in particular.

Local housing market adjustments normally will insure that changes in property taxes will be reflected in rental values. When the local property tax is increased throughout a market area, the current cost of supplying rental housing increases by the amount of the tax increase. Over time, housing supplies within the area will be reduced (and prices increased) until all current costs are again met and a normal return accrues to owners of equity and suppliers of mortgages. Accordingly, rents eventually must rise dollar-for-dollar with an increase in property tax. (Note that, in a equilibrium market, deductibility of the local tax against Federal income tax would not result in reduced Federal liability for landlords because the increase in gross receipts would match the increased deduction.) Tenants will experience an increase in rent and no change in their income tax liability.

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

To summarize the effect of the property tax increase, the landlord would have the same net income and no change in income tax; the tenant would have no change in income tax and higher rent; and the owner-occupier would have higher (imputed) rent as a "tenant," but the same net income and a reduction in his income tax as a "landlord." He would be favored relative to the renter first by receiving income from assets free of tax, and, in addition, his advantage over the tenant and landlord would increase with higher rates of local property tax. This 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 were unchanged.

Deductibility of Mortgage Interest

The mortgage interest deduction for owner-occupiers is often discussed in the same terms as the foregoing property tax argument. There are, however, quite significant differences, and, because of these, the model tax treatment would continue to allow deductibility of home mortgage interest.

The effect of this policy may be equated to allowing any taxpayer to enjoy tax-free the value of consumption services directly produced by a house (or other similar asset), regardless of the method he uses to finance the purchase of this asset. The tax-free income allowed is thus the same whether he chooses to purchase the asset out of funds previously accumulated or to obtain a mortgage loan for the purpose.

This position is based on the reasoning that, given the preliminary decision (based on measurement difficulty) not be attempt to tax the net income received from his house by the person who purchases it with previously accumulated or inherited funds, it would be unfair to deny a similar privilege to those who must borrow to finance the purchase.

There is a related reason in favor of allowing the mortgage interest deduction, having to do with the difficulty of tracing the source of funds for purchase of an asset.

Prospective homeowners of little wealth are obliged to offer the house as security to obtain debt financing. By contrast, an individual of greater wealth could 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 borrow to finance housing, and it is very difficult, if not impossible, to correlate the proceeds of any other loan with the acquisition of a house.

Nevertheless, a case may be made for disallowing interest deduction for borrowing identifiably for the purpose of financing an owner-occupied home (or other consumer durable). There is no doubt that most people finance home purchases with a mortgage using the home as security. Mortgage interest payments are surely highly correlated with net income produced by the associated housing, and denying the deduction would increase the tax base by an amount equal to a significant fraction of the aggregate net income from owner-occupied dwellings. For those who cannot otherwise finance home purchases, it would end the tax bias against renting. These considerations deserve to be weighed against the view taken here that the efficiency and equity gains from denying the mortgage interest deduction are insufficient to counterbalance the equity losses and the increased administrative complexity of the necessary rules for tracing the sources of funds.

Consumer Durables

Precisely the same arguments that have been made concerning houses also apply to consumer durables, such as automobiles, boats, and recreational vehicles. These assets generate imputed incomes and may be subject to State and local personal property taxes. The model tax would treat these assets in the same way. That is, property tax assessed against consumer durables would not be deductible, but all interest payments, including those related to purchase of durables, would be allowed as deductions.

MEDICAL EXPENSES

The present tax law allows the deduction of uninsured medical expenses, in excess of a floor, and partial deduction for medical insurance premiums. The principal argument for deductibility is that medical expenses are not voluntary consumption. Rather, they are extraordinary outlays that should not be included in the consumption component of the income definition.

Opponents of deductibility can cite a fairly high degree of "consumer choice" in the extent, type, and quality of medical services that may be elected by persons of similar health. At the extreme, health care choices include cosmetic surgery, fitness programs at resorts and spas, frequent physical examinations, and other expenditures that are not clearly distinguishable from ordinary consumption. The remainder of medical expenditures is generally insurable, and insurance premiums may be regarded as regular, predictable consumption expenditures. Indeed, tax deductibility of medical expenses may be viewed itself as a type of medical insurance that is inadequate in amount for most taxpayers and has some quite unsatisfactory features.

Model Tax Treatment

The model tax would not allow deductions for medical expenses or medical insurance premiums. The benefits of medical insurance would not be included in income. Nondeductibility of medical expenses would simplify the tax law as well as recordkeeping for households. It also would eliminate the necessity of making the sometimes difficult administrative determination of eligibility of a medical expense for deduction.

An optional treatment is presented here that would provide a refundable tax credit for a taxed share of large medical expenses. This optional approach is intended as an explicit medical insurance program, administered under the tax law. There is a presumption here, however, that administration of such a program by the tax authorities would be preferred to other alternatives.

"Tax Insurance" Under Present Law

Under present law, eligible medical expenses in excess of 3 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 (3 percent of AGI), but higher-income taxpayers receive a higher rate of insurance subsidy.

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 only 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.

Present law also allows deduction of half of private insurance premiums (up to a deduction limit of $150) without regard to the floor, the balance being treated as uninsured medical expenses subject to the 3-percent floor. Insurance proceeds are not taxable so long as they do not exceed actual expenses. In the case of fully insured expenses, the result is the same as including all insurance proceeds in income, allowing deduction of all outlays without floor, and allowing deduction for a share of premiums as well. Hence, total medical costs -- insurance premiums plus uninsured losses -- are partially deductible without floor to the extent of insurance coverage and fully deductible above a floor for the uninsured portion. Those who cannot itemize have no "tax insurance," while itemizers pay a coinsurance rate -- ranging from 30 percent to 86 percent -- that varies inversely with income.

Optional Catastrophe Insurance Provision

Viewed as a mandatory government insurance program, the present tax treatment of medical expenses deserves reconsideration. One alternative is a policy that would provide a subsidy -- either in the form of a refundable tax credit or direct appropriation -- for very large medical expenses. Under such a scheme, the floor for the deduction would be raised, but the "coinsurance" rate would be increased for all taxpayers and made uniform, rather than dependent on the taxpayer's marginal rate. For example, if a tax credit were used, its amount might be equal to 80 percent of expenses in excess of a flat floor, say, $1,000 per year. Alternatively, the floor amount might be made a share of income.

While a catastrophe insurance provision would be a major change in the system of financing medical care, it need not have a large budgetary consequence when combined with repeal of the present deductions. 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. Full reimbursement would, however, have the undesirable effect of eliminating the market incentives to restrain medical costs. Some rate of coinsurance is desirable to help ration medical resources. Supplemental private insurance would undoubtedly be made available for insurable medical expenses not reimbursed by the tax credit. No deduction would be allowed for private medical insurance premiums, but proceeds would not be taxable.

STATE AND LOCAL TAXES

The way State and local government should be treated in a comprehensive income measurement system presents difficult conceptual problems. These units might be treated simply as the collective agencies of their citizens. Ideally, in this view, the value of consumption services provided in-kind to the members of the group would be attributed to the individuals and counted on the uses side of their individual income accounts. The same amounts would appear on the sources side, as imputations for receipts in the form of services. Payments to the group would be deducted, as not directly measuring consumption, and payments received from the group would be added to the sources side of the individual income calculation.

The difficulty is in measuring the value of services provided by the collective unit. This problem is solved for such a voluntary collective as a social club by disallowing any deductions for payments made to it by members. In effect, these payments are regarded as measuring the consumption received by members. When it comes to a larger collective organization, such as a State government, this approach is much less satisfactory. The payments to the organization are no longer good proxies for the value of services received. For that reason there is a strong equity case for allowing a deduction of such payments in calculating individual income (including, in individual income, any grants received -- "negative taxes").

Unfortunately, there is no practical method for imputing to individuals the value of services received, so that it is not possible to carry out the complete income measurement system. As in the case of services from owner-occupied homes, the model plan concedes that the value of most services provided collectively will be excluded from the tax base. And as with owner-occupied housing, there is a resulting bias introduced by the Federal tax system in favor of State and local collection expenditure over individual expenditures. The general principle, then, is that payments to the State or local government are excluded from the tax base other than in cases when there is a reasonable correspondence between payments and value of services received. There remains, however, the question of what constitutes "payment" for this purpose, and here particular difficulty is presented by indirect taxes such as sales taxes. Analysis of this issue, together with considerations of simplicity in administration, lead to the prescription of the model tax system that a deduction is allowed only for State and local income taxes. Other taxes may be deducted only as costs of doing business.

Income Tax Deductibility

Income taxes represent the clearest analogy with dues paid into a voluntary collective. These payments reduce the resources available to the payor for consumption or accumulation, and hence they are properly deductible.

Property Tax Deductibility

The issue of property tax deductibility for homeowners has been discussed above. Deduction of that tax should not be allowed so long as the associated implicit rental income from housing is excluded from taxable income. Other State and local taxes that are generally deductible under present law are income taxes, general sales taxes, and motor fuel taxes.

Sales Tax Deductibility

General sales taxes, it may be argued, should not be deducted separately because they do not enter household receipts. Unlike the personal income tax, which is paid by households out of gross-of-tax wages, interest, dividends, and the like, the sales tax is collected and remitted to government by businesses that then pay employees and suppliers of capital out of after-sales-tax receipts. Therefore, the sum of all incomes reported by households must be net of the tax; the tax has already been "deducted" from income sources. To allow a deduction to individuals for the sales tax would be to allow the full amount of the tax to be deducted twice.

The argument above is modified somewhat to the extent that the rate of sales tax varies among States and localities that trade with each other. Jurisdictions with high sales tax rates may sustain locally higher prices if they can effectively charge the sales tax to their own residents who purchase goods outside the jurisdiction. In this case, compensating higher wages, rents, etc. (in money terms) must also prevail in the high-rate area to forestall outmigration of labor and capital. The additional tax will increase nominal income receipts in the region of high tax rates.

The question is an empirical one on the degree to which sales taxes do result in price level differences among jurisdictions. In view of the difficulty of establishing this relationship and of measuring the individual expenditures on which sales taxes are paid, the deduction for sales taxes is not allowed in the model comprehensive income tax. A disadvantage of this treatment is that to the extent sales taxes do cause price level differences, the choice of financing investment by State and local governments will be biased toward income and away from sales taxes.

Alternative Treatments of Sales and Income Taxes

An alternative treatment of both sales and income taxes may be considered, whereby a deduction is allowed only for amounts in excess of a significant floor (possibly expressed as a fraction of the tax base). As at present, standard amounts of sales tax, related to income, could be included in the income tax form, with sales taxes on large outlays (e.g., for an automobile) could be allowed in addition to making the calculation. This approach would relieve most taxpayers of recordkeeping and be roughly equivalent to including at least some of consumption services that are provided by State and local governments in the tax base. (The floor could even be related to an estimate of the extent to which State and local taxes finance transfer payments, included in the base by recipients.)

Benefit Taxes

Certain State and local government services are financed by taxes and charges that are closely related to the taxpayer's own use of those services. Such taxes can be looked upon as measures of the value of consumption of those services and so should not be excluded from income. This argument holds especially for State and local taxes on motor fuels that are earmarked for the construction of highways and for other transportation services. The amount of gasoline consumed is a rough measure of the value of these services used, and, conversely, the consumer can choose the amount of highway services used, and taxes paid, by choosing the size of vehicle and the amount of his driving.

Other State and local user charges and special taxes, such as sewer assessments, fishing licenses, and pollution taxes, are not deductible under current law. This treatment is consistent with the arguments above. In addition, there are a number of local excise taxes that were enacted at least partly for the purpose of controlling consumption. Allowing deduction of such taxes, e.g., on gambling, alcohol, tobacco, firearms, etc., would be adverse to this purpose.

CONTRIBUTIONS TO CHARITIES

Contributions to qualified charitable organizations are presently deductible, subject to certain limits, as an indirect subsidy to philanthropy. Gifts are arguably also of a different nature than ordinary consumption for the donor, and therefore not part of income. Against this view, the voluntary nature of contributions may be cited as evidence that contributors derive satisfaction from giving just as they do from other uses of resources. Since contributions are not taxed to donees, either when received by philanthropic organizations or when distributed to ultimate beneficiaries, a component of income is clearly lost to the tax base as a result of the present policy. Taxation of the donor may be regarded as a substitute for taxation of the donee.

Accordingly, <u>the model tax would allow no deduction to the donor for gifts to charitable organizations and would not include benefits of such donations in income to recipients</u>.

The question of how to treat charitable contributions extends beyond issues of income measurement, however. Many persons would regard the benefits of a tax incentive to philanthropy as more valuable than the potential benefits of tax simplification and horizontal equity of the model tax treatment. Consequently, optional methods for providing an incentive to charity, in the form of donor deductibility or a tax credit, also are discussed.

Charity as Income to Beneficiaries

A charitable contribution is a transfer between a donor and beneficiaries with a philanthropic organization as an intermediary. The philanthropic organization usually converts cash contributions into goods and services, such as hospital care, education, or opera performances, that are subsidized or provided free to the beneficiaries. In many cases, e.g., cancer research, the benefits are very broadly diffused throughout society. The value of these services is a form of income-in-kind to the beneficiaries, but under present law there is no attempt to tax 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 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, but with taxation to the recipient, subject only to the general exemption of very low-income taxpayers.

There is, however, no generally satisfactory way to measure 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 very difficult to value.

Charities as Public Goods

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

On the other hand, some persons argue that this kind of hidden public finance should not be given to programs that are under private, and perhaps even individual, control. Moreover, it may be viewed as inequitable that some beneficiaries should receive untaxed benefits if others must pay the full cost for similar benefits (e.g., education, health care, etc.).

A Practical Alternative to Taxing Charitable Organizations

If it is considered logical but impractical to tax benefits to the beneficiary, 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 beneficiaries. Denial of deductibility, therefore, may be viewed as a proxy for taxing beneficiaries. This describes the present treatment of gifts between individuals. The model tax repeats this treatment for gifts to organizations.

Alternative Tax Incentives for Philanthropy

The rationale for deductibility of gifts and exemption from income of charitable institutions comes down to providing a tax incentive to encourage their activities. On the other hand, concern for tax equity only would suggest taxation of the full value of the charitable contribution on at least one side of the transfer. The latter conclusion may be reached whether one invokes a "standard-of-living" or an "ability-to-pay" criterion of equity.

Optional Tax Credit. The use of the tax system to provide an incentive for charitable activities may be accomplished by an alternative policy option -- the replacement of the deduction with a tax credit. A flat credit (percentage of contribution) could be provided at a level that would just balance the revenue gain from denying deductibility. A credit of, for example, 25 percent would 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, health care, and the arts, bearing the additional burden nominally imposed on the higher-income contributors. Other activities, such as religion and welfare, might be more likely to benefit from the tax savings given to lower-income contributors.

The choice between tax credits and deductions thus requires a judgment about the desired amount of stimulus among types of charities. The relative fairness of these devices may be judged according to one's concept of income. If gifts are regarded as reductions in the donor's income, and if rates of tax are chosen to produce a desirable degree of tax progressivity, then the deduction is to be preferred on equity grounds. Conversely, if charitable giving is a use of one's income that is to be encouraged by public subsidy, a subsidy per dollar of gift that does not vary with the taxable income of the donee may be more appropriate.

CASUALTY LOSSES

Model Tax Treatment

The issue of deductibility of casualty losses is analogous to that of the property tax deduction. Damage to property due to accidents or natural disasters reduces the present and potential income from ownership of that property. Consequently, casualty losses are properly deductible business expenses. However, as argued previously, owner-occupied houses and consumer durables produce incomes equal to a certain portion of the current rental value to the user, and that income is fully exempt from tax under present law and would be under the model tax. Deduction of casualty losses would represent an asymmetric treatment of these household assets -- their income is exempt from tax, but interruption of the flow of income due to casualty would provide a tax reduction. The model tax would allow no deduction for casualty losses except to business property. Casualty insurance premiums for household property would not be deductible and insurance benefits would not be included in income.

Present Law Treatment

Under current law, insurance premiums are not deductible, but proceeds offset the deduction for actual losses. Hence, the effect for insured losses is the same as full deduction of losses, without floor, and inclusion of insurance proceeds in income.

The logic cited above for refusing the deduction of losses would suggest that insurance premiums for household assets also are a cost of maintaining tax-exempt income. Such costs, therefore, should not be deductible. Because insurance premiums are approximately equal to the expected value of insurance benefits, if no deduction is allowed for premiums, the aggregate of insurance benefits may be regarded as tax-prepaid. Consequently, these benefits should not be taxable as income when paid.

INTERNATIONAL CONSIDERATIONS

The Residence Principle

There are two basic prototype approaches to the taxation of international flows of income. The first is the residence principle, under which all income, wherever earned, would be defined and taxed according to the laws of the taxpayer's own country of residence. The second prototype is the source principle, which would require the taxpayer to pay tax according to the laws of the country or countries in which his income is earned, regardless of his residence. Adoption of one prototype or the other, as compared with the mixed system that now prevails, would have the desirable effect of insuring that no part of an individual's income would be taxed by more than one country, and would reduce the number of bilateral treaties necessary to assure against double taxation.

A number of considerations point to the residence principle as the more desirable principle to establish. First, the concept of income as consumption plus change in net worth implies that attribution of income by source is inappropriate. Income, by this definition, is an attribute of individuals, not of places. Second, if owners of factor services are much less mobile internationally than the factor services they supply, variations among countries in taxes imposed by residence will have smaller allocation effects than tax variations among places of factor employment. Third, the income redistribution objective manifested by the use of progressive income taxes implies that a country should impose taxes on the entire income of residents. The usual concept of income distribution cannot be defined on the basis of income source.

For these reasons, the model plan recommends that the United States seek, as a long-run objective, a world wide system of residence principle taxation. This objective would be made much more feasible with the integration of individual and corporate income taxes. Clearly, the residence principle requires that a taxable income be attributable to persons. If taxable income were attributed to corporations, they would be encouraged to move their residence to countries with low tax rates.

Even after establishment of the residence principle, some problems would remain. For example, individuals who live in countries that tax pensions upon realization might be induced to retire to those countries that require prepayment of taxes on pensions by including pension contributions in taxable income. Such international differences in tax structure would contine to require bilateral treaty agreements.

Establishing the Residence Principle

To encourage the establishment worldwide of the residence principle, the model tax would reduce in stages, and according to the outcome of international treaty negotiations, the rates of U.S. withholding taxes on income paid to foreign residents and the foreign tax credit allowed to U.S. residents on foreign source income. This process would depend upon corresponding reductions by foreign countries in the taxation of income of U.S. residents.

The first step in the process of establishing the residence principle is to define a unique tax residence for each individual. These definitions would be established initially by national statute, and ultimately settled by international tax treaty. The second step would be to devise a tax system that encouraged other countries to forego taxation of U.S. residents on income earned abroad. 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, transition to the model U.S. tax system would be designed as a slow but steady movement toward residence principle taxation.

Interim Rules

Foreign Shareholders. As a practical matter, it would not be feasible to exempt foreign shareholders from U.S. taxation until such time as the residence principle received broad political acceptance both 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 taxation subject to reduction by treaty. Other forms of income paid to foreign residents would continue to be subject to withholding tax at existing statutory or treaty rates. These rates also could be reduced by treaty.

Foreign Tax Credits. Eventually, a deduction -- not a credit -- should be allowed for foreign income taxe, because they are not significantly different from State and local income taxes, for which a deduction is also allowed. This approach would encourage foreign governments to provide U.S. firms operating abroad with benefits approximately equal to the amount of taxes. Otherwise, U.S. firms would gradually withdraw their investments. However, 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. In the meantime, 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.

Foreign Corporations. In keeping with the model income tax definition of income, the earnings of a foreign corporation controlled by U.S. interests 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. This would eliminate deferral here just as the integration plan eliminates shareholder deferral of tax as income in the form of corporate retained earnings. 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 that are not controlled by U.S. interests 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 any underlying foreign corporate income tax. A foreign tax credit would be allowed to U.S. shareholders only to the extent of foreign withholding taxes, and 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 Foreign Income. 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. resident earning salary income abroad would be allowed to claim a foreign tax credit up to the limit of U.S. withholding taxes that are imposed on the salary incomes of foreign residents in the U.S.

THE FILING UNIT

To this point, the concern of this chapter has been to develop a practical definition of income for purposes of a comprehensive income tax. That discussion has involved issues of timing, valuation, and scope, as well as considerations of administrability. The major issues that remain to be discussed have to do with assessment of the tax against income as defined.

Model Tax Treatment

Among the more difficult problems of translating an income definition into a tax system are (1) to determine what social or economic unit should be required (or allowed) to file a tax return and (2) how rates are to be applied to filing units having different characteristics. The model tax would designate the family as the primary tax unit, with separate rate schedules, as under current law, for three types of families -- unmarried individuals without dependents, unmarried individuals with dependents (heads of households), and married couples with or without dependents. Other provisions for two-earner families and for dependent care are described below.

Problems of Taxation of the Filing Unit

To illustrate the issues involved in choosing among alternative tax treatments of families, consider 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 satisfy them simultaneously. This is readily illustrated by the following hypothetical case. Both partners of married couple A work, and each has earnings of $15,000. Married couple B has $20,000 of earnings from the labor of one partner and $10,000 from the other.

If individual filing were mandatory, with the same rate structure for all, couple A may pay less tax 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 income and 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, or a total of $3,500. This violates the first criterion.

Now consider a system of family filing in which all income within the family is aggregated and the tax is calculated without regard to the relative earnings of each partner. (Unmarried individuals would be subject to the same rates as a family.) In this case, the two couples would pay the same tax on their total income of $30,000. However, both couples would be financially worse off than if they were unmarried. Each couple would now pay a tax of $3,500 on the total of $30,000. As compared with separate filing, more income is taxed at the higher marginal rate. This violation of the second criterion is sometimes referred to as a "marriage tax."

The simplest device for dealing with this penalty on marriage is "income splitting," whereby the combined income of a married couple is taxed as though it were attributed half to one spouse, and half by the other. Each half is subject to the rate schedule applicable to an unmarried individual. To continue the above example, each couple with a total income of $30,000 would, with income splitting, pay a rate of 10 percent on each $15,000 share, or a total of $3,000 in tax. Notice that there may be a "marriage benefit" so long as each prospective spouse does not have the same income. Upon marriage, the combined tax for couple B would fall from $3,500 to $3,000.

Choice of the Filing Unit

Direct appeal to the concept of income does not settle these issues, because that concept presupposes 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 <u>marriage tax</u>; (2) no discrimination against secondary workers; and (3) the administrative ease of identifying individuals without the requirement of a definition of families. By contrast, the arguments in favor of <u>family</u> filing are: (1) families with equal incomes should 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.

The last point is critical. A concept of income as a use of resources 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 separate treatment of family members would suggest assessment of tax even to minor children. Chiefly because of this problem, it is recommended that the family be made the primary tax unit.

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 6/: 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 taxed separately. Persons not currently married and their children living with them are treated as family units.

The Problem of Secondary Workers

A system of joint family filing may cause an efficiency loss to the economy; namely, the discouragement of labor force participation by secondary workers in a family. 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."

Two-earner families and single-adult families with dependents also face expenses for dependent care, which may be regarded as altering such families' ability to pay taxes. Hence, taxability of families will vary according to the number of adults, the number of wage earners, and the number of children.

Compare the circumstances of three three-person families of equal income: family X has two adult wage earners; family Y has two adults, only one of whom is a wage earner; and family 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 secondary wage earners. 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. The model tax would recognize the difference of the type illustrated by these three families by two special adjustments to taxable income, and by separate rate schedules -- one for families with one adult and another for those with two adults.

Tax Adjustments for Differences in Family Status

The first adjustment in the model tax is that only <u>75 percent of the wage income of secondary earners would be included in family income.</u> This lower rate of inclusion would apply only to a limited amount of earnings of the secondary worker. In the model tax this limit would be $10,000. Earnings of the secondary worker means the income of all family wage earners, except that of the member with the largest wage income. This provision would reduce the "wife tax" on families with more than one wage earner.

<u>The second adjustment would be a child care deduction equal to half of actual child care costs</u> up to a limit of either $5,000 or the taxable earnings of the secondary worker, whichever is smaller. This deduction would be allowed only for a spouse who is a secondary worker, or for an unmarried head of household. The dependent care adjustment would provide some allowance for the reduced standard of living associated with the absence of full-time household services of a parent.

The model tax would provide separate rate schedules, as in present law, for single individuals, for families with a married couple, and for families with a single head of household. Rate schedules applicable to individuals would be 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. A single individual would, 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 would be designed so that the tax liability would be the sum of (1) half the tax calculated from the single rate schedule and (2) half the tax from the rate schedule for couples.

The model tax also would have, as part of its rate schedule, a "zero rate bracket" that would exempt a fixed amount of income on each return from tax. The level of this exemption could be adjusted to reduce the potential marriage benefit that may result from different schedules of positive rates for married as compared to single filers. The desired relation in level and progressivity of tax among taxpayers of different family status would be achieved, therefore, by a combination of rates and rate brackets that is different for each type of family, and also by specifying a level of exemption per filing unit.

Provision of an exemption for each filing unit would have much the same effect as the standard deduction under present law. The exemption would provide a minimum level of income for each family or individual that would not be subject to tax. However, unlike the present law, the use of the exemption by a family would not disallow any other subtractions from receipts in the determination of taxable income. Under the model tax, deductions for employee business expenses, State and local income taxes, pension contributions, interest payments, etc. would not be reduced by, nor dependent upon, the exemption of a subsistence amount of income.

ADJUSTING FOR FAMILY SIZE

Most observers would agree that the tax treatment of families should vary by family size, as well as by marital status and the number of wage earners. <u>The model tax would adjust for family size by means of a specified exemption per family member</u>, as in present law.

<u>Exemptions Versus Credits</u>

The use of the personal exemption as an adjustment for family size has been much criticized. One line of 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 families. This observation has led some people to suggest either a vanishing exemption, which diminishes as income increases, or institution of 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 a vanishing exemption or family credit often reflects 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 also 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. Therefore, in the context of a basic reform of the tax system that involves revision of the rate structure, there is no reason that the substitution of tax credits for exemptions should result in a more progressive tax.

If the change in the standard of living that accompanies the addition of a family member is akin to a reduction in the family's income, then an exemption would be an appropriate family-size adjustment. If, on the other hand, one views the family-size adjustment as a type of subsistence subsidy for each member of a taxpayer's family, a credit may be more appropriate. The model tax reflects the former view.

The point to be emphasized here is that this choice is often argued in the wrong terms. If tax rates are adjustable, the issue of exemptions versus credits is essentially a question of the proper relative treatment of equal-income families of different sizes at various points of the income distribution. Should the tax reduction on account of additional family members be greater as family income increases? Or is this, per se, inequitable?

SAMPLE COMPREHENSIVE INCOME TAX FORM

In order to summarize the major provisions of the model comprehensive income tax, and to provide a ready reference to its provisions, a listing of the items of information that would be required to compute the tax is provided below. In a few cases -- unincorporated business income, capital gains and losses, and income from rents and royalties -- supplemental schedules would be required to determine amounts to be entered. However, as compared with present law, recordkeeping requirements and tax calculation would be simplified greatly, despite the fact that several presently excluded items of income are added.

For most taxpayers, the only calculations that would be complicated would be the exclusion of a portion of wages of secondary workers and the child care allowance for working mothers and heads of households. The rest of the calculation would simply involve the addition of receipts, subtraction of deductions and exemptions, and reference to a table of rates. For single individuals and couples with one wage earner who have only employee compensation and limited amounts of interest and dividends, a still simpler form could be devised.

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, and 3)

Household Receipts

5a. Wages, salaries, and tips of primary wage earner (attach forms W-2)7/

b. Wages, salaries, and tips of all other wage earners (attach forms W-2)

c. Multiply line 5b by .25; if greater than $2,500, enter $2,500

d. Included wages of second worker, subtract line 5c from line 5b

e. Wages subject to tax, add lines 5a and 5d

6. Receipts of pensions, annuities, disability compensation, unemployment compensation, workmen's compensation, and sick pay. (Includes social security benefits, except Medicare, and veteran's disability and survivor benefits.)

7. Interest received (attach forms 1099)

8. Rents, royalties, estate and trust income, and allocated earnings from life insurance reserves (attach schedule E)

9. Unincorporated business income (attach schedule C)

10. Net gain or loss from the sale, exchange, or distribution of capital assets (attach schedule D)

11. Allocated share of corporate earnings (attach forms W-x)

12. Public assistance benefits, food stamp subsidy, fellowships, scholarships, and stipends (attach forms W-y)

13. Alimony received

14. Total receipts (add lines 5e and 6-13)

Deductions

15. Employee business expense (includes qualified travel, union and professional association dues, tools, materials, and education expenses)

16. Nonbusiness interest expense (attach statement)

17. State and local income tax

18. Alimony paid

19. Child care expenses

    a. If line 1c is checked and line 3 is not zero, or if line 1b is checked and both lines 3 and 5b are not zero, enter total child care expenses

    b. Multiply line 19a by .5

    c. Enter smaller of line 19b or $5,000

    d. Child care deduction. If unmarried head of household, enter smaller of line 19c or line 5a

    e. If married filing joint return, enter smaller of line 19c or line 5d

20. Total deductions (add lines 15-18, and 19d or 19e)

Tax Calculation

21. Income subject to tax. Subtract line 20 from line 14 (if less than zero, enter zero)

22. Basic exemption. Enter $1,600

23. Family size allowance. Multiply line 4 by $1,000

24. Total exemption. Add lines 22 and 23

25. Taxable income. Subtract line 24 from line 21

26. Tax liability (from appropriate table)

27. a. Total Federal income tax withheld

    b. Estimated tax payments

    c. Total tax prepayments (add lines 27a and 27b)

28. If line 26 is greater than line 27c, enter BALANCE DUE

29. If line 27c is greater than line 26, enter REFUND DUE

FOOTNOTES

1/ The use of food stamps is restricted to a class of consumption items, but the range of choice allowed to recipients is sufficiently broad that the difference between the face value and the purchase price of the coupon may be regarded as a cash grant.

2/ This imputed income estimates the return to both equity and debt supplied during construction. To include interest paid in the calculation would count the debt portion twice.

3/ To be increased in increments to 12 months according to the Tax Reform Act of 1976.

4/ To be increased in increments to $3,000 according to the Tax Reform Act of 1976.

5/ A rule of thumb that is commonly suggested is that monthly rental is 1 percent of market value. However, as experience with local property taxes has shown, accurate periodic assessment is technically and politically difficult.

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

7/ Wages reported by the employer would exclude employee contributions to pension plans and disability insurance, and would also exclude the employee's share of payroll taxes for social security retirement and disability (OASDI). Wages would include employer contributions to health and life insurance plans, the employee's allocated share of earnings on pension reserves, and the cash value of consumption goods and services provided to the employee below cost.