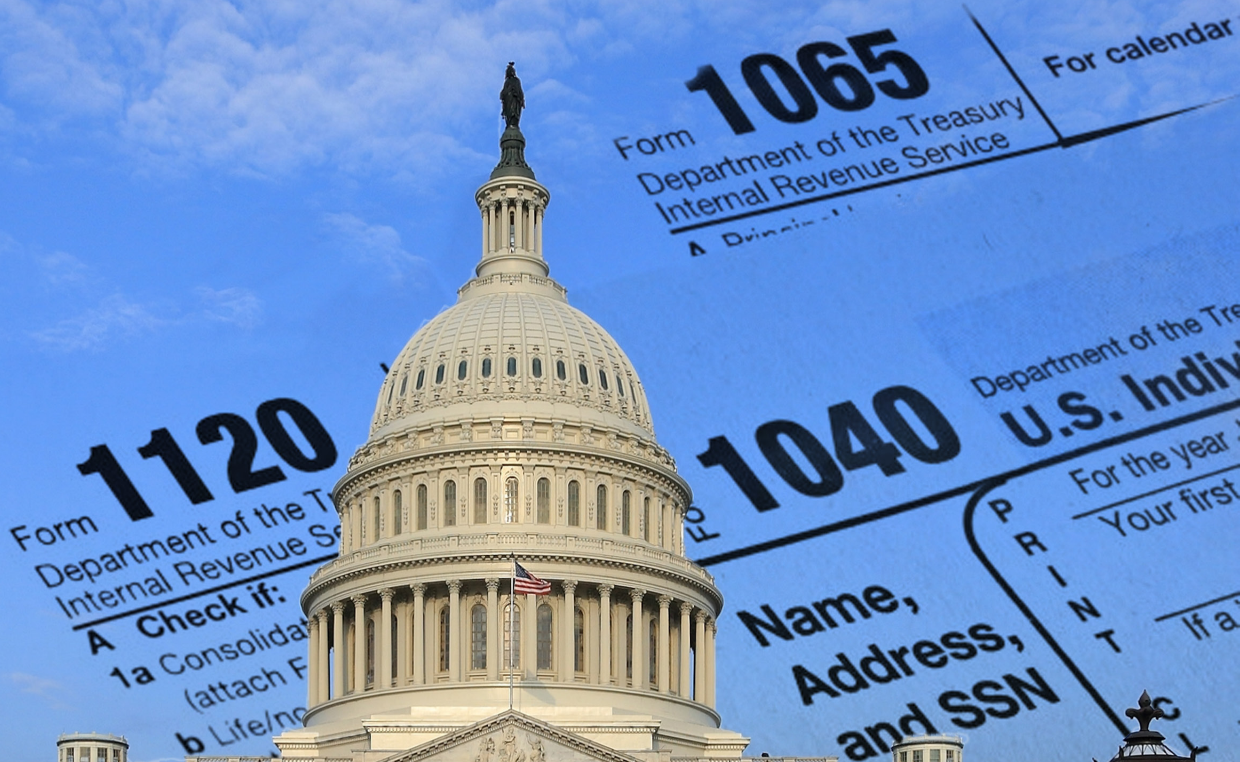
TAXPAYERS FOR COMMON SENSE

MAKING GOVERNMENT WORK

Reform the Tax Code

Eliminate subsidies, fix international taxation, provide for stable revenue



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Taxpayers for Common Sense, like many others, believes federal tax policy should foster economic growth. An improving economy will reduce the rate of growth of our debt – and should ultimately decrease its overall size. Tax policy, like federal spending, should help maximize the benefits of economic growth for all taxpayers.

The U.S. tax code last underwent a major overhaul 30 years ago. Today, it is a confusing thicket of narrow carve-outs, parochial preferences, and revenue giveaways. There must be a more consistent review of the individual and corporate tax codes to ensure that tax breaks produce corresponding benefits to taxpayers. It is past time for Congress to address our failing tax system and to create a fairer system that moves America toward more prosperity.

Congressional reform should focus on eliminating hidden and direct subsidies, replacing our outdated and dysfunctional international tax rules, and providing a stable source of revenue adequate to the needs of our government. If Congress accomplishes those three goals, simplification, greater fairness and more transparency in the tax code also will be achieved.

Goal #1
Reduce or eliminate subsidies

Tax reform must substantially reduce the number and costs of subsidies provided through the corporate and individual income taxes. Although these subsidies are intended to reward or encourage specific activity, they distort economic and personal decision making and often reward activity that would have occurred even without the tax subsidy. Moreover, these subsidies shift the tax burden to others either through higher current tax rates or through borrowing that will be repaid through higher taxes on future generations. These subsidies take many forms including:

- Complete or partial exemptions from taxation
- Favorable accounting rules that accelerate the deductions or create long-term deferrals of income
- Direct subsidies in the form of credits that reduce or eliminate tax liability or, in some cases, provide cash payments.

Subsidies through exemptions from taxation

Since the beginning of the modern income tax, Congress has favored selected activities by providing full or partial exemption from tax for income derived from, or devoted to, those activities either through direct exclusion of the income or through special deductions. These exclusions are particularly costly to the U.S. Treasury because of the permanent benefit they bestow.

Exemption based on form of organization

In the case of certain organizations, the code grants an outright exemption based on the form of business organization. These favored organizations include charitable and civic organizations but also such inherently commercial entities such as credit unions and small property casualty insurance companies. These exemptions are provided under section 501(c) and should be reviewed as part of tax reform. Additionally, the code provides exemptions from corporate income tax in the form of pass-through taxation for S Corporations, REITS, Master Limited Partnerships and Cooperatives. The use of these business forms by very large businesses erodes the corporate tax base and disadvantages businesses that are unable to organize in such a manner.

Exemption based on source of income

The code also provides numerous tax exemptions for specific types of investment income. These include interest on tax-exempt bonds, qualified retirement savings, and the inside build-up on life insurance. There's also partial exclusion for qualified capital gains and some dividend income. In addition, individuals exclude from their income retirement savings, inside-build up on life insurance and significant gains on the sale of a principal residence.

Partial exemption for selected business activities

A special deduction eliminates tax on a portion of a business's income. For example, the Section 199 production activity deduction allows nine percent of business income from qualified activities to escape taxation. The percentage depletion deduction provides a similar benefit to natural resource extraction businesses and royalty owners.

Exemption based on use of income

Individuals can avoid tax on their wages by choosing to receive their income in employer-provided benefits such as education or healthcare benefits.

The itemized deduction rules allow taxpayers to direct their pre-tax income to specific uses such as mortgage interest or charitable contributions and thereby avoid tax on that income. These itemized deduction deliver benefits that are inherently regressive. Lower income taxpayers typically do not benefit from itemizing deductions because the standard deduction exceeds their spending on items that would be deducted. In addition, taxpayers whose income would otherwise be taxed at higher rates receive a greater benefit than those taxed at lower rates. Thus, the subsidy is greater for those who have the greatest economic ability to pay personal expenses without a subsidy.

Politically, Congress may be unable to repeal many of these subsidies. However, tax reform should be restructured so the tax system is less regressive. For example, the limit on the amount of mortgage interest eligible for benefit could be lower and the deduction could be converted to a credit.

Favorable accounting rules

As an alternative to exemption, Congress has frequently chosen to subsidize favored activities by providing accelerated deductions or deferrals of income recognition. The result is a reduction in current tax payments and an implied promise to pay the deferred tax at a later date. In effect, the government makes an interest-free loan in the amount of the taxpayer's economic tax liability for the term of the deferral. The value of this subsidy depends on the term of the deferral and the current cost of money. When interest rates are high, a long-term deferral may be economically tantamount to an exclusion.

Broad-based examples of tax deferrals accomplished through accelerated deductions include those resulting from accelerated depreciation and small business expensing. More selective benefits are provided by rules that allow the expensing of intangible drilling costs and other exploration and development costs associated with natural resources.

Recognition of realized income may be deferred for substantial periods through favorable accounting rules such as the Last-In First-Out inventory method and the Like-Kind Exchange rules. In some cases, these deferrals may be essentially permanent.

Direct subsidies through tax credits

An increasingly popular means of delivering a subsidy is the use of tax credits that directly reduce the tax a corporation or individual would otherwise owe. Tax credits are available for such diverse activities as purchases of residential energy efficiency property, health insurance or education, adoption expenses, production of alternative energy, research and experimentation, and investments in qualified new markets.

These programs allow taxpayers to receive a federal grant with little or no demonstration that the investment supports the intended policy behind the credits and with minimal oversight. A taxpayer simply asserts on a tax return that a qualifying expenditure has been made. In theory, such assertions could be audited, but given Internal Revenue Service audit rates, they rarely are. The subsidy is available even if the taxpayer is fully able to fund the expenditure without government assistance and even if the taxpayer does little to promote the benefit for which the credit was originally intended.

Tax credits, by definition, are highly targeted subsidies that are expressly intended to distort economic decision making and frequently subsidize otherwise non-economic investment. In tax reform, each credit should be reviewed with the same stringency that Congress should bring to any spending program that picks winners and losers in the economy.

Goal #2

An economically competitive international tax system

A broad consensus exists that Congress must reform U.S. tax treatment of domestic businesses that invest abroad. The United States taxes resident individuals and domestic corporations on all income, whether from a U.S. source or foreign source. In the case of income earned by a domestic corporation indirectly through a Controlled Foreign Corporate subsidiary (CFC), U.S. tax is generally deferred until the income is distributed as a dividend from the CFC to the domestic corporation. To mitigate double taxation of foreign-source income, the U.S. allows a domestic corporation to claim a credit for foreign income taxes paid by it and its foreign subsidiaries. Given the current 35 percent U.S. corporate tax rate and the substantially lower rates of our major trading partners, this system often results in significant potential tax on repatriated income.

The current U.S. tax system, combined with financial statement rules, creates an incentive for the U.S. parent of a CFC that has low-taxed foreign earnings to reinvest those earnings indefinitely outside the U.S. Estimates suggest that as much as $2 trillion of deferred income has not been distributed for tax purposes in the U.S.

New rules for international taxation are needed. They should be grounded in today's economic environment of global taxpayers, characterized by the increasing importance and mobility of intellectual property and constant developments in information and communication technologies.

Congress should follow through on the international provisions offered by then-Finance Committee Chairman Max Baucus (D-MT) in 2013 and then-Ways and Means Committee Chairman Dave Camp (R-MI) in 2014. Both proposals sought to narrow the U.S. worldwide taxation regime and eliminate the disincentive under current law to repatriate foreign earnings. Further, they would enact base erosion protections to increase taxation of foreign income earned with respect to the U.S. market.

Congress should end the present deferral of tax on pre-reform foreign income of CFCs through a deemed repatriation and provide a permanent regime that eliminates future deferrals. To assure the competitiveness of U.S. based companies, the new rules should provide a special deduction or other mechanism that results in a 20 percent effective tax rate on this income (before foreign tax credits). Foreign tax credit should be allowed for taxes paid on the taxable portion of the included income.

Goal #3

Stable, sustainable revenues

Compelling economic, fiscal and tax policy considerations support the idea of implementing a new, additional tax to work with the income tax as a part of reform. The current budgetary path is unsustainable. Managing spending in the coming years will be increasingly difficult. Creating a modern income tax system while maintaining current levels of revenue will be politically difficult. As a consequence, serious reductions in the debt may continue to elude Congress.

A looming debt crisis

Federal debt is growing faster than the economy and will exceed 100 percent of GDP by 2035. Over the long term, ballooning federal debt will draw money away from private investment in productive capital.

Limited possibilities for spending reductions

An aging population and rising health care costs will push federal spending up in the coming years, while rising interest rates will increase the government's interest payments on the debt. A select group of lawmakers were unable to agree on spending cuts mandated by the Budget Control Act triggering automatic cuts that have been weakened over time, while spending on infrastructure fell well below the level of investment being made by our competitors. All this suggests that significant further reductions in spending would require sharp cuts to entitlements, which likely are politically impossible absent a larger budget agreement.

A tax system in need of an expensive overhaul– The current income tax system badly needs reform, yet repeated reform proposals, countless working groups and numerous reports have failed to bring change. Almost everyone in Washington agrees the corporate tax rate of 35 percent is too high, but reducing it to international levels would cost about $1 trillion, an amount almost equal to what Congress appropriates each year. Many also believe that individual tax rates should be lowered and flattened. Although rate reductions theoretically could be financed by eliminating special exemptions, deductions and credits, it would be difficult to find enough new revenue in these to pay for all the larger reforms that an overhaul of the tax code would involve.

Nothing but tough choices– Congress faces tough choices as it confronts deficits and the debt, the desire for tax reform, entitlement reform and the difficulty of further deep cuts in discretionary spending. Individual members have different priorities, but many will find that the existing income tax system cannot meet the challenges ahead. Many other countries, faced with their own challenges, have added a consumption tax to the mix of taxes they impose.

The U.S. does not currently have a broad-based consumption tax; however, such taxes frequently are suggested either as a replacement for one or more existing taxes, or as sources of additional revenue for deficit reduction. Prior to enactment of the income tax, consumption taxes in the form of tariff and excise taxes were the principal source of federal revenue. Although most other countries have opted for a value added tax, or VAT, imposed on most goods and services, such a tax would impose extensive new collection and reporting burdens across the public, private and charitable sectors. It would require creating new systems within the IRS to administer and enforce the tax. The tax, furthermore, would be avoided by saving rather than consuming.

Another consumption tax worth consideration could be a carefully crafted upstream tax on carbon. A rate within the range applied in other countries would generate considerable revenue. Imposition of a carbon tax could be done in a way that would not require the creation of a large new bureaucracy to measure actual emissions and collect the tax. The IRS already collects a variety of excise taxes under well-established procedures. A tax of $20/ton would generate approximately $1 trillion over 10 years.

Path to Reform

Whatever the path tax reform takes in the years ahead, it is clear it will be a challenging endeavor. But, as history shows us, even though tax reform has never been easy, it can be done. As problems with the existing code and annual tax extenders packages continue to mount, the need for reform grows.

Notes

About TCS

Taxpayers for Common Sense is a national budget watchdog and independent taxpayer advocate dedicated to increasing transparency and exposing wasteful and corrupt government spending. Founded in 1995 as a 501(c)(3) organization, TCS believes the federal government should operate efficiently and live within its means.

TCS promotes government spending decisions that reflect national priorities and encourages common sense solutions to complex policy problems.