THE THEORY AND PRACTICE OF TAX REFORM

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SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM. By *The President's Advisory Panel on Federal Tax Reform*. 2005. Pp. xv, 272. *Available at* http://www.taxreformpanel.gov/final-report/.

INTRODUCTION

On January 7, 2005, President Bush—flush with recent electoral victory—issued an Executive Order creating the President's Advisory Panel on Federal Tax Reform.[1] The Order instructed the bipartisan Panel to recommend one or more plans for major reform of the federal income tax.[2] The president did not, however, permit the Panel to begin its work on a blank slate. Instead, the Order required (among other things) that the Panel's proposals be revenue-neutral, simpler than current law, "appropriately progressive," and supportive of homeownership and charity.[3] Although the Order contemplated that the Panel might offer more than one tax reform plan, it required that at least one option "use the Federal income tax as the base for its recommended reforms."[4]

The Panel[5] went to work promptly, held several hearings around the country, and produced a Report (not quite on schedule[6]) in November 2005. With Congress having difficulty enacting any legislation and with its limited legislative capacity focused on issues more pressing than revenue-neutral tax reform, the Report was widely viewed as dead on arrival.[7] The Report is, however, a substantial and thoughtful piece of work, and when Congress is finally able to turn its attention to tax reform sometime in the next few years, it can and should look to the Report for ideas—especially since the Report's recommendations were largely driven by the Panel's determination to repeal the alternative minimum tax (AMT), and repeal (or at least major

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1. Exec. Order No. 13,369, 70 Fed. Reg. 2323 (Jan. 7, 2005).

2. *Id.*

3. *Id.*

4. *Id.*

5. The Co-Chairs of the Panel were former senators Connie Mack and John Breaux. The other Panel Members were William E. Frenzel, Elizabeth Garrett, Edward P. Lazear, Timothy J. Muris, James M. Poterba, Charles O. Rossotti, and Liz Ann Sonders. P. iii.

6. The original Order had called for the submission of the report no later than July 31, 2005. Exec. Order No. 13,369, 70 Fed. Reg. at 2324.

7. Steven Pearlstein, *Tax Reform That's Bold and Beautiful*, WASH. POST, Nov. 4, 2005, at D1.

reform) of the AMT is almost certain to be an issue of great legislative interest in the not-too-distant future.[8]

Part I of this Review outlines the basics of the two proposals that the Panel presents in the Report. Part II evaluates some of the proposals' details. Finally, Part III concludes with two comments on the place of the Panel's Report within the long-standing tax reform debate.

I. The Panel's Report

Following the Executive Order's suggestion that the Panel might offer more than one reform plan, the Panel's Report endorses both a "Simplified Income Tax Plan" (SITP) and a "Growth and Investment Tax Plan" (GITP). Although the two plans have slightly different rate structures—brackets of 15%, 25%, 30%, and 33% under the SITP, and brackets of 15%, 25%, and 30% under the GITP—and differ significantly in their treatment of business and investment income, they have many features in common (p. 61 tbl.5.1). Each would repeal the alternative minimum tax (pp. 85–87); replace the standard deduction and personal exemptions with a "family credit," thereby eliminating the distinction between "above-the-line" deductions available to all taxpayers and itemized deductions available only to taxpayers not claiming the standard deduction (pp. 63–68); greatly reduce marriage penalties by giving married taxpayers a tax rate schedule with brackets twice as wide as those applicable to single taxpayers and by giving married taxpayers a "family credit" twice as large as a single person's credit (p. 89); eliminate the deduction for state and local taxes (pp. 83–84); replace the home mortgage interest deduction with a 15% credit, while capping the loan principal amount generating credit-eligible interest at the average cost of housing within the taxpayer's area (resulting in limits ranging from about $227,000 to $412,000) (pp. 70–75); make the charitable contribution deduction available to all taxpayers, but only to the extent contributions exceed 1% of income (pp. 75–76); cap the exclusion for employer-provided health insurance at the average cost of health insurance, while allowing a similarly capped deduction for the purchase of health insurance outside the employment context (pp. 78–82); and greatly expand opportunities for tax-favored savings outside the employment context by allowing every taxpayer to contribute up to $10,000 per year to a "Save for Retirement" (SFR) account and another $10,000 per year to a "Save for Family" (SFF) account, both based on the "tax pre-paid" Roth IRA model.[9] Both proposals retain tax-favored

8. *See infra* Section II.C. For the gory details on the impending AMT train wreck in the absence of legislative intervention, see Staff of J. Comm. on Tax'n, 109th Cong., Present Law and Background Relating to the Individual Alternative Minimum Tax (Comm. Print 2005).

9. Pp. 119–21, 159. Under the Roth IRA model, contributions to tax-favored accounts are not deductible and distributions from the accounts are not taxable. Eligibility to make contributions to these "tax pre-paid" accounts would not be phased out for high-income taxpayers and would not be denied to taxpayers participating in tax-favored employer-sponsored savings plans. Pp. 119–20.

treatment for employer-sponsored retirement savings, but the tax favoritism in the SITP takes the familiar form of cash flow treatment (under which no tax is imposed at the time contributions are made, but tax is imposed when the taxpayer receives account distributions), while the GITP applies the "tax pre-paid" Roth IRA model to employer-sponsored plans (pp. 115–19, 159–60).

The biggest differences between the two plans are in their treatment of business and investment income. Although the SITP has very significant consumption tax features, including the tax-favored savings vehicles described above, it retains the norm of depreciation, rather than immediate expensing, for most long-lived business assets.[10] The GITP, in sharp contrast, adopts the consumption tax approach of immediate expensing for all business assets (pp. 163–64). Although the Panel's Report does not claim the GITP is an income tax, it is also not a pure consumption tax because it retains a modest amount of taxation of investment income—a 15% rate applicable to dividends, capital gains, and interest (pp. 152, 159).

II. Looking at Some Details

A. *Tax Favored Savings, Wage Taxes, Cash Flow Taxes and the Budget Window*

Despite its retention of the "income tax" label, the SITP would constitute a significant move in the consumption tax direction—primarily as a result of the introduction of SFR and SFF accounts. Under a consumption tax, income saved in one year is not taxed until it is spent on consumption in some later year. The current "income" tax follows this consumption tax—or "cash flow"—model with respect to employer-sponsored retirement savings and traditional individual retirement accounts (IRAs).[11] If a taxpayer faces the same tax rate in both the year in which income is saved and the subsequent year in which the income (augmented by the investment return on the savings) is consumed, the results to the taxpayer will be the same under either a cash flow model (with tax imposed only in the year of consumption) or a wage tax model (with tax imposed only in the year of saving).[12] Unlike

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Withdrawals from "Save for Family" accounts could be made to pay for retirement, health, education, or the down payment on a home. P. 120.

10. Pp. 131–32. The SITP would eliminate most double taxation of corporate income by providing an exclusion for dividends paid out of corporate profits subject to U.S. tax and an exclusion for 75% of the capital gain on the sale of stock of a U.S. corporation. Pp. 124–25.

11. *See* I.R.C. § 402(a) (2000) (employer-sponsored plans); *id.* § 408 (IRAs). Current law does not precisely follow the consumption tax model, in that it imposes tax on distributions from employer-sponsored retirement plans and IRAs whether or not the taxpayer spends the distributed amounts in the year of distribution. However, to the extent retirees do spend distributed amounts on current consumption, the tax result is consistent with a consumption tax.

12. For example, suppose that a taxpayer subject to a 20% tax rate at all relevant times wants to devote $10,000 of this year's earnings to retirement savings, and that any amounts saved this year will triple in value by the retirement year in which the taxpayer consumes the savings. Under the *cash flow* approach, he will be able to save the entire $10,000 (because no current tax is owed on

employer-sponsored retirement plans and traditional IRAs, Roth IRAs are taxed under the wage tax model[13]—but Roth IRAs constitute only a small portion of tax-favored retirement savings.[14]

The proposed SFR and SFF accounts both follow the wage tax model rather than the dominant cash flow model. Although they depart from the usual technique for introducing non-income tax features into the "income tax," the accounts would constitute a major increase in the hybridization of the so-called income tax.[15] If a married couple were to save the maximum amount of $40,000 per year in the two new accounts ($10,000 for each spouse in each type of account), and the invested funds grew at the rate of 5% per annum, at the end of thirty years they would have over $2.6 million in their accounts, which they could consume free of tax. The SITP would retain the current ceiling on annual contributions to employer-sponsored retirement plans (which would continue to be taxed under the cash flow model) (p. 117). If each spouse saved the annual maximum of $44,000 at work[16] each year for thirty years, and the rate of return on the investment was again 5%, at the end of thirty years they would have over $5.7 million in their employer-sponsored plans (which would, however, be taxed upon distribution). When wealth of this magnitude is afforded wage tax or cash flow treatment, the continued application of the "income tax" label is dubious.

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As interesting as the Panel's decision to make the SITP less of an income tax is its decision to use wage tax treatment rather than cash flow

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saved income), which will grow to $30,000 by the year of consumption. In that year he will pay $6,000 tax (20% of $30,000), and he will be able to spend the remaining $24,000 on consumption. Under the *wage tax* alternative, he will be able to save only $8,000 (because he must devote the other $2,000 to the tax on the $10,000 of earnings), but that will grow to $24,000 by the year of consumption, and he will be able to spend the entire $24,000 on consumption in that year. Where t_1 represents the tax rate in the year of savings and t_2 represents the tax rate in the year of consumption, and any amounts invested will triple in value between the two years, the formula for the amount the taxpayer can consume in the later year under cash flow taxation is $\$10,000 \times 3 \times (1-t_2)$, and the formula for the amount the taxpayer can consume in the later year under wage taxation is $\$10,000 \times (1 - t_1) \times 3$. As long as t_1 and t_2 are identical, the two formulas produce the same number.

13. I.R.C. § 408A; *see also id.* § 402(c) (permitting taxpayers to elect wage tax treatment, in lieu of cash flow treatment, for elective contributions to employer-sponsored plans).

14. This is true even when the focus is limited to savings outside the employment context. In 2005, 37.6 million households owned traditional IRAs, while only 16.1 million households owned Roth IRAs. Sandra West & Victoria Leonard-Chambers, *The Role of IRAs in Americans' Retirement Preparedness*, Research Fundamentals (Inv. Co. Inst., Wash. D.C.), Jan. 2006, at 1, 2 fig.2.

15. The proposed accounts would replace a number of existing specialized vehicles for tax-favored retirement savings, including IRAs, Roth IRAs, health savings accounts, Coverdell savings accounts (for higher education), and qualified tuition programs. Pp. 119–21. Given the restrictive eligibility requirements and contribution limits for these existing programs, the net effect of repealing the existing programs and replacing them with the two proposed accounts would be a large increase in the availability of tax-favored savings vehicles.

16. I.R.C. § 415(c); I.R.S. Notice 2005-75, 2005-45 I.R.B. 929 (inflation-adjusted contribution ceiling for 2006).

treatment to accomplish that goal. The Panel's other proposal, the GITP, exhibits even greater enthusiasm for wage tax treatment; it would replace cash flow taxation of employer-sponsored savings with wage taxation (pp. 159–60). At first glance, this preference for wage taxes over cash flow taxes is difficult to understand. After all, cash flow taxation has been the norm for tax-favored savings under the federal income tax for many decades, with apparently satisfactory results. Given the fact that the two approaches generally produce similar or identical results in the end, what could explain the Panel's preference? One reason might be cosmetics. For a taxpayer in the 33% bracket (the top bracket under the SITP), $10,000 in a wage tax account is as good as $14,925 in a cash flow account.[17] If the Panel feared that cash flow account contribution ceilings of almost $15,000 would appear too generous, it might have opted for wage tax treatment to reduce the nominal contribution ceilings to $10,000 without any change in actual generosity.

One would hope, however, that the Panel had a better reason than that for its rejection of the long-standing preference for cash flow taxation. There *is* a substantive difference between wage taxes and cash flow taxes whenever a taxpayer is not subject to the same tax rate in the year income is earned and saved, and the later year in which the savings are consumed. Under a wage tax, the tax liability is a function of the tax rate in the earlier year, while under a cash flow tax it is a function of the tax rate in the later year. The Panel might have believed, for some reason, that the tax rate in the earlier year is the more appropriate rate to apply when the two rates differ. In fact, however, the Report expresses no such belief.[18] It provides no explanation whatsoever for the choice of wage taxation rather than cash flow taxation for the SFR and SFF accounts.[19]

The Report is slightly more forthcoming with respect to the proposal, under the GITP, to switch to a wage tax model for employer-sponsored savings. The Report claims to favor the wage tax model "on policy grounds," but the only policy it actually mentions is that wage taxation "has the advantage of being simpler because the traditional IRA approach involves claiming a deduction when money is contributed and reporting income when the money is withdrawn" (p. 160). Even if the factual premise were correct, this simplicity argument would be very weak (because claiming IRA deductions is not complicated). But, in fact, the premise is wrong. The up-front tax benefit for

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17. This is because the tax has already been paid in the case of the wage tax account (a tax of $4925, which is 33% of pre-tax wages of $14,925), whereas the tax has yet to be paid in the case of the cash flow account. If the taxpayer withdraws the entire $10,000 from the wage tax account, the taxpayer will owe no tax and can spend the entire $10,000. If the taxpayer withdraws the entire $14,925 from the cash flow account, the taxpayer will owe tax of $4925 and will be able to spend only the remaining $10,000.

18. This is not surprising in the case of the SITP, since the SITP would retain cash flow treatment for employer-sponsored retirement savings. If the Panel had asserted the superiority of wage taxation for savings outside the employment context, it would have had to explain why the same logic did not apply within the employment context.

19. Pp. 119–21 (describing the proposal without explaining the rationale for the wage tax choice).

employer-sponsored savings under a cash flow tax is an exclusion, not a deduction, and from the employee's point of view nothing could be simpler than an exclusion.

The real reason for the Panel's preference for wage taxation over cash flow taxation is mentioned in the Report—as a piece of information, but without any acknowledgment that it is the reason for the preference. The Report explains that the Panel interpreted the president's revenue-neutrality directive to require only that the proposals be revenue-neutral over a "budget window" consisting of the first ten years a proposal is in effect (p. 46). The Report also explains that the SFR and SFF accounts would produce only a slight reduction in revenue within the ten-year window; taxpayers contributing to the accounts would pay tax on wages when earned, and some taxpayers would elect to make taxable conversions of existing cash flow accounts to wage tax accounts (p. 47). Outside the budget window, however, the revenue loss would grow rapidly, as taxpayers received tax-free distributions from wage tax accounts instead of taxable distributions from cash flow accounts. Citing the work of Treasury Department revenue estimators, the Report explains: "[F]or [wage tax] retirement accounts, the revenue cost during the ten-year budget window is roughly one-third of the total revenue cost of this program; two-thirds of the revenue loss is not reflected in the revenue tables provided in this report" (p. 47). Although the Report carefully avoids offering the budget window as a reason for preferring wage tax treatment over cash flow taxation,[20] it is obvious—almost embarrassingly obvious—that this is the one and only reason for the Panel's embrace of wage taxation. It is deeply disappointing that a bipartisan Panel, operating free of political constraints, would resort to budget flim-flammery to make its proposals appear revenue-neutral when they really are not, abandoning a decades-long preference for cash flow taxation in the process. On the other hand, perhaps the Panel deserves some credit for being so disarmingly honest about its dishonesty. Without ever admitting that its preference for wage taxation is solely a matter of budget gimmickry and that its proposals are, therefore, not really revenue-neutral, the Report provides a thorough and lucid description of the gimmickry it employs. It is a strange performance, perhaps reflective of a compromise between Panelists who did not want to use budget gimmickry at all and those who wanted to use gimmickry without calling attention to it.

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20. In its discussion of wage tax treatment of employer-sponsored retirement savings under the GITP, the Report mentions the budget window difference between wage taxation and cash flow taxation, but it does not offer that difference as a reason for favoring wage tax treatment. P. 160. Similarly, in a discussion of the SFR and SFF accounts, the Report mentions that wage tax treatment and cash flow treatment "have different near-term tax revenue consequences," but it does not suggest that difference is a reason to prefer one approach over the other. P. 93.

B. *Marriage Penalty Relief*

The Report recommends reducing marriage penalties in the tax-rate structure by giving married couples who file joint returns rate brackets twice as wide as the rate brackets for single taxpayers.[21] Similarly, the family credit (the replacement for personal exemptions and the standard deduction) would be twice as large for a married couple as for a single person (p. 89). The Report offers exactly two sentences in support of these proposals: "Couples find it hard to understand why they should pay more in tax after they get married than they would have paid if they had remained single," and "By providing marriage penalty relief, the Panel's options help reduce the barriers faced by potential second earners" (p. 89).

The first sentence is fine as far as it goes, but it does not go nearly far enough. Unmentioned by the Report, the federal income tax has a long and not very happy history of disputes over the relative treatment of married and unmarried taxpayers.[22] The approach proposed by the Report has been tried before: it was introduced into the income tax in 1948.[23] The 1948 legislation produced no marriage penalties, but many marriage bonuses. Every marriage bonus can be seen, from the other side of the coin, as a singles penalty. Single persons complained, and in 1969 they were somewhat mollified by legislation making the rate brackets for single persons more than half the width of the joint-return brackets.[24] The result was a system with both marriage penalties and marriage bonuses, and the basic compromise of 1969 has continued (albeit with considerable tweaking) to this day. It is not necessarily unreasonable to propose a return to the 1948 approach, but it is unreasonable to propose it so cavalierly, without any discussion of the difficulty of the problem and the objections single persons will certainly raise to the proposed solution.

As with the issue of wage taxation versus cash flow taxation, the Report helpfully provides the information necessary to understand the inadequacy of its marriage penalty policy analysis. The Report includes a table with a number of examples of how the SITP would affect the tax liabilities of hypothetical taxpayers (p. 142 tbl.6.6), showing that married taxpayers would fare much better than both single taxpayers and heads of households. For example, for taxpayers (under age 65) at the ninety-fifth percentile of the income distribution, the SITP would result in a decrease of 8.1% in the tax liability of a married couple, an increase of 5.9% in the tax liability of a single person, and an increase of 15.2% in the tax liability of a head of

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21. P. 89. This would eliminate rate bracket marriage penalties for married couples vis-à-vis single taxpayers other than heads of households.

22. For a brief review of the history, see Lawrence Zelenak, *Doing Something About Marriage Penalties: A Guide for the Perplexed*, 54 TAX L. REV. 1, 4–8 (2000).

23. Revenue Act of 1948, Pub. L. No. 80-471, §§ 301–305, 62 Stat. 110, 114–16.

24. Tax Reform Act of 1969, Pub. L. No. 91-172, § 803, 83 Stat. 487, 678–85.

household.[25] The Report proposes a massive shifting of the income tax burden from married taxpayers to unmarried taxpayers, with virtually no discussion of the merits of the proposal.

The second sentence of the Panel's justification for its proposal—about "reduc[ing] the barriers faced by potential second earners"—seems to be based on a misconception. Joint filing by married couples raises two different concerns. First, when two people get married, their tax liability may change as a result of the change in their filing status, even though the income of each person remains the same. When marriage causes an increase in combined tax liability, that is a marriage penalty. The proposal would indeed decrease marriage penalties, albeit (as described above) at a considerable cost to unmarried persons. The second concern is the "stacking effect." When two people are already married and one spouse (typically the husband) is firmly committed to the workforce, while the other spouse (typically the wife) is deciding between paid work and full-time homemaking, joint returns will discourage the latter spouse from employment.[26] If she takes a job, her income will be "stacked" on top of her spouse's existing income, and all her income will be subject to a relatively high marginal tax rate.[27] Separate filing by married couples would eliminate the stacking effect, and a two-earner deduction would reduce it,[28] but making joint-return rate brackets twice as wide as the brackets applicable to single taxpayers has no impact on it.[29]

C. *The Alternative Minimum Tax and the Deduction for State and Local Taxes*

The alternative minimum tax (AMT) functions as a shadow income tax, with a broader base than the regular income tax and a different rate structure

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25. P. 142 tbl.6.6. For taxpayers at the fiftieth percentile of the income distribution, a single person would receive a tax reduction of 4.0%, a head of household would receive a minuscule reduction of 0.4%, and a married couple would receive a reduction of 30.9%. P. 142 tbl.6.6.

26. *See* Lawrence Zelenak, *Marriage and the Income Tax*, 67 S. CAL. L. REV. 339, 365–72 (1994) (describing this phenomenon and labeling it the "stacking effect"); *see also* Zelenak, *supra* note 22, at 19–21, 34 (noting the common confusion between marriage penalties and the stacking effect, and explaining that the 1948 income tax system—with joint return rate brackets twice as wide as the rate brackets for unmarried taxpayers—produced the stacking effect despite producing no marriage penalties).

27. Of course, nothing in the Internal Revenue Code specifies that one spouse's income gets the benefit of the lower rates while the other spouse's income is stacked on top and subject to higher rates. However, if one spouse is firmly committed to the workforce and the other is at the workforce-homemaking margin, the spouses will act as if the Code so specified.

28. *See* Economic Recovery Tax Act of 1981 (former I.R.C. § 221), Pub. L. No. 97-34, § 103, 95 Stat. 172, 187–88 (repealed 1986).

29. Increasing the width of the joint-return's lower rate brackets would decrease the marginal tax rates faced by some spouses considering entry into the work force, thus decreasing the stacking effect for those spouses. The stacking effect has nothing to do, however, with the width of joint-return rate brackets relative to the width of the rate brackets for unmarried taxpayers, and so has nothing to do with marriage penalties per se.

(featuring a higher exemption and a lower top rate).[30] If a taxpayer's tentative minimum tax under the AMT rules exceeds the taxpayer's regular tax liability, he must pay both his regular tax liability and the excess of the tentative minimum tax over the regular tax.[31] When the predecessor of the current AMT was enacted in 1969,[32] it was designed to affect only a small number of rich taxpayers who made extensive use of tax preferences, and the tax worked as intended for decades.[33]

The AMT, however, is now becoming a monster, with its claws reaching deep into the middle class. The Panel wrote its Report in the shadow of a prediction by the Staff of the Joint Committee on Taxation that in 2006 the AMT would affect 18.4% of taxpayers in the $75,000–$100,000 income range, and 62.6% of taxpayers with incomes in the $100,000–$200,000 range.[34] The growth in the AMT is largely explained by three factors: (1) the exemption amounts and the rate structure of the regular tax are indexed for inflation, but those of the AMT are not; (2) the large reductions in the regular tax enacted during the Bush administration have not been matched by corresponding cuts in the AMT;[35] and (3) the AMT disallows several decidedly middle-class tax benefits, including dependency exemptions and the deduction for state and local taxes. The AMT monster will continue to grow in the absence of legislative action; by 2010 the AMT is likely to apply to more than one-third of taxpayers with incomes from $50,000 to $75,000, and almost three-quarters of taxpayers with incomes from $75,000 to $100,000.[36] The Panel's Report notes that the AMT is expected to produce more than $1.2 trillion of tax revenue over the next ten years (p. 43), and that by 2013 the AMT without the regular tax would produce more revenue than the regular tax without the AMT (p. 87).

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30. I.R.C. §§ 55–58 (2000 & Supp. 2006).

31. The effect is the same as requiring the taxpayer to pay the greater of the regular tax or the tentative minimum tax.

32. Tax Reform Act of 1969, Pub. L. No. 91-172, § 301, 83 Stat. 487, 580–86.

33. *See, e.g.*, S. REP. NO. 99-313, at 518 (1986) (describing the alternative minimum tax as being designed "to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits").

34. STAFF OF J. COMM. ON TAX'N, 109TH CONG., PRESENT LAW AND BACKGROUND RELATING TO THE INDIVIDUAL ALTERNATIVE MINIMUM TAX 13 tbl.3 (Comm. Print 2005). Legislation enacted after the Panel issued its Report provided significant AMT relief for 2006, but that legislation merely delays the AMT train wreck by one year. Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, § 301, 120 Stat. 345, 353 (2006). (Despite the name of the Act, it did not become law until 2006.)

35. The two most significant pieces of Bush-era tax cut legislation are the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (codified as amended in scattered sections of 26 U.S.C.); and the Jobs and Growth Tax Relief Act of 2003, Pub. L. No. 108-27, 117 Stat. 752 (codified as amended in scattered sections of 26 U.S.C.).

36. Leonard E. Burman et al., *The AMT: Projections and Problems*, 100 TAX NOTES 105, 110 tbl.2 (2003) (projecting an AMT impact in 2010 on 36.6% of taxpayers in the $50,000–$75,000 income range, and on 72.9% of taxpayers in the $75,000–$100,000 income range).

The Report brands the AMT as "the most vivid example of the wasteful complexity that has been built into our system," and forcefully recommends its repeal (pp. 85–86). The Report's condemnation of the AMT is based not on the substantive design of the AMT, viewed as a free-standing tax system, but rather on the complexity of subjecting taxpayers simultaneously to two parallel systems: "Eliminating the AMT would free millions of middle-class taxpayers—21.6 million in 2006 and 52 million in 2015—from filing the forms, preparing the worksheets, and making the seemingly endless calculations required to determine their AMT liability."[37]

If the only reason for rejecting the use of parallel tax systems is return preparation complexity, perhaps AMT repeal is not so urgent after all. In tax year 2003, paid preparers were responsible for 62% of all individual tax returns, with another 25% of returns being prepared by taxpayers with the use of tax preparation software; only 13% of returns were prepared by taxpayers themselves without the use of software.[38] Joseph Thorndike has suggested that this makes the return preparation complexity allegedly caused by the AMT a non-issue: "The AMT is shaping up to be the nation's next great nondisaster. Move over, Y2K (the global computer nonevent of 2000)—the AMT wants a spot in the Chicken Little Hall of Fame."[39] If the "seemingly endless computations," which so concerned the Panel, are handled by H&R Block or by TurboTax, they are not a problem, and the nation can continue with its parallel taxes indefinitely. Thorndike predicts the AMT will not "cause enough pain to ensure its own demise."[40] He is not happy about this because he views the AMT as "a bad tax, a blight on the nation's revenue structure."[41] Oddly, however, he does not explain what is wrong with having parallel taxes if they do not result in computational headaches.

The question is significant because the Panel urges repeal of the AMT based on its tax return preparation burden, and it appears the Panel has greatly exaggerated that burden. My sympathies are with the Panel, how-

37. P. 86. Of course, if the objection is only to the complexity of requiring taxpayers to deal with two parallel systems, it might make just as much sense to repeal the regular tax and to keep a reformed version of the AMT, rather than repealing the AMT and keeping a reformed version of the regular tax. The Report considers this possibility, but rejects it because of what the Panel views as substantive design flaws in the AMT—including the absence of inflation indexing, large marriage penalties, and the disallowance of personal and dependency exemptions. P. 87. However, the Panel's SITP proposal could be viewed as a reformed version of a stand-alone AMT rather than a reformed version of the regular tax, given that it shares with the AMT a broader base and a lower top marginal rate than the regular tax—especially since both the SITP and the AMT (but not the regular tax) allow no deduction for state and local taxes. In any event, nothing of substance turns on whether the SITP is viewed as an improved version of the regular tax or as an improved version of a stand-alone AMT.

38. Eric Toder, *Changes in Tax Preparation Methods, 1993–2003*, 107 Tax Notes 759, 759 (2005).

39. Joseph J. Thorndike, *The Great Noncrisis of the AMT*, 107 Tax Notes 245, 245 (2005).

40. *Id.*

41. *Id.*

ever. It certainly offends "an academic desire for tidiness"[42] to have two tax systems when one should suffice—especially when the secondary tax system has strayed so far from its original purpose. And the Panel correctly notes that some of the current features of the AMT are objectionable—especially the absence of inflation adjustments.[43] If those features were removed, however, would there be any reason beyond aesthetics for making AMT repeal a high priority? Actually, I think there would. Letting H&R Block or TurboTax do the math may suffice for return preparation, but for planning purposes taxpayers need to understand how they are affected by the complex interplay of the AMT and the regular tax. Is one's marginal tax rate the regular tax rate or the AMT rate? If one makes an expenditure eligible for a deduction or credit under the regular tax but not under the AMT, will one be able to claim the tax benefit? If taxpayers—unaware that they are subject to the AMT—are induced to engage in behavior which is tax-favored under the regular tax but not under the AMT, the result is simply unfair.[44] The impact of the AMT on tax planning, not its impact on return preparation, is the best reason for repealing the tax, despite the Report's failure to mention that concern.

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Having decided to propose repeal of the AMT, the Panel was faced with the loss of $1.2 trillion of tax revenue within the ten-year budget window (p. 43). That meant that some treasured tax breaks would have to be sacrificed to achieve revenue-neutrality. The president's instructions to the Panel suggested that the tax benefits for charitable contributions and for homeownership were not to be eliminated, and the Panel wanted to increase, not decrease, opportunities for tax-favored savings. The deduction for state and local taxes, therefore, was doomed. It was the only tax break that did not seem to be off-limits, the repeal of which would raise enough revenue to cover most of the cost of the AMT repeal. Analyses performed by the Staff of the Joint Committee on Taxation suggested that repeal of the deduction could cover close to two-thirds of the revenue cost of repealing the AMT, at least over the next few years.[45]

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42. Comm'r v. Duberstein, 363 U.S. 278, 290 (1960).

43. *See supra* note 37.

44. This is probably happening now, with respect to the tax credits for purchases of hybrid automobiles and certain other energy-efficient products. *See* Lawrence Zelenak, *Of Prius Buyers, Blue States, Consumer Energy Credits, and the Alternative Minimum Tax*, 109 TAX NOTES 657, 659–62 (2005). Inducing desired behavior through the use of mirage-like tax benefits may be a cost-effective legislative approach (at least in the short run), but the cost effectiveness cannot justify the unfairness.

45. The Staff estimated that the AMT would raise $57.0 billion of revenue in 2006, $66.0 billion in 2007, $81.4 billion in 2008, and $91.8 billion in 2009, for a total of $296.2 billion over the four-year period. STAFF OF J. COMM. ON TAX'N, 109TH CONG., PRESENT LAW AND BACKGROUND RELATING TO THE INDIVIDUAL ALTERNATIVE MINIMUM TAX 11 tbl.1 (Comm. Print 2005). In its tax expenditure analysis released a few months earlier, the Staff had estimated the reductions in tax

The Report advocates the repeal of the state and local tax deduction for the same reason Willie Sutton robbed banks—because that's where the money is. Perhaps viewing that explanation as insufficiently high-minded, however, the Panel offers a different justification in the Report:

> This deduction provides a federal tax subsidy for public services provided by state and local governments. Taxpayers who claim the . . . deduction pay for these services with tax-free dollars. These services . . . represent a substantial personal benefit to the state or local residents who receive them . . . . The Panel concluded that these expenditures should be treated like any other nondeductible personal expense, such as food or clothing, and that the cost of those services should be borne by those who want them—not by every taxpayer in the country. (p. 83)

This is too glib. Certainly some taxes can be viewed as payments for government services received, and as to those taxes the Panel's argument is sound. But some state and local taxes are redistributive—think of taxes used to finance state expenditures under TANF (Temporary Assistance for Needy Families) or Medicaid, and property taxes used to finance public schools that the taxpayer's family does not use; as to those, the Panel's argument does not apply. The inadequacy of the argument is so obvious it is surprising that the Report does not make a more serious attempt to defend its proposal—perhaps by offering evidence that the bulk of state and local taxes are taxes-for-services rather than taxes-for-redistribution, or by suggesting some rough-justice rule for distinguishing nondeductible taxes of the former sort from deductible taxes of the latter sort. A long-standing deduction with a considerable constituency (consisting of both taxpayers claiming the deduction and state and local governments politically able to impose higher taxes because of the deduction) and a plausible policy justification (at least in part) deserves more respectful consideration before it is repealed.

The explanation for the inadequate explanation may be that the Panel thought the state and local tax deduction was doomed to a slow death under current law, as a result of the nondeductibility of state and local taxes under the ever-growing AMT. If taxpayers despair for the deduction even without tax reform, they may not require a very convincing rationale for hastening its demise. The Report suggests as much when it notes that "the AMT is increasingly erasing the benefit of the state and local tax deduction for many middle-class taxpayers" (p. 84).

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liability caused by the deduction of nonbusiness state and local taxes (including property taxes on owner-occupied homes) at $51.8 billion in 2006, $47.3 billion in 2007, $46.7 billion in 2008, and $48.4 billion in 2009, for a total of $194.2 billion. Staff of J. Comm. on Tax'n, 109th Cong., Estimates of Federal Tax Expenditures for Fiscal Years 2005–2009, at 33 tbl.1, 39 tbl.1 (Comm. Print 2005) (providing separate estimates for property taxes on owner-occupied homes and for all other nonbusiness state and local taxes).

D. *Home Mortgage Interest and Health Insurance: Tilting at Two Windmills*

Two of the Panel's recommendations are especially admirable on the merits, and especially unlikely to be adopted by Congress: the proposal to replace the home-mortgage interest deduction with a 15% credit for a limited amount of home-mortgage interest (pp. 70–75), and the proposal to limit the exclusion for employer-provided health insurance to the average cost of health insurance while allowing a similarly capped deduction for individually purchased health insurance (pp. 78–82).

The reduction of the tax benefit for home-mortgage interest would be severe for many taxpayers—a surprising result, given the president's requirement that the Panel's proposals "recogniz[e] the importance of homeownership . . . in American society."[46] Consider, as a fairly typical example, a taxpayer with a $400,000 mortgage at an interest rate of 5% and a marginal tax rate (under current law) of 28%, living in an area where the average cost of a home is $300,000. Under current law, the taxpayer can claim his entire $20,000 interest expense as an itemized deduction, producing a tax savings of $5,600. Under the Panel's proposal, only $15,000 of his interest expense would be eligible for the credit (i.e., the interest on the principal amount of the loan, capped by the $300,000 average price of area homes), and the amount of the credit would be only $2,250 (15% of $15,000). Other taxpayers would experience results much worse than this. A taxpayer with a $1,000,000 mortgage with an interest rate of 5%, subject to a marginal tax rate of 35% and living in an area with an average home price of $230,000, would go from a tax savings of $17,500 under current law (35% of $50,000 of deductible interest) to a credit of only $1,725 (15% of the interest of $11,500 on principal of $230,000). If the language in the Executive Order was intended as code for "leave the home-mortgage interest deduction alone," the president should have been more explicit, as the Panel failed to crack the code.

The Report makes a strong case for its proposal on the merits, beginning with the suggestion that "the tax code [may] encourage[] overinvestment in housing at the expense of other productive uses" (p. 70). The Report goes on to note that the current deduction "exceed[s] what is necessary to encourage home ownership or help more Americans buy their first home," and that "the $1 million mortgage limit may encourage taxpayers to purchase luxury residences and vacation homes" (p. 71). It also notes the uncomfortable (to defenders of the current deduction) facts that 55% of the benefit of the deduction is enjoyed by the 12% of taxpayers with cash incomes of $100,000 or more (p. 72), that 46% of taxpayers paying home-mortgage interest obtain no tax benefit because they claim the standard deduction (p. 74), and that a number of countries without tax benefits for home-mortgage interest have homeownership rates comparable to that of the United States (p. 72).

46. Exec. Order No. 13,369, 70 Fed. Reg. 2323 (Jan. 7, 2005).

Based on all this, the Report reasonably claims that its proposed credit, unlike the current deduction, "would encourage home ownership, not big homes" (p. 73).

But the merits will not matter, as this particular proposal was even deader on arrival than the Report as a whole.[47] The National Association of Realtors estimated that home prices would fall by 15% if the proposal were enacted,[48] the Mortgage Bankers Association labeled the proposal "a tax increase for a lot of working Americans,"[49] and the National Association of Home Builders released survey results indicating that 75% of likely voters opposed the proposal.[50] Neither the president nor Congress has indicated any interest in the proposal. The only hope for a more rational homeownership tax policy may be sustained inflation—the $1 million statutory limit on "acquisition indebtedness" generating deductible interest expense is not adjusted for inflation,[51] and Congress has shown no inclination to increase the ceiling in response to its erosion by inflation.

The story of the health insurance recommendation is basically the same—another meritorious but doomed proposal. In a tax system designed to exclude from the tax base the costs of subsistence, the proper treatment of health insurance is clear—the cost of basic health insurance coverage should be excluded from the tax base, regardless of whether one obtains the coverage through employment or purchases the coverage on the individual market, and there should be no tax benefits for the additional costs of "Cadillac" health insurance.[52] By limiting the exclusion for employer-provided health insurance to the average cost of health insurance, and by providing a similarly capped deduction for the cost of individually purchased health insurance,[53] the Report gets this exactly right. Naturally, the Report's health insurance proposals are quixotic. America's Health Insurance Plans (AHIP) quickly released poll results showing that over 90% of

47. In the words of the Munchkin coroner, the proposal was "not only merely dead," but "really most sincerely dead."

48. Eduardo Porter & David Leonhardt, *Tax Plan Could Raise Homeowners' Costs*, N.Y. TIMES, Nov. 3, 2005, at C1.

49. *Id.*

50. Sandra Fleishman, *Tax Proposal May Not Float, but It Sure Is Making Waves*, WASH. POST, Nov. 12, 2005, at F1.

51. I.R.C. § 163(h)(3)(B)(ii) (2000 & Supp. 2006).

52. For a defense of these propositions, see Lawrence Zelenak, *Of Head Taxes, Income Taxes, and Distributive Justice in American Health Care*, 69 LAW & CONTEMP. PROBS. 103, 109–12 (2006).

53. Under current law, individually purchased health insurance can be deducted as a medical expense under I.R.C. § 213, but only to the extent total medical expenses exceed 7.5% of the taxpayer's adjusted gross income, and even then only if the taxpayer itemizes deductions rather than claims the standard deduction. I.R.C. § 213(a).

voters opposed capping the exclusion for employer-provided insurance,[54] and President Bush specifically rejected the proposal a few months later.[55]

In his 2007 State of the Union address President Bush proposed—surprisingly—a reform of the tax treatment of health insurance similar to the Panel's proposed reform.[56] The immediate negative reaction from leading members of the Democratically-controlled Congress suggests the proposal has little or no chance of becoming law.[57]

III. The Tax Reform Big Picture

A. *Not with a Bang, but with a Whimper*

The Panel's Report focuses attention on a major tax reform debate. Over the past several decades, the core of the tax reform debate has been between proponents of taxing income and proponents of taxing consumption. There is almost universal agreement that the federal tax system should be at least modestly progressive,[58] and no one (except Congress[59]) is in favor of a loophole-ridden tax base. There has been tremendous disagreement, however, over whether the tax base should move closer to the Haig-Simons income tax ideal,[60] or whether the attempt to tax income should be abandoned in favor of consumption taxation.[61]

Given the status of income-versus-consumption as *the* issue in the tax reform debate, it is remarkable that the Panel presents both an option which it labels an income tax and an option which it carefully refrains from calling an income tax, while expressing no preference between them. Moreover, each proposal is really an income-consumption tax hybrid. The SITP is even

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54. *Voters Polled in Bellweather [sic] States Shows Majority Reject Healthcare Tax Proposals*, Managed Care Bus. Wk., Nov. 15, 2005, at 39.

55. R.J. Lehmann, *Health Insurance Advocates Applaud Rejection of Tax Plan Plank*, BestWire, Jan. 17, 2006.

56. *'The State of Our Union Is Strong; Our Cause in the World Is Right,'* N.Y. Times, Jan. 24, 2007, at A16 (extensive excerpts from the State of the Union address).

57. Robin Toner & Robert Pear, *Bush Revives Some Past Proposals and Offers a New Initiative on Health Insurance*, N.Y. Times, Jan. 24, 2007, at A15.

58. Even proponents of single-rate tax systems tout the average rate progressivity produced by exemptions or rebates built into their systems. *See, e.g.*, Neal Boortz & John Linder, The FairTax Book 81–90 (2005); Robert E. Hall & Alvin Rabushka, The Flat Tax 124 (2d ed. 1995).

59. *See infra* text accompanying note 65.

60. Haig-Simons income is "the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question." Henry C. Simons, Personal Income Taxation 50 (1938).

61. The debate is too voluminous to cite more than a few examples here. In the legal literature, significant contributions include William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 Harv. L. Rev. 1113 (1974); Barbara H. Fried, *Fairness and the Consumption Tax*, 44 Stan. L. Rev. 961 (1992); Edward J. McCaffery, *The Uneasy Case for Wealth Transfer Taxation*, 104 Yale L.J. 283 (1994); and Alvin C. Warren, Jr., *Fairness and a Consumption-Type or Cash Flow Personal Income Tax*, 88 Harv. L. Rev. 931 (1975).

less of an income tax (and thus more of a consumption tax) than current law, and the GITP has enough vestigial income tax features that the Panel, having refrained from calling it an income tax, also refrains from calling it a consumption tax.

Regardless of the fate of the Panel's proposals in the short term, I suspect that the proposals—especially the SITP—foreshadow the outcome of the great tax base debate. Official abandonment of income taxation is probably politically impossible, both because of the difficulty of explaining to the electorate why those who work hard for their wages should be taxed while those who sit back and collect investment income should not, and because of the massive transition problems in switching to a fundamentally different system. On the other hand, much can be done to move the income tax closer to a consumption tax without the public relations or transition problems inherent in the switch to a pure consumption tax. The tremendous expansion of Roth IRA-type savings vehicles proposed in the SITP is perhaps the most politically promising strategy for slouching toward a consumption tax (without ever getting all the way there). This was recognized by the Bush administration at least as early as 2003, when it first proposed the "Retirement Savings Accounts" and "Lifetime Savings Accounts" on which the Panel based its SFR and SFF accounts.[62] Although the administration's ongoing push for these accounts has not yet succeeded, the accounts are politically plausible in a way that "pull[ing] the income tax out by its roots and throw[ing] it away" is not.[63] This may be the way the income-versus-consumption debate ends—not with a bang, but with a whimper.

B. *Tax Reform Can Succeed, but Only Because It Will Fail*

To those who have followed United States income tax policy for several decades, the three desiderata of the Report's title—"Simple, Fair, and Pro-Growth"—are very familiar. In 1984, the Treasury Department issued a report which played an important role in the development of the Tax Reform Act of 1986. The Report was titled *Tax Reform for Fairness, Simplicity, and Economic Growth*.[64] The 1984 and 2005 Reports are similar in substance as well as in name (although the 1984 Report is considerably more committed to the *income* tax ideal than the 2005 Report). Whenever experts issue a dispassionate report on income tax reform, they always favor making the

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62. Patti Mohr, *White House Begins Selling Its Tax Cut to Congress*, 98 TAX NOTES 631, 633–34 (2003). The administration proposes these accounts annually. For the current proposal, see U.S. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2007 REVENUE PROPOSALS 5–10 (2006).

63. John Godfrey, *Archer Keen on Killing Code; Full Speed Ahead on Tax Reform*, 70 TAX NOTES 1431, 1431 (1996) (quoting remarks of Ways and Means Chairman Bill Archer at a press conference on March 4, 1996).

64. U.S. DEP'T OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH (1984).

system simpler, fairer, and more pro-growth than current law, and they always conclude that a broader-based, lower-rate tax is the way to achieve those goals. To state the obvious, the obstacles to making the tax system simpler, fairer, and more efficient were not technical in 1984, and they are not technical today. The problems are political. After Congress succeeded in enacting a relatively simple, fair, and efficient income tax in 1986, it promptly set to work dismantling its accomplishment. In his remarks to the President's Panel, Milton Friedman offered a cynical—but very plausible—view of how the 1986 Act came about, why it unraveled, and why the time might soon be ripe for legislation resembling the 1986 Act:

> The function of taxes is as a way in which . . . legislators can raise campaign funds and that's widely recognized. A seat on the Ways and Means Committee is a very valued seat because it's a good way to raise funds. . . . [A]s of 1986 . . . the tax system had gotten so complicated, you had filled up the blackboard essentially so that Congressmen had nothing more to sell, and they were therefore willing to wipe the slate clean and start over again. . . . And maybe it's time again for another wiping the slate clean and getting rid of . . . our tax system [which] . . . everybody agrees . . . is obscene.[65]

Whether advocates of a fairer, simpler, and more efficient tax system should be cheered or disheartened by Friedman's analysis is debatable. The good news is that real tax reform will be possible when the Code has become so loophole-ridden that the tax-writing committees have little left to sell to campaign donors; and the Code may soon attain that condition, thus making the Panel's Report particularly relevant for the near future. The bad news, of course, is that Congress will broaden the base only so that it can begin again to narrow it; there is no hope that the accomplishments of tax reform will endure.

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65. *Sixth Meeting of the President's Advisory Panel on Federal Tax Reform* 117–18 (2005) (remarks of Milton Friedman, Senior Research Fellow, Hoover Institute, Stanford University).