COMPREHENSIVE TAX REFORM: HAS ITS TIME COME AROUND AGAIN?

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I. **Can History Repeat Itself?** It has been 25 years since the last major overhaul of the nation's income tax laws under the Tax Reform Act of 1986 ("**TRA-86**"). The world has changed dramatically since that time and the nation's economy has been replaced by a global economy. The tax laws have become outmoded and no longer work efficiently, and Congress has added to the problem by constantly attempting to use the Code as an instrument of social, economic and political change. There have been literally thousands of changes to the Code since TRA-86 resulting in inscrutable complexity that threatens to remove the "self" from our once efficient self-assessment system of taxation.

The years leading up to the enactment of TRA-86 witnessed unprecedented bipartisan cooperation (but not without an extraordinary degree of political intrigue) in Congress with an unlikely coalition of liberal Democrats and conservative Republicans joining forces in support of the tax overhaul. These efforts were coupled with strong leadership and support both from Treasury and the President. TRA-86 broadened the tax base, lowered marginal rates and simplified the tax laws, all on a revenue neutral basis. A repeat of this formula today is more easily said than done. All tax benefits that have been added to the Code, which are almost as numerous as the stars, have a well funded cadre of supporters, lobbyists and political action groups who will vehemently argue that the elimination of their particular tax benefit will endanger the very fabric of our nation. It took extraordinary political will and a willingness on both sides of the aisle to compromise ardently held ideological views to enact TRA-86, and it will require more of the same to achieve comprehensive tax reform today.

II. **Why the Sudden Interest in Tax Reform?** Prior to December, 2010, calls for comprehensive tax reform were fairly muted; however, since that date hardly a day goes by without a discussion in all forms of the news media about tax reform. Hearings on tax reform have been, and continue to be, held by the House Ways and Means Committee and the Senate Finance Committee, and the Obama Administration has at least partially embraced this movement by calling for corporate tax reform. What events have sparked this sudden change?

A. **<u>Report of the National Commission on Fiscal Responsibility and Reform -- "The Moment of Truth"</u>**. President Obama's National Commission on Fiscal Responsibility and Reform (the "**Fiscal Commission**") issued its report to the President and to the nation in December, 2010 entitled "The Moment of Truth -- Report of the National Commission on Fiscal Responsibility and Reform" (the "**Fiscal Commission Report**"). Although the Report failed to garner the required supermajority approval of the Fiscal Commission, its recommendations have nevertheless served the purpose of focusing public attention and debate on the need to reform the nation's tax laws. The primary objective of the Fiscal Commission was to restore fiscal responsibility to our government in a time of ballooning national debt and a looming problem with the cost of entitlements as the baby boomer generation begins to retire. One of the principal recommendations contained in the Fiscal Commission Report is for a complete overhaul of the nation's income tax laws. The Fiscal Commission's recommendations were met with an initial outburst of support from the public at large.

B. **<u>Report of the National Taxpayer Advocate to Congress (January 2011)</u>**. In January, 2011, the National Taxpayer Advocate rendered her annual report to Congress in which she identified comprehensive tax reform and simplification as the number one need for the tax system. On page 3 of her report, the National Taxpayer Advocate states that "the most serious problem facing taxpayers -- and the IRS -- is the complexity of the Internal Revenue Code." This report, coming close on the heels of the Fiscal Commission Report, added further fuel to the growing fire for comprehensive tax reform.

III. **<u>Fiscal Commission's Tax Reform Recommendations</u>**.

A. **<u>Fiscal Commission's Stated Objectives for Tax Reform</u>**. Part II of the Fiscal Commission Report is devoted to the topic of tax reform. On page 28 of the Fiscal Commission Report, the Commission concisely sets forth the objectives it seeks to achieve through tax reform as follows:

> "Tax reform should lower tax rates, reduce the deficit, simplify the tax code, reduce the tax gap, and make America the best place to start a business and create jobs."

B. **<u>Specific Proposals</u>**.

1. Rather than "tinker around the edges," the Fiscal Commission recommended that the tax reform process begin by adopting "zero based budgeting" which would initially eliminate all tax expenditures contained in the present Code, with estimated savings of $1.1 trillion. The savings would then be applied to three specific purposes: <u>first</u>, to substantially reduce current marginal rates for individual taxpayers; <u>second</u>, to pay down the national debt; and <u>third</u>, to reinstate a small number of more targeted tax

expenditures “that promote work, home ownership, health care, charity and savings.” Fiscal Commission Report at p. 29.

If no tax expenditures were reinstated at all, the Fiscal Commission would set marginal rates for individual taxpayers at 8% for the lowest bracket, 14% for the middle bracket and 23% for the top bracket. (A preliminary proposal issued by the Fiscal Commission in November, 2010 would have applied the 8% rate to household income between $0 and $70,000; the 14% rate to household income above $70,000 and up to $210,000; and the top 23% marginal rate to household income in excess of $210,000. However, the final report did not include these recommendations.)

2. An “illustrative tax plan” for individual taxpayers was set forth in the Fiscal Commission Report which would reinstate modest targeted tax expenditures described below, produce marginal rates of 12%, 22% and 28%, and include the following changes:

(a) Repeal the AMT.

(b) Repeal PEP and Pease.

(c) Require all taxpayers to take the standard deduction, and the right to itemize deductions would be eliminated.

(d) Tax long-term capital gains and dividends at standard rates (i.e., no preferential rates).

(e) A 12% tax credit would be available for mortgage interest to all taxpayers, but the mortgage amount would be capped at $500,000 and would only be available for a principal residence.

(f) The exclusion for employer provided healthcare insurance would be capped at the 75th percentile of premium levels in 2014, with the cap frozen in nominal terms through 2018 and phased out by 2038.

(g) For charitable gifts, a 12% tax credit would be available to all taxpayers, but only for charitable contributions that exceed 2% of adjusted gross income.

(h) Interest on state and local bonds issued after the date of enactment would be fully taxable.

(i) For retirement accounts, a cap on tax-preferred contributions would be imposed equal to the lower of $20,000 or 20% of income; this would be coupled with an expansion of a saver’s credit.

(j) All other tax expenditures for the benefit of individuals would be eliminated.

Fiscal Commission Report at p. 31.

3. For C corporations, the Fiscal Commission had several recommendations which are summarized on pages 32 and 33 of the Fiscal Commission Report. First, the multiple brackets applicable to taxable income of a C corporation contained in the current version of the Code would be replaced with a single rate of tax that the Commission recommended be set somewhere in the range of 23% to 29%. Second, it was recommended that special subsidies for different industries contained in the Code should be eliminated. The Report notes that the elimination of these subsidies would "create an even playing field for all business instead of artificially picking winners and losers." Third, the Fiscal Commission Report recommended changing the way that we tax foreign source income by moving to territorial system in order to bring the U.S. system more in line with our international trading partners.

   Once again, the Fiscal Commission Report included an illustrative tax reform plan based upon establishing a single rate of tax at 28% for C corporations and would include the following:

   (a) Eliminate the current 9% deduction for qualified domestic production activities.

   (b) Eliminate the use of the LIFO method of accounting for inventories.

   (c) Eliminate all general business tax credits.

   (d) Eliminate over 75 other tax expenditures.

   (e) Adopt a territorial system of taxing foreign source income.

   (f) Maintain the current law treatment of passive, foreign source income under Subpart F of the Code.

4. The Fiscal Commission Report also recommended increasing the level of tax revenues from the current level of 18% of GDP to 21% of GDP and then capping it at that level.

IV. **<u>The Case for Tax Reform as Set Forth in The National Taxpayer Advocate's 2011 Report to Congress</u>**. The National Taxpayer Advocate's Report to Congress issued in January, 2011 (the "**NTA Report**") cites four basic reasons that comprehensive tax reform is needed:

A. **<u>The Code Imposes Extraordinary Compliance Burdens on Both Individual Taxpayers and Businesses</u>**. The most salient statistics cited in the NTA Report regarding the burden of compliance with the Code's tax reporting requirements are the following:

1. IRS data reveals that U.S. taxpayers and businesses spend approximately 6.1 billion hours a year complying just with the filing requirements of the Code.

2. If tax compliance were an industry, to consume 6.1 billion hours the "tax industry" would require the equivalent of more than 3 million full-time workers, making it one of the largest industries in the nation.

3. The cost of compliance for both individual taxpayers and businesses is huge both in absolute terms and relative to the amount of tax revenues collected. The NTA Report estimated that the cost of complying with individual and corporate income tax filing requirements for 2008 (the last year for which this data was available) amounted to $163 billion, or 11% of the aggregate income tax receipts.

4. There have been approximately 4,428 changes to the Code over the past 10 years, an average of more than one per day, including an estimated 579 changes in 2010 alone.

5. The Code has grown from 1,395,000 words in 2001 to 3.8 million words in 2010.

B. **The Code is Rife Not Only With Complexity But Also Special Tax Breaks**. On page 5 of the NTA Report, the National Taxpayer Advocate cites numerous illustrative examples of special benefits built into the Code favoring specific types of individuals or businesses which create complexity and favor taxpayers who can afford expensive tax advice to enable them to take advantage of these tax benefits. As the NTA Report notes on page 5, "The outcome of this situation is predictable -- taxpayers develop a sense of cynicism about the tax system and the government that has foisted it on them, and tax compliance takes a hit."

C. **Complexity Leads to Compliance Problems**. The NTA Report cites IRS data which reveals ". . . that when taxpayers have a choice about reporting their income, tax compliance rates are astonishingly low." NTA Report at p. 7. It notes that employees whose compensation is withheld against in compliance with current Code requirements report better than 99% of their earned income. However, the NTA Report also notes that among workers whose income is not subject to tax withholding, the rate of reporting drops to 43% for non-farm, sole proprietors and to 28% for unincorporated farming businesses. This is a large contributor to the tax gap.

D. **The Code is So Complex That Even The IRS Has Difficulty in Administering It**. The complexity of the Code creates problems not only for taxpayers but also for the IRS. The NTA Report describes a litany of problems encountered by the IRS in administering the tax laws that it is charged with enforcing.

E. **Recommendations for Tax Reform**. The NTA Report strongly urges Congress to substantially reform and simplify the Code and sets forth a number of specific suggestions for accomplishing this task.

V. **Role of the ABA Tax Section in Achieving Comprehensive Tax Reform**.

A. **The ABA Tax Section Has Been An Outspoken Advocate for Tax Simplification**. The ABA Tax Section has a long-standing policy of support for simplification of our nation's tax laws. In 2009, the Section issued a white paper setting forth its call for tax simplicity, stability and transparency. In obvious reference to the bent of Congress over the 30 years to use the Code as means to achieve economic and social ends, the white paper offers the following observation:

> Simplicity in income taxation requires an over-arching bias against delivery of rewards and punishments through the tax system. The core, preferred approach should be an income tax base focused on the measurement of economic income, with due regard for ease of compliance, ease of administration, economic efficiency, and similar treatment for similar taxpayers. American Bar Association Section of Taxation, *Statement of Policy Favoring Tax Simplicity, Stability, and Transparency*, available at http://www.abanet.org/tax/pubpolicy/papers/whitepaper_sopfavoringtaxsimplicitystabilityandtransparency.pdf.

The Section has also advocated for any comprehensive overhaul of the Code to include a thoughtful and comprehensive review of the entire federal civil tax penalty regime. The Tax Section issued a white paper on this topic in 2009 (American Bar Association Section of Taxation, *Statement of Policy Favoring Reform of Federal Civil Tax Penalties*, available at http://www.abanet.org/tax/pubpolicy/papers/whitepaper_sopfavoringreformoffederalciviltaxpenalties.pdf), and has issued a number of other white papers related to reform of the federal wealth transfer taxes and policies regarding U.S. international taxation.

B. **ABA Tax Section's Current Tax Reform Comments Project**. One of the primary objectives established by Council for the 2010-2011 fiscal year was for the Section to take a more active role in the tax legislative process wherever possible. Section leadership determined that the efforts being undertaken by Congress to examine the feasibility of comprehensive tax reform presented such an opportunity. Accordingly, Section leadership issued an invitation to each of its committees whose jurisdiction included either a substantive or procedural area of the tax law to prepare comments containing recommendations for achieving tax reform in their respective areas of expertise for submission to Congress in hopes that they would assist Congress in its efforts to reform the nation's tax laws. Each committee was asked to examine the Code provisions within its primary jurisdiction and determine if there were ways to simplify these Code provisions, make them more administrable, fix bona fide inequities and eliminate redundancies. We also asked each committee if there were any provisions within its jurisdiction that no longer served a significant purpose and could be eliminated. As a result of this request, 25 sets of comments will be submitted to Congress over the coming months. All of these comments will be submitted under the "Blanket Authority" procedure which provides other sections of the ABA the opportunity to review and comment on each of the Section's proposals.

VI. **What Lies Ahead?** If prior tax reform efforts are a reliable guide, accomplishment of comprehensive tax reform will only occur with strong leadership and bipartisan cooperation on the part of the President, the Treasury and members of Congress. Events in Washington over the past six months certainly dampen any sense of optimism, but it is hoped that the overriding, urgent need for comprehensive tax reform will transcend partisan politics and ultimately lead to the enactment of a fairer, simpler and more efficient system of taxation.

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