Chapter 5

INCOME TAX REFORM AND SIMPLIFICATION FOR INDIVIDUALS & FAMILIES

I. Summary

The Treasury Department proposals will lower tax rates and reduce the current number of rate brackets from 15 to three: 15, 25, and 35 percent. The amount of income that can be earned tax-free will also be increased by raising to $2,000 the personal exemptions for the taxpayer, spouse, and dependents and by increasing the zero bracket amounts. Very few families below the poverty level will be subject to income tax.

The tax base will be broadened to make this rate reduction possible, simplify the system, and make it fairer by eliminating special preferences and abuses. The definition of individual taxable income will be expanded to include certain fringe benefits and other items. Deductions for tax shelter investments and business expenses that involve personal consumption will be curtailed. The itemized deduction for State and local taxes will be phased out, and charitable contributions will be deductible only to the extent that they exceed 2 percent of adjusted gross income. Left intact will be the current itemized deductions for interest on the principal residence of the taxpayer, medical expenses, and casualty losses.

Elimination of several tax credits and other items will substantially simplify the tax forms. The Internal Revenue Service will consider the possibility of initiating a new system under which it calculates tax liability for many taxpayers.

The deductions for contributions to Individual Retirement Accounts will be increased to $2,500 per employee and from $250 to $2,500 for spouses working in the home. Other proposed changes that involve the taxation of business and capital income, including the corporation income tax, are of less concern to most individuals and are discussed in chapters 6 and 7. (The appendix to the present chapter contains a detailed listing of all proposals primarily affecting individuals and families.)

II. Rate Reduction

The reforms proposed by the Treasury Department will expand the income tax base enough to allow substantial rate reductions for individuals. On incomes above the tax threshold ($11,800 for a family of four) three rates -- 15, 25, and 35 percent -- will apply. Under current law, marginal rates range from 11 percent to 50 percent. Thus the top marginal rate will be cut by 30 percent under the Treasury Department proposals. The proposed rate schedules for single returns, head of household returns, and joint returns are compared with those under current law in Table 5-1. On average, marginal tax rates will be 20 percent lower under these proposals than under current law. The effects on marginal rates paid at various points in the income distribution were discussed further in Chapter 4.

Individual income taxes in 34 States rely on the Federal income tax base. Taxpayers will experience further rate reductions if States cut rates to hold their revenues constant in the face of an increased tax base.

As noted in previous chapters, rate reduction will encourage saving, investment, work effort, innovation, and other productive behavior. It will reduce the attraction of both tax avoidance through legitimate tax shelters and illegal underreporting of income. Even without elimination of tax preferences, credits, and deductions, rate reduction will lessen the disparities in the tax treatment of various sources and uses of income. When combined with some of the other proposals described below, rate reduction should also help to reduce interest rates and lead to a more robust and efficient economy.

While lower marginal rates tend to increase work incentives for everyone, beneficial incentive effects will be especially pronounced for secondary workers, persons who often have considerable discretion over their labor market activity. Lower marginal rates will also reduce the extent to which the tax system influences choices of occupation and the amount of personal investment in education.

Rate reduction will provide significant benefits to those who receive little or no income in preferred forms. Thus, rate reduction will be particularly helpful to persons who now receive the bulk of their labor income in the form of cash wages. This group includes secondary workers, workers in retail and certain service industries, and other workers who generally do not benefit from large fringe benefit packages. By the same token, those employers who now pay their employees in cash, rather than fringe benefits, will find that the after-tax wages of their employees will rise slightly relative to those of other employers, without any added cost to the employer. These employers will find that any competitive disadvantage they experience in attracting workers because of the current tax law will be diminished.

On the other hand, rate reduction will have a less favorable impact on the sectors of the economy that benefit most from preferential treatment under current law. Rate reduction will reduce the attraction of tax-exempt bonds relative to taxable investments. Since charitable contributions are encouraged by high marginal tax rates that reduce the after-tax cost of giving, reducing marginal rates may reduce contributions. Deductions or exclusions for the cost of health insurance (whether provided by employers or by individuals) will becomes less valuable, thus leading to a reduction in the demand for such insurance and for health services.

Table 5-1

Proposed Tax Rate Schedule

Single Returns		Head of Household Returns		Joint Returns	
Taxable income	Marginal tax rate	Taxable income	Marginal tax rate	Taxable income	Marginal tax rate
	(percent)		(percent)		(percent)
Less than $2,800	0	Less than $3,500	0	Less than $3,800	0
$2,800 to 19,300	15	$3,500 to 25,000	15	$3,800 to 31,800	15
$19,300 to 38,100	25	$25,000 to 48,000	25	$31,800 to 63,800	25
$38,100 or more	35	$48,000 or more	35	$63,800 or more	35

1986 Current Law Tax Rate Schedules

Single Returns		Head of Household Returns		Joint Returns	
Taxable income 1/	Marginal tax rate	Taxable income 1/	Marginal tax rate	Taxable income 1/	Marginal tax rate
	(percent)		(percent)		(percent)
Less than $2,510	0	Less than $2,510	0	Less than $3,710	0
2,510- 3,710	11	2,510- 4,800	11	3,710- 6,000	11
3,710- 4,800	12	4,800- 7,090	12	6,000- 8,290	12
4,800- 7,090	14	7,090- 9,490	14	8,290- 12,990	14
7,090- 9,280	15	9,490- 12,880	17	12,990- 17,460	16
9,280-11,790	16	12,880- 16,370	18	17,460- 22,040	18
11,790-14,080	18	16,370- 19,860	20	22,040- 26,850	22
14,080-16,370	20	19,860- 25,650	24	26,850- 32,630	25
16,370-19,860	23	25,650- 31,430	28	32,630- 38,410	28
19,860-25,650	26	31,430- 37,210	32	38,410- 49,980	33
25,650-31,430	30	37,210- 48,780	35	49,980- 65,480	38
31,430-37,210	34	48,780- 66,130	42	65,480- 93,420	42
37,210-45,290	38	66,130- 89,270	45	93,420-119,390	45
45,290-60,350	42	89,270-118,190	48	119,390-117,230	49
60,350-89,270	48	118,190 or more	50	177,230 or more	50
89,270 or more	50				

Office of the Secretary of the Treasury
Office of Tax Policy

1/ Estimated.

The impact on currently favored sectors can, of course, easily be exaggerated. All tax rate reductions can be opposed on the grounds that high tax rates increase the value of exemptions and deductions for favored activities. But imposing high tax rates on most income, in order to accord favorable treatment to some sources and uses of income, is hardly an efficient way to provide subsidies, even if that is desired. A more efficient and productive economy in the end helps participants in all sectors. For example, though rate reductions would initially raise the after-tax cost of health insurance, the overall cost of health care should eventually be less than in the absence of tax reform. Costs will respond to the reduced demand for such care and to the greater attention that would be focused on the cost of both health care and insurance.

III. Fairness for Families

Families with incomes at or below the poverty level should not be subject to income tax. Thus, the tax threshold -- the level of income at which tax is first paid -- will be raised so that for most taxpayers it approximates the poverty level, as determined by the Bureau of the Census. The proposed tax threshold will be increased relatively more for returns filed by heads of household (those single persons who maintain households for dependents), in recognition of the particular economic difficulties of such households.

After considering various means of setting the tax threshold, the Treasury Department proposes to retain the basic structural features of the present income tax: the personal exemption and the zero-bracket amount. The personal exemption for taxpayers, spouses, and dependents for 1986 will be increased to $2,000, compared with a projected $1,090 under current law (after indexing for inflation expected to occur during 1985). The zero-bracket amounts for single persons, heads of household, and married couples filing jointly will be increased, as shown in Table 5-2. The personal exemptions, zero-bracket amounts, and tax brackets will continue to be indexed to prevent their value from being eroded by inflation. These proposed changes are designed to reflect differences in ability to pay taxes that result from differences in family size and composition. The increase in the personal exemption recognizes the greater financial responsibilities and lesser ability to pay of those taking care of dependents.

The proposed changes in the personal exemptions and zero-bracket amount would raise the 1986 tax threshold for a married couple filing jointly with no dependents from $5,890 to $7,800. A couple with two children would pay no income tax unless its income exceeded $11,800. Under current law, the same family will pay tax on income above $9,613, assuming full use of the earned income credit. (See Table 5-2 and Figure 5-1.)

Table 5-2

Comparison of Personal Exemptions, and ZBA
Under Current Law and Treasury Department Proposals

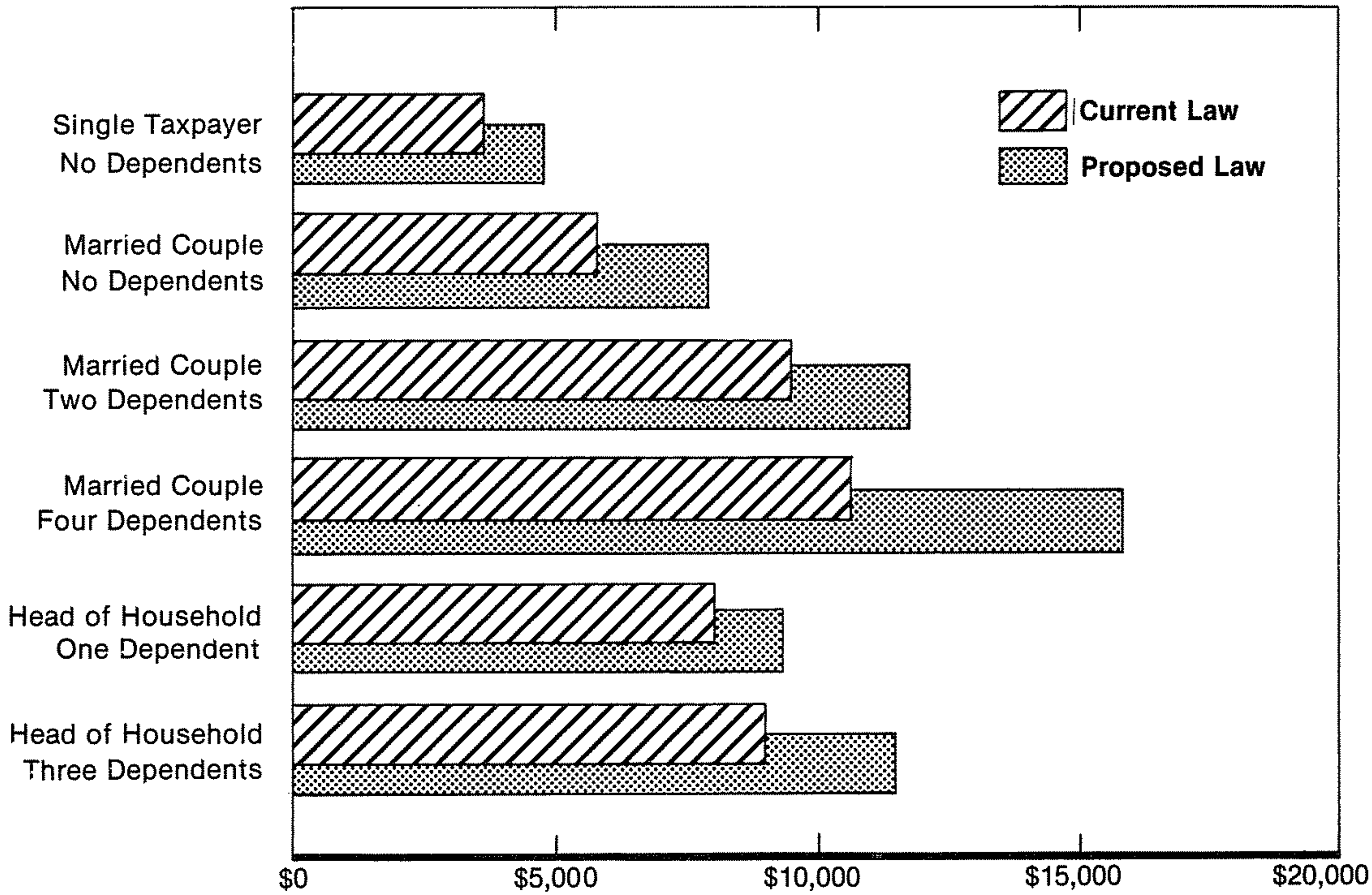
	1986 Levels	
	Current Law 1/	Treasury Proposal
Personal Exemption	$1,090	$2,000
Zero-Bracket Amount		
Single persons	2,510	2,800
Heads of households	2,510	3,500
Married couples	3,710	3,800

1/ Includes indexation for expected inflation in 1985.

Figure 5-1

COMPARISON OF TAX FREE INCOME LEVELS UNDER CURRENT LAW (1986) AND UNDER THE PROPOSAL

For Taxpayers Under Age 65



This increase in the tax threshold will exempt all families in poverty from Federal income tax. Table 5-3 shows the relationship between the poverty level of income and the tax threshold for households of different sizes and compositions under both current law and the Treasury Department proposals. For single persons without dependents, where the tax threshold will still be $1,000 less than the poverty level. If the tax-free income level for single taxpayers were raised further, in order to benefit those single persons whose tax threshold is below the poverty level, it would be too high relative to the levels for heads of household and married couples. An increase in tax -- or marriage penalty -- would be imposed on single persons who decide to marry.

For single taxpayers without dependents who live with relatives or unrelated persons, the comparison of the tax-free income level with the poverty income level may be misleading. When the tax-free income level for these individuals is combined with the tax-free income levels for other members of the household, the total generally exceeds a poverty income level. For example, the tax-free income levels for taxpayers who are under age 21, who account for over one-quarter of all single persons with income subject to tax, often should be combined with the tax-free income levels of parents and other household members. Similarly, the combined poverty level for two single persons who share living quarters might, if appropriately measured, be close to that of a married couple. Their combined tax-exempt income level might exceed that poverty level.

The existing tax treatment of the blind, disabled, and elderly has evolved with little rationale. The Treasury Department proposes that all special treatment provided these groups under current law, including the additional personal exemptions, be replaced with a single tax credit for the elderly, blind, and disabled. Under the proposal, persons receiving workers' compensation, black lung payments, and certain veterans' disability pay would be treated similarly to persons who are permanently and totally disabled and receive disability pay from employers. Once the tax benefits of this expanded credit are taken into account, the tax-exempt level of income for a single person who is disabled for an entire year, and whose income is composed mainly of such disability payments, would be $9,700. For a family of four, the level would be $17,200. These tax-exempt levels substantially exceed of those applying to other taxpayers ($4,800 for single persons; $11,800 for families of four). In about 80 percent of States, a family of four solely dependent upon workers' compensation would pay no Federal income tax even if it received the maximum payment under that State's program.

Under the Treasury Department proposal, as under current law, tax-exempt levels for the elderly will be substantially higher than those for the non-elderly. When both the increased personal exemption and

Table 5-3

Comparison of the Poverty Threshold and the Tax-Free Income Level Under Current Law and the Treasury Proposal 1/
(1986 Levels)

Status	Poverty Threshold	Tax-free Income Levels: Current Law 2/	Tax-free Income Levels: Treasury Proposal 2/
Single persons without dependents	$5,800	$3,600	$4,800
Heads of households with one dependent	7,900	7,979	9,303
Married couples 3/	7,400	5,890	7,800
Married couples with two dependents 3/	11,600	9,613	11,800

1/ Includes expected indexation for inflation in 1985.

2/ Assumes full use of the earned income tax credit where applicable.

3/ Assumes one earner.

the new expanded credit for the elderly, blind and disabled are taken into account, the tax-exempt level for elderly couples receiving no social security income, at $14,533, will be essentially unchanged from current law. It will be $16,800 for a couple receiving the average amount of social security income, virtually the same as under current law. By comparison, a non-elderly couple will have a tax-exempt amount of only $7,800. (See also Figure 5-2.)

The benefits of the existing two-earner deduction are not well-focused for families where marriage increases tax burdens. While marriage penalties are reduced in some cases, marriage bonuses are created in others. With the proposed increase in personal exemptions and flatter rate structure, the two-earner deduction will be unnecessary. For most taxpayers the work incentive of second earners will be greater under the proposed lower and flatter rate structure than under existing law, with its two-earner deduction. The Treasury Department therefore proposes that the two-earner deduction be eliminated in favor of tax rate reduction.

The earned income tax credit (EITC) adds considerable complexity to the system, especially for those least able to understand it. If simplicity were the primary goal of tax reform, the EITC would be eliminated, and with it a large number of tax returns filed only to claim the refundable credit. Given the equity objectives of reform, however, the EITC is retained, and it is indexed to prevent its erosion by inflation.

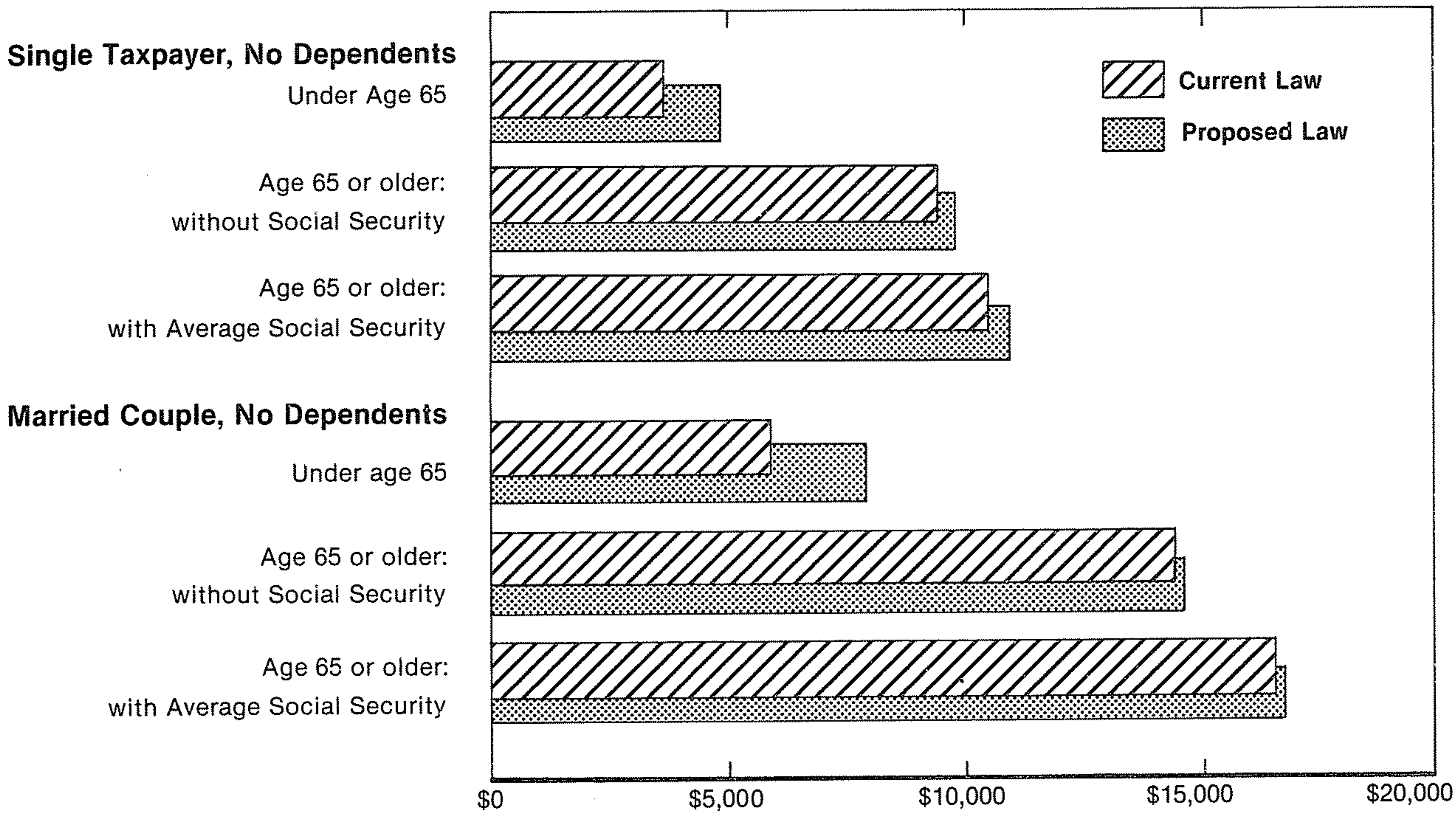
The complicated child and dependent care credit should be replaced by a simpler deduction. A deduction is more appropriate than a credit, because child and dependent care is an expense related to earning income. Accordingly, the true net income of those who incur child care expenses in order to be employed will be better measured if they are allowed to deduct such costs, up to a limit. Failure to allow a deduction, besides being unfair, would adversely affect work incentives. Of course, a deduction is relatively less favorable to low-income taxpayers than is a credit. The choice of a deduction in this case reflects the view that progressivity should be provided directly, through changes in the rate structure, rather than through individual provisions that lack logic and add to complexity.

Recognition of the cost of raising dependents, the cost of maintaining a household, and the cost of child care will be especially beneficial to low-income single heads of household, a group that has grown from 2.6 percent of total income tax returns in 1963 to 8.9 percent in 1982. In combination the Treasury Department proposals should have an especially positive effect on the amount of labor supplied by members of this group.

Figure 5-2

COMPARISON OF TAX FREE INCOME LEVELS UNDER CURRENT LAW (1986) AND UNDER THE PROPOSAL

For Taxpayers Under and Over Age 65



IV. Fair and Neutral Taxation

Equity and neutrality require that all income be subject to tax regardless of its source or use. Otherwise, families in similar circumstances will pay different amounts of tax, depending on how they earn or spend their income.

A. Excluded Sources of Income

1. Fringe benefits. Many fringe benefits are not subject to tax under current law; among the most important fringe benefits presently excluded from tax are contributions to qualified retirement plans, and accident, health, and group term life insurance provided by employers. It is unfair that one taxpayer is excused from paying income tax on the value of a fringe benefit, while another who wants to enjoy the same good or service, but does not receive it as a fringe benefit, must purchase it with after-tax dollars. Nor is the solution to extend the exemption of fringe benefits even further, as some have suggested. Health care is made much more expensive for all because it is effectively subsidized through the tax system for some. The tax advantage now accorded some fringe benefits causes more of them to be consumed than if, like most goods and services, they could only be bought with after-tax income. This distortion of consumer choices would only be accentuated by widening the exemption of fringe benefits. Moreover, extending the scope of the exclusion of fringe benefits would exacerbate inequities in the treatment of employees receiving fringe benefits and those who receive income in other forms. Finally, the growing tendency to pay compensation in tax-exempt forms reduces the base for the social security taxes and thus weakens the social security system. These inequities and distortions can be reduced only if statutory fringe benefits are taxed more nearly like other income.

The Treasury Department supports the proposal contained in the Administration's Budget for fiscal year 1985 to place a limit on the amount of health and accident insurance provided by an employer that can be obtained tax-free by an employee. The Treasury Department proposes to repeal the exclusion of such premiums, to the extent that they exceed $70 per month for a single person and $175 per month for a family. The proposed limits would have no effect on approximately 70 percent of all employees, because the limits exceed their employers' contributions. For example, for 1985 the maximum monthly contribution by the Federal Government to plans for its non-postal employees will be $52 for a single person and $116 for a family. The Treasury Department also proposes to repeal the current exclusions for employer-provided group life insurance, death benefits, dependent-care services, housing and housing allowances for ministers, and certain military cash compensation and proposes to permit provisions dealing with educational assistance plans and group legal services to expire. The value of taxable fringe benefits will be reported by the employer, and tax will be withheld on it. No revenue gain is projected from repealing the exclusion of military compensation, because it is expected that compensation will be increased to offset the loss of this tax benefit.

Presently the exclusion of fringe benefits from taxable income has gone so far that it has become necessary to offset the distorting effects of some tax provisions by allowing employers to offer a choice of tax-free benefits. On the one hand, current law encourages the use of tax-free forms of compensation, but on the other it attempts to counteract these incentives by allowing employers to offer employees the choice that is normally associated with payment of wages in cash. Under the Treasury Department proposals, it will not be necessary to restrict so-called cafeteria plans, plans that allow employees to choose among tax-exempt fringe benefits. Since premiums for medical insurance below the proposed cap will be the only major statutory fringe benefit that will remain exempt, the provisions authorizing tax-free cafeteria plans will be largely redundant and should be repealed. Of course, employers -- and their employees -- may find nontax reasons, such as lower insurance rates for groups and the accommodation of different preferences, for allowing employees to select from a menu of taxable fringe benefits. Cafeteria plans might continue for this purpose.

Taxing most statutory fringe benefits will greatly simplify the administration of the tax laws by relieving the pressure to pay compensation in non-taxable forms. Employers can continue, in effect, to offer certain goods and services for sale through salary deductions, but in the absence of tax inducements for paying wages as fringe benefits, most compensation will be in cash.

Employees will compare the full market prices of formerly subsidized consumption with other uses of their after-tax dollars. As a result, it is expected that employers will provide less life insurance and legal insurance, and that employees will purchase more directly. Purchases of insurance for marginal amounts of health coverage will also decline. These purchases are often quite inefficient because administrative costs, while small relative to large health bills, can be quite large relative to the cost of moderate or small amounts of health care. The rapidly rising cost of health care in the United States can be attributed in part to the large subsidy inherent in the current tax laws. The proposal to cap these health insurance benefits will help contain future increases in costs of health care.

Repeal of the current exemption of fringe benefits will require both employees and employers to reconsider the mix of fringe benefits offered and accepted. To allow time for adjustment, taxation of fringe benefits will be phased in gradually, as existing employment contracts expire.

2. Retirement savings. Current law allows saving for retirement to be sheltered from tax until retirement. Tax-preferred vehicles for retirement saving include qualified retirement plans established by corporate employers, individual retirement accounts (IRAs), and H.R.

10 plans for the self-employed (Keogh plans). The Treasury Department proposes that eligibility for IRAs be extended on equal terms to those who work in the home without pay and to those who work in the labor market. Moreover, the limit on tax-deferred contributions to an IRA will be raised to $2,500 ($5,000 for a husband and wife). This proposal will allow most American families to pay no tax on the income they save, as under a tax on consumed income, and will stimulate saving.

3. Wage replacements. Under the Treasury Department proposals, unemployment compensation will be made fully subject to taxation. There is no reason to tax moderate-income workers more heavily than unemployed persons with the same incomes. Employees in many seasonal industries are employed, then laid off, and then rehired on a predictable annual cycle. For them, unemployment compensation is more accurately seen as a part of annual earnings than as insurance against lost wages. Beyond that, many recipients of unemployment compensation have income from other sources or are married to working spouses. Tax equity is not served by exempting from tax the unemployment compensation they receive, while fully taxing other families with the same amount of income received from other sources.

The failure to tax wage replacement programs under current law is quite unfair. If a program is designed to replace 70 percent of before-tax wages for all employees, tax exemption results in a 70 percent wage replacement for low-income employees who have no other source of income. By comparison, it produces total wage replacement for a taxpayer in the 30 percent tax bracket, and lost wages are more than fully replaced for taxpayers in higher tax brackets.

The current tax law provides quite inconsistent treatment of persons who are elderly, blind, and disabled. The proposed new credit for these groups will ensure greater equality of treatment of various sources of income that they receive. Tax-exempt levels of income will continue to exceed substantially the levels applying to other taxpayers. Families with large amounts of income from other sources, however, will no longer be allowed a complete exclusion for workers' compensation or for black lung or certain veterans' disability payments. Instead, such income will be taxable, but made eligible for the credit. The proposed taxation of wage replacement programs will apply only to amounts received as a result of future settlements.

The taxation of wage replacements will have little effect on families with low or moderate incomes; these families generally will not be taxable because of the increase in exemptions and zero-bracket amounts proposed in this package. Many moderate income disabled workers will also receive additional benefit from the credit for the elderly and the disabled. For example, a family of four that receives $9,000 or more of workers' compensation will not owe tax until its income exceeds $17,200. Further, workers in 80 percent of States who are totally disabled for the entire year will be exempt from tax if they had no other income. For persons with high incomes -- including both those with generous rates of wage replacement and those with substantial income from other sources -- taxation of wage replacement payments will have a positive work incentive effect. Under current law, some individuals receive nontaxable wage replacement in excess of the after-tax wages they would receive if they continued work. Under the proposal, these individuals will again be given a positive incentive to work.

4. Scholarships and fellowships. Scholarships and fellowships should be taxable, to the extent that they exceed tuition, because the stipends are used largely for consumption, such as food and lodging. For most students, the higher tax threshold provided by the personal exemptions and zero-bracket amount will prevent the taxation of these benefits. Students with substantial other sources of income, however, will be treated like other individuals with the same income.

5. Capital gains. Only 40 percent of long-term capital gains -- appreciation on assets held for more than 6 months -- are currently subject to tax. On the other hand, capital gains and losses are measured without regard to inflation during the time the taxpayer holds an asset. In other words, tax is applied to fictitious gains that only reflect inflation, as well as to real increases in the value of capital assets. Thus real (inflation-adjusted) gains are taxed at effective rates that can far exceed the nominal tax rate, and in some cases tax is collected even when assets decline in real value.

The Treasury Department proposes to eliminate the taxation of fictitious gains by allowing taxpayers to index (adjust for inflation) the basis (usually the cost) of assets in computing capital gains. Moreover, real capital gains should be fully taxed as ordinary income. By equalizing the tax treatment of real capital gains and other sources of income, these reforms will improve the equity and neutrality of the tax system.

Given recent rates of inflation, taxing real capital gains as ordinary income would be no less generous, on average, than current law. Thus, the Treasury Department proposals should have no negative effect on capital formation and the supply of venture capital. This is discussed further in chapter 6.

Elimination of the distinction between capital gains and ordinary income will allow substantial simplification of the tax law and facilitate taxpayer compliance and tax administration. Each year the courts hear literally hundreds of tax cases involving capital gain versus ordinary income issues. Moreover, some of the most technical and complicated provisions of the Internal Revenue Code are necessary to deal with ramifications of the distinction between ordinary income and capital gains. These include the provisions dealing with depreciation recapture, collapsible partnerships and corporations, dealer versus investor determinations, and so-called section 1244 (small business corporation) stock. Finally, taxpayers and their advisors spend enormous resources for tax planning designed to achieve capital gain characterization.

6. Interest indexing. During an inflationary period, interest payments include an element that is neither income to the lender, nor an expense for the borrower, but merely compensates the lender for the reduction in the purchasing power of principal that results from inflation. Under current law this so-called "inflation premium" is subject to tax as interest income to the lender and is allowed as an interest expense to the borrower.

At even moderate rates of inflation, tax liability can exceed the amount of interest earned, once adjustment is made for inflation. Suppose, for example, that the interest rate is 12 percent at a time when the inflation rate is 8 percent; the real (inflation-adjusted) interest rate is thus 4 percent. A taxpayer in the 20 percent tax bracket who holds a $1,000 bond that pays interest of $120 per year pays $24 in tax. Since the real component of interest, after adjustment for inflation, is only $40, the taxpayer pays an effective tax rate of 60 percent, not the statutory rate of 20 percent. For a taxpayer in the 40 percent bracket the situation is even worse; tax liability is $48, or 120 percent of real interest income.

The Treasury Department proposes that a portion of interest receipts be excluded from tax in order to avoid this taxation of the inflation premium. An equal reduction is proposed for the deduction of non-mortgage interest expense in excess of $5,000 per year. The proposal for interest indexing is discussed briefly below and in greater detail in chapter 6.

7. Dividends-received exclusion. Current law provides an exclusion from gross income for the first $100 ($200 for married taxpayers filing a joint return) of dividend income received from a domestic corporation. Because the exclusion provides little, if any, investment incentive and contributes to complexity in the tax system, it should be repealed. The proposed partial deduction for dividends paid (described in Chapter 6) can be expected to have far more favorable benefits to the owners of corporate stock.

B. Preferred Uses of Income

Deductions for certain personal expenditures should be curtailed, in order to broaden the tax base, simplify compliance and administration, reduce government interference with private decision-making, and allow rates to be reduced for all. Two of the most important itemized deductions represent substantial Federal subsidies to State and local governments and to charities.

The deduction for State and local taxes, other than the deductions for State and local taxes constituting expenses of earning income, will be phased out. Therefore, no itemized deductions for State and local taxes will be allowed. The above-the-line deduction of charitable contributions by nonitemizers will be repealed a year before its current expiration date, and the itemized deduction for contributions will be limited to the excess over 2 percent of adjusted gross income. On the other hand, the existing deductions for medical expenses and casualty losses, which are allowed only to the extent that expenses and losses exceed 5 percent and 10 percent, respectively, of adjusted gross income, will be retained. Table 5-4 indicates floors applied to various itemized deductions under both current law and the Treasury Department proposal.

Itemized deductions for State and local taxes and charitable contributions together totalled some $122 billion in 1982, and they reduced individual income tax collections by roughly $30 billion. Had the policies proposed by the Treasury been in effect in that year, individual income tax rates could have been cut by about 10 percent, on average, without sacrificing revenue. Federal support of this magnitude can be defended only if there is reason to believe that the subsidized activities would otherwise be carried on at too low a level and if the present tax deduction is an efficient form of subsidy.

1. State and local taxes. Itemized deduction for State and local taxes are not required for the accurate measurement of income. Many years ago, with top rates in the neighborhood of 90 percent, the deduction was perceived to be necessary to prevent the sum of the marginal tax rates for Federal and State income taxes from exceeding 100 percent. Given the present levels of tax rates, such an argument is no longer relevant. The deduction is sometimes defended as a subsidy that is required to reduce the taxpayer's net cost of paying State and local taxes. Some would argue that the deduction has the advantage of encouraging greater expenditures by State and local governments.

Expenditures by State and local governments provide benefits primarily for residents of the taxing jurisdiction. To the extent that State and local taxes merely reflect the benefits of services provided to taxpayers, there is no more reason for a Federal subsidy for spending by State and local governments than for private spending. Both equity and neutrality dictate that State and local services should be financed by taxes levied on residents or on businesses operating in the jurisdiction, in the absence of evidence that substantial benefits of such expenditures spill over into other jurisdictions. There is no reason to believe that most expenditures of State and local governments have such strong spillover effects that they would be greatly under-provided in the absence of the deduction for State and local taxes. There is no reason to have high Federal tax rates and provide implicit Federal subsidies to spending of State and local governments by allowing deduction for their taxes. It would be better -- fairer, simpler, and more neutral -- to have lower Federal tax rates and have State and local government services -- like private purchases -- funded from after-tax dollars.

Moreover, the deduction for State and local taxes is not an efficient subsidy. Because itemized deductions are claimed by approximately one-third of all families (or 35.1 percent of total returns in 1982), it is doubtful that they increase significantly the

Table 5-4

Floors for Deductions on Individual Income Tax Returns*

Item	Floor: Current Law	Floor: Proposal
Medical expenses	5% of AGI	5% of AGI
Casualty expenses	10% of AGI	10% of AGI
Charitable contributions	No floor	2% of AGI
Itemized deductions for miscellaneous expenses	No floor (Available only to itemizers)	1% of AGI (Combined and made available to all taxpayers)
Employee business expenses	No floor (Available to all taxpayers)	

*Deductions generally would be allowed only to extent they exceed the floor.

level of State and local government services. The benefits of the subsidy thus accrue primarily to high-income individuals and high-income communities. To the extent that such subsidies are warranted, they could be provided in a much more efficient and cost-effective way through direct Federal outlays.

The three most important sources of State and local tax revenue in the United States are the general sales tax, the personal income tax, and the property tax. There may be a tendency to believe that itemized deductions should be eliminated for some of these taxes, but retained for others. The Treasury Department rejects this view, because the degree of reliance on these three tax bases varies widely from state to state. Five States have no general sales tax, and six have no personal income tax. Moreover, local governments in various States make widely different use of the property tax; in 1982 the tax represented from below 40 percent to almost 100 percent of total local tax collections in various states. To allow itemized deductions for some of these revenue sources, but not others, would unfairly benefit residents of the States levying the deductible taxes, relative to those who live elsewhere. Moreover, it would distort tax policy at the State and local level away from the non-deductible revenue source. Current law does this by allowing deductions for certain taxes but not for many fees and other taxes.

Moreover, because the deduction for State and local taxes leads to higher Federal tax rates for all, there is a net benefit only for States (and localities) that levy above-average taxes. Residents of States (and localities) with below-average taxes are worse off than if there were no deduction.

Finally, because income levels vary across the country, taxpayers in various States make differing use of itemized deductions and pay different marginal tax rates, on average. That is, residents of high-income States make more use of itemized deductions and pay higher marginal tax rates, on average, than do residents of low-income States. Under current law, the Federal Government pays part of State and local taxes only for those who itemize, and it pays a higher percentage of State and local taxes the higher the average income of those who do itemize deductions. Thus, under present law, the Federal Government underwrites a greater share of State and local expenditures in high-income States than in low-income States. In order to be even-handed and avoid this distributionally perverse pattern of subsidies, no itemized deductions should be allowed for taxes and fees paid to State and local governments. In order to minimize dislocations and inequities, the Treasury Department proposes that these deductions be phased out over a two-year period.

Elimination of this itemized deduction will probably have little direct effect on the revenues of State and local jurisdictions, unlike direct reductions in revenue sharing or similar cutbacks in Federal grants. It may make citizens more conscious of the actual social cost of services provided by State and local governments. Governments will have incentives to rely more heavily on user charges when appropriate. Under current law, the use of such charges is discouraged, since they are not deductible. Finally, these proposed changes will reduce the extent to which low-tax and low-income jurisdictions indirectly subsidize high-tax and high-income jurisdictions.

In considering the effect of the Treasury Department proposals on State and local governments, it should be noted that 34 State income tax systems piggyback on the Federal individual income tax base, and many of the 46 States with corporate income taxes rely on income measurement rules of the Federal corporate tax. The base broadening contained in the Treasury Department proposals will produce large increases in individual and corporate tax revenue for these States, with little or no effort on their part. Therefore, if State revenues are not to increase, rate reduction will also be necessary at the State level.

2. Charitable contributions. Many organizations that benefit from the deduction for charitable contributions provide services that have important social benefits. Services of this kind may not be provided at optimal levels if left to the marketplace. In the absence of charitable organizations, these services might have to be provided or funded directly by government. Instead, in our pluralistic society they have been subsidized through the tax system by the allowance of itemized deductions for charitable contributions. Some would argue that a deduction is especially appropriate when charitable contributions of a high percentage of current income substantially reduce the taxpayer's true ability to pay, as measured by income available for private use. The important question is whether it is necessary or efficient to allow a deduction for all contributions -- and thereby force tax rates to be higher -- in order to achieve the desired stimulus to charitable giving. To the extent that contributions would have been made in the absence of the tax benefit, the deduction only reduces revenues and causes all tax rates to be higher, without stimulating giving. For example, little incentive is provided by a deduction for the first dollars of contributions -- those that are most likely to be made in any case.

The Treasury Department proposes to allow a tax deduction for charitable contributions only to the extent that they exceed 2 percent of adjusted gross income. For example, a taxpayer with $25,000 of income and $1,200 of contributions, would be allowed to deduct only $700; the first $500 would be nondeductible.

Under present law, charitable donations of appreciated property can result in substantial tax saving. The full value of certain donated property can be deducted against ordinary income, without any requirement that gain on the property be recognized for tax purposes. Such treatment conflicts with basic principles governing the measurement of income, produces an artificial incentive to donate appreciated property rather than cash, and also leads to abuse and administrative problems for the Internal Revenue Service when taxpayers overvalue donated property. The Treasury Department proposes that the deduction for a charitable contribution of appreciated property be limited to the smaller of the indexed basis of the asset or its fair market value. This reform would increase tax equity and eliminate the attraction of fraudulent schemes based on donation of property with overstated values. It is consistent with tax law in circumstances where appreciated property is used to pay a deductible expense, or where such property is the subject of a deductible loss; a taxpayer generally is not allowed a tax deduction in respect of untaxed appreciation in property.

Under current law, the deduction for charitable contributions is generally limited to 50 percent of adjusted gross income. Thus, those who contribute more than 50 percent of their income to charity are taxed on the amount contributed in excess of 50 percent of income. Individuals who contribute all of their income to charity, such as those who have taken a vow of poverty, must therefore pay tax on one-half of their contribution. By repealing the limits on the deductible charitable contributions, the Treasury proposal will benefit those who contribute all or most of their income to charity.

Before 1982, only itemizers were allowed a deduction for charitable contributions. Extension of this deduction to nonitemizers -- taxpayers who on average have only small amounts of deductions -- creates unnecessary complexity, while probably stimulating little additional giving and presenting the IRS with a difficult enforcement problem. In 1983, 33 percent of those who did not itemize claimed the "above-the-line" deduction for charitable contributions. Of these, 70 percent claimed $25, the maximum amount allowed. In appraising this deduction, it would be useful to know whether taxpayers actually made these contributions or only claimed them. If the donations were made, one must ask whether they would have been made in the absence of the deduction. If they would have been made, the deduction provides no incentive for increased giving and is equivalent to an increase in the zero-bracket amount. The above-the-line deduction is scheduled to be increased in 1986, then eliminated thereafter. Since there is some lag in taxpayers' response to incentives, eliminating the incentive in 1986 is unlikely to have a significant effect on the level of charitable contributions.

In recent years, a little more than half of all tax returns with itemized deductions reported contributions of less than 2 percent of adjusted gross income (AGI). Even so, these proposed changes in the tax treatment of charitable contributions will have only a modest effect on the amount of charitable giving. It is doubtful that the first dollars of giving, or the giving of those who give only modest amounts, are affected much by tax considerations. Rather they probably depend more on factors such as financial ability to give, membership in charitable or philanthropic organizations, and a general donative desire. As potential giving becomes large relative to income, however, taxes are more likely to affect the actual level of donations. Under the Treasury Department proposal, incentives are maintained for the most sensitive group, taxpayers who give above-average amounts.

By removing tax deductions for small charitable gifts, the Treasury Department proposal simplifies recordkeeping requirements for taxpayers and eliminates the need for IRS to spend resources auditing these small transactions.

3. Interest expense. Under current law all interest expense is deductible, either as a business or investment expense or as an itemized deduction. As a result, taxpayers are allowed deductions for interest expense that does not produce currently taxable income. Home mortgages, automobile loans, and other consumer credit are examples of debt incurred to finance personal consumption, rather than business investments. Debt may also be used to finance investments that yield income that is tax-preferred, either because it is taxed at preferential rates or because tax liability is postponed to a later year. Under a comprehensive definition of income, full interest deductions would not be allowed for debt of either type.

The Treasury Department proposes that the deductions individuals can claim for interest expense be limited to the sum of mortgage interest on the principal residence of the taxpayer, passive investment income (including interest income), and $5,000 per return. This limitation would permit a taxpayer to deduct mortgage interest on his or her home, interest for the purchase of a car, and interest on a considerable amount of consumption and investment-related debt. It would, however, curtail the subsidy implicit in the current law deduction for interest on debt to finance large amounts of passive, tax-preferred, investment assets (such as corporate stock) or extraordinary consumption expenditures (such as second homes).

Interest expense, like interest income, is overstated during a period of inflation. Thus, the Treasury Department proposes that deductions for interest expense also be adjusted for inflation. The adjustment would apply only to the extent that interest deductions exceeded the interest on the taxpayer's principal mortgage, plus $5,000 per return ($2,500 per return for a married couple filing separately). Again, inflation adjustment of interest expense would not affect the current ability to deduct both mortgage interest on the taxpayer's home and on a considerable amount of consumer debt. Neither the indexing of net interest expense nor the limit on interest deduction would affect the vast majority of taxpayers. In 1981, only 3.3 percent of individual tax returns claimed itemized deductions for non-mortgage interest in excess of $5,000.

4. Simplification benefits. Eliminating the deduction for State and local taxes and limiting those for charitable contributions will simplify compliance and administration. It will no longer be necessary for taxpayers to wonder which taxes are deductible and which are not. The table used to calculate deductions for sales tax, a major nuisance and the source of numerous errors and much inaccuracy, can be eliminated. So also can the significant recordkeeping requirements for taxpayers who choose to claim sales tax deductions based on actual receipts rather than the table.

Those who can confidently predict that their charitable contributions will not exceed 2 percent of AGI will not need to worry about either writing checks or obtaining and keeping receipts for contributions. Moreover, disputes over valuation of donated property will be reduced, since deductions will be limited to indexed basis, and disputes over basis can occur only if contributions exceed the two percent threshold.

With itemized deductions limited in this way and the zero-bracket amount increased, the number of returns with itemized deductions will fall by about one-third. Virtually the only taxpayers who would choose to itemize would be those who could claim a deduction for mortgage or other allowable interest, those with large charitable gifts, and those with large medical expenses or casualty losses.

As in the case of taxation of fringe benefits, wage replacements, and other sources of presently excluded income, the increase in the personal exemption and zero-bracket amounts will prevent the few low-income households who itemize from being adversely affected by the proposed reductions in itemized deductions.

C. Abuses

1. Mixed personal and business expenses. Some expenditures combine business expenses with personal consumption. Among obvious examples are expense-account meals and entertainment, travel that has little or no business purpose, and automobiles used for both personal and business transportation. Some of these expenditures are legally deductible under current law as business expenses. Others are improperly claimed as deductions, both by unscrupulous taxpayers and by generally honest taxpayers who give themselves the benefit of the doubt in marginal or uncertain cases. When the expenses are deducted, the government effectively pays part of the cost of personal consumption that others must purchase with after-tax dollars.

As long ago as 1962, this abuse of the tax system was recognized and criticized by President Kennedy: " ... [T]oo many firms and individuals have devised means of deducting too many personal living expenses as business expenses, thereby charging a large part of their cost to the Federal Government. Indeed, expense account living has become a byword in the American scene. This is a matter of national concern, affecting not only our public revenues, our sense of fairness, and our respect for the tax system, but our moral and business practice as well."

The 1984 tax reforms addressed the issue of unjustified business deductions for expensive automobiles, aircraft, personal computers and other mixed-use property. To reduce abuse in this area further, several reforms are proposed. No deduction will be allowed for most entertainment expenses; allowable deductions for meals and lodging will be limited; and deductions for travel involving a substantial personal element will be curtailed in order to avoid government subsidies to thinly disguised vacation trips. The Treasury Department proposal also establishes bright line rules for determining deductible travel expenses in areas that have generated large numbers of audits and substantial amounts of litigation in the past. These reforms will improve the image of the income tax by preventing its abuse by those who take tax deductions for personal expenses. It will also simplify tax administration by providing sharp guidelines as to deductibility.

These proposals would increase the price of purchasing travel and entertainment indirectly through a business to the same price paid by the typical taxpayer, who does not have access to business perks. The demand by businesses and certain executives for expensive meals and various forms of entertainment would decline. As a result, the price of such services and goods would also tend to decline, benefitting the typical citizen who is unable to obtain a subsidy for consumption expenditures by characterizing them as business expenses. Because the providers of these high-priced meals and entertainment would face reduced demand, the production of these goods and services would also tend to fall. At the same time, providers of nonsubsidized consumption goods and services, such as moderately-priced meals, would face an increased demand.

It is doubtful that aggregate employment in food services will decline at all as a result of the Treasury Department proposals. For most taxpayers, consumption of restaurant meals is not subsidized. Elimination of many other preferences throughout the tax law will increase the relative demand for unsubsidized consumption such as this. In assessing the impact on this industry, as well as others, it would be a mistake to look only at the elimination of one type of preference in attempting to assess the overall impact of the tax reform package.

2. Income shifting. Progressive tax rates make it attractive for parents to shift taxable income to their children in order to reduce taxes. Income can be shifted by giving income-earning assets to the children or by establishing trusts that pay income to the children. Though such arrangements clearly can have valid non-tax motivations, their tax consequences violate both the principle that families with equal incomes should pay equal taxes and the notions of vertical equity embodied in the schedule of tax rates, regardless of their motivation in a particular case. Moreover, they contribute to the perception that the tax system is unfair. Although income shifting would be less attractive under the less highly graduated rate structure proposed, it would continue to occur.

The Treasury Department proposes several steps to prevent income shifting. First, under most circumstances unearned income of children under 14 derived from property given to the child by the parents, to the extent it exceeds the child's personal exemption, would be taxed at the parent's marginal tax rate. With a personal exemption of $2,000 and an interest rate of 10 percent, a child with investments of less than $20,000 would not be affected by this proposal. This provision would affect very few taxpayers. In recent years, only about 250,000 children under age 14 claimed as dependents on another's tax return reported unearned income in excess of the personal exemption.

Second, in both the case of a trust that reverts to the creator of the trust and of trust income that is not required to be distributed to beneficiaries or set aside for them, the income of the trust would be taxed to its creator, rather than to the trust or its beneficiaries. This reform, though intended primarily to preserve the fairness of the tax system, also would have substantial advantages in terms of simplification. It would reduce the incentive to create elaborate trusts or engage in other complicated transactions designed to shift income to others.

IV. Simplification

Many of the proposals described in this chapter, though intended primarily to increase the neutrality and fairness of the tax system, would allow simplification of the tax system for most individuals. Yet others, described in this section, are proposed with the primary objective of further simplifying taxpayer compliance.

A. A Return-Free System

To simplify taxpayer compliance, the Internal Revenue Service will consider initiation of a system under which many individual taxpayers would no longer be required to prepare and file tax returns. Instead, the IRS, at the election of eligible taxpayers, would calculate tax liability, based on withholding and information returns currently submitted by employers and third parties. The IRS will not need any information for this purpose that it would not receive from third parties under current law. All taxpayers included in the return-free system would be provided copies of the calculation of tax liability prepared for them by the IRS and would be allowed to question the computation of their taxes.

The return-free system would initially be limited to single wage earners with uncomplicated financial transactions, the population of roughly 15 million taxpayers now filing the simplified form 1040EZ. After a pilot program, the system could be extended to other individual taxpayers, and by 1990, roughly 66 percent of all taxpayers could be covered by the return-free system. It is estimated that at this level of participation this system would save taxpayers annually approximately 97 million hours and $1.9 billion in fees paid to professional tax preparers.

B. Other Simplification for Individuals

Movement toward a broad-base tax requires that better measures of income be obtained and that currently excluded items be counted in income subject to tax. In some cases, additional calculations would be needed, but on balance a broad-base income tax would reduce the complexity caused by current law. Many of the most important sources of complexity under current law arise from tax-induced changes in the economic affairs of millions of individuals. For example, the Treasury Department proposals will reduce the incentive to invest in tax shelters. Thus, many fewer individuals will need to appraise calculations of the after-tax benefits of complicated tax-shelter investments, much less shift assets in search of such shelters. Similarly, if employers insist on providing free in-kind benefits to employees, then the calculation of taxable compensation may be made more difficult. But if they pay wages in cash, or charge appropriately for other goods they want to provide, then their wage and fringe benefit structure, as well as the calculations they make for tax purposes, will actually be simpler than before.

Additional proposals will both simplify the income tax and make it more comprehensive. These include elimination of the preference for capital gains; imposition of a uniform tax on compensation income in whatever form derived (with few exceptions); repeal of the $100/$200 partial dividends received deduction; elimination of provisions such as the credit for political contributions and the presidential campaign checkoff; and restricting eligibility for income averaging. Itemized deductions for expenses of earning income and certain other deductions will be combined into one adjustment (an above-the-line deduction) subject to a floor of one percent of AGI. Because of the floor, taxpayers with only minimal expenses of this kind willnot need to bother with recording the expenses and claiming a deduction.

V. Reducing Noncompliance

A. The Tax Gap

During recent years considerable attention has been focused on the existence and size of the "underground economy." That term has multiple definitions but in the minds of many the focus is on illegal activities or clandestine economic operations. Those engaged in totally legal activities may, nonetheless, improperly fail to comply with the tax laws. This report employs the term "tax gap," in lieu of "underground economy," to encompass the revenues lost from all failures to comply with the tax law.

The tax gap is, thus, a broad concept which represents the difference between total payments received through voluntary compliance and the total amount of tax that would be collected if there were full compliance with the tax law. Thus, the tax gap includes not only the tax due on all unreported income, regardless of whether the underlying activities are legal or illegal, but also the tax that is not paid because of overstated business expenses and personal deductions.

Largely on the basis of studies of taxpayer compliance, the IRS estimated that in 1981 the tax gap was $90.5 billion. (See Table 5-5.) Nine billion dollars of the gap represents a minimal estimate of the lost income tax revenue from illegal activities, primarily illegal drugs, gambling, and prostitution. The remaining $81.5

Table 5-5

Income Tax Gap - 1981
(in billions of dollars)

Legal Sector Tax Gap, Total	$81.5
Corporation tax gap, Total	6.2
Individual tax gap, Total	75.3
Individual income tax liability reporting gap, Total	68.5
Nonfilers' income tax liability (Net of prepayments and credits)	2.9
Filer's income tax liability	65.6
Unreported income	52.2
Overstated business expenses	6.3
Overstated personal deductions 1/	6.6
Net calculation errors	0.5
Individual income tax remittance gap, Total	6.8
Employer underdeposit of withholding	2.4
Individual balances due after remittance	4.4
Illegal sector tax gap (partial) 2/	$9.0
Total legal and illegal tax gap	$90.5

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Office of Tax Analysis
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1/ Includes itemized deductions, personal exemptions, and statutory adjustments.
2/ Income from illegal drugs, gambling, and prostitution only.

Source: Internal Revenue Service. Income Tax Compliance Research, Estimates for 1973-1981. (July, 1983) billion of the gap was from omitted income or overstated deductions in activities that are otherwise completely legal. Of the $81.5 billion, $6.2 billion is attributable to corporations, $6.8 billion results from acknowledged but unpaid liabilities (essentially collection problems), and $2.9 billion is due to those who improperly fail to file tax returns. The remaining $65.6 billion gap is on returns of individuals who file income tax returns but who omit or understate income or overstate expenses: $52.2 billion is attributable to unreported or underreported income; $12.9 billion is due to overstated deductions; and $0.5 billion is due to net calculation errors in the taxpayer's favor.

The total unreported income for individuals (both filers and non-filers) in 1981 was $250 billion. The eight largest areas of omission were: wages and salaries ($94.6 billion) with a 94 percent compliance rate; non-farm proprietorships (including partnership and small business corporations) ($58.4 billion) with a 79 percent compliance rate; interest income ($20.5 billion) with a compliance rate of 86 percent; capital gains ($17.7 billion) with a 59 percent compliance rate; "informal supplier" income ($17.1 billion) with a 21 percent compliance rate; farm income ($9.5 billion) with an 88 percent compliance rate; pension and annuities ($8.8 billion) with an 85 percent compliance rate; and dividends ($8.8 billion) with an 84 percent compliance rate. The causes of these underpayments vary, and resolution will require a number of actions. Fundamental tax reform will help to stem the growth of the tax gap. Although the Treasury Department study was directed primarily toward restoring simplicity and equity to the tax system, its proposals will have some impact on the tax gap.

The breakdown in tax compliance and taxpayer morale during the last 20 years seems to be attributable, at least in part, to growing perceptions of unfairness in the current tax system. For example, a public opinion survey conducted for the IRS during the summer of 1984 supports the view that many taxpayers fail to comply because they believe inequities in the tax structure inherently favor others. Loopholes such as tax shelters, personal use of business assets, deductions for what are essentially personal expenses (e.g., disguised vacations), and nontaxable fringe benefits contribute to this perception. By sharply curtailing these avenues of tax avoidance and evasion, the proposals will diminish this form of rationalization for failure to comply with the tax laws.

Enactment of the reforms described above will reduce the number of taxpayers claiming itemized deductions by about one-third. As the list of deductible expenses is curtailed, the opportunities to inflate itemized deductions will disappear. Also, lower tax rates reduce the benefits of cheating. Hence, though broadening the tax base to allow a reduction in tax rates is the primary objective of these proposals, an important by-product of base-broadening is a reduction in the tax gap.

The tax gap is not entirely a consequence of cheating by taxpayers. In many cases it is a result of oversight or carelessness. This may explain much of the underreporting of interest and wages. IRS statistics indicate that 81 percent of the approximately 25 million taxpayers who make errors in the reporting of interest do so in amounts of $200 or less. In other cases individuals admit to owing tax, but do not have the resources to pay the tax. If the amount of tax owed is small, the cost of collection may exceed the outstanding liability.

The proposal to eliminate filing of returns for a majority of individual taxpayers is motivated primarily by the objective of simplification. However, coincident with this change, the IRS contemplates continued development and expanded use of information returns. Accordingly, in the return-free system, the unreported income from wages, dividends, interest, capital gains and all other form of income on which third-party reports are made to IRS will be subject to greater scrutiny. As a result, it is reasonably anticipated that a significantly greater part of the currently unreported income will be included in the computation of tax liabilities.

While a simpler and fairer tax system reduces both the opportunities and the incentives for tax evasion, some opportunities will remain, and determined taxpayers will continue to use them. There will always be a trade-off between the types and levels of enforcement activities and the amounts of tax evasion. The balance between the two must be determined by public policy, consistent with the traditions and institutions of our free and democratic society.

From the point of view of tax policy and tax administration in a free society, we must recognize that eliminating the tax gap attributable to illegal sector activities is essentially hopeless. If, despite our best attempts, we cannot stop the underlying illegal activity, we should not delude ourselves into believing that we can actually collect taxes on that activity. Thus, tax reform by itself will not help to convert the illegal sector tax gap into tax receipts.

The $81.5 billion tax gap previously estimated for 1981 may substantially overstate the actual gap under current law. The 23 percent rate reduction enacted in the Economic Recovery Tax Act of 1981 (ERTA) substantially lowered the tax consequences of omitted incomes. The 1981, 1982, and 1983 enactments of expanded information reporting for certain income such as tips, capital gains, and mortgage interest payments, and the backup withholding requirements for dividend and interest permanently improved compliance in these areas. The lower tax rates and doubled personal exemptions that The Treasury Department is proposing will further lower the tax gap.

While tax reform and lower tax rates may reduce the benefits of evasion, some benefits would remain. In the so-called "informal" sector and in both farm and non-farm small businesses where business is transacted in cash or where there is a mixing of business and personal activities, many of the problems that lead to the current tax gap will remain.

B. Amnesties

Several states have recently enacted amnesties for past failures to comply with their tax laws, and the possibility of a Federal amnesty has been discussed. Advocates of amnesties view them as a means of encouraging future compliance. They reason that amnesties will improve compliance by those who may be otherwise less than forthright with the tax authorities. Some even see amnesties as a source of substantial short-run revenue as delinquent taxpayers discharge past liabilities. In a well-documented study on tax amnesty titled "Tax Amnesty: State and European Experience," the Congressional Research Service elaborates on many of the difficulties associated with amnesty programs.

The Treasury Department rejects the idea of forgiving past tax liabilities, civil penalties, and interest. To include tax, civil penalties, and interest in an amnesty would further undermine taxpayer morale by sending a clear signal to the American public concerning non-compliance and tax fraud: "Don't bother to pay now. We may forget you owe anything. Even if you have to pay tax, we won't charge interest." Even a limited amnesty that applied only to criminal prosecution, without affecting liabilities for tax, penalties, and interest, would have very much the same effect.

Amnesties can only reinforce the growing impression that the tax system is unfair and encourage taxpayer non-compliance. After reviewing state and foreign experience with amnesties, the Treasury Department rejects their use by the Federal Government.

APPENDIX 5-A

LIST OF PROPOSED REFORMS

INCOME TAX REFORM AND SIMPLIFICATION FOR INDIVIDUALS

A. Rate Reduction

1. Reduce rates and collapse present 15 tax rates for single taxpayers and 14 tax rates for married taxpayers and heads of households into 3 rates.

B. Fairness for Families

1. Increase the zero-bracket amount from $2,510 to $2,800 for single filers, from $2,510 to $3,500 for heads of households, and from $3,710 to $3,800 for joint filers.

2. Increase personal exemptions from $1,090 to $2,000.

3. Fold additional exemptions for the blind and elderly into an expanded credit for the elderly and disabled, and make all taxable disability income eligible for the credit.

4. Repeal deduction for two-earner married couples.

5. Index earned income tax credit.

6. Replace child and dependent care credit with a deduction from gross income with same cap ($2,400 if one child, $4,800 if two or more).

C. Fair and Neutral Taxation

1. Excluded Sources of Income
   a. Fringe Benefits

      1. Repeal exclusion of health insurance above a cap ($175 per month for family coverage, $70 per month for individual coverage).
      2. Repeal exclusion of group-term life insurance.
      3. Repeal exclusion of employer-provided death benefits.
      4. Repeal exclusion of dependent care services or reimbursement.
      5. Repeal special treatment of cafeteria plans.
      6. Repeal exemption of voluntary employee's beneficiary associations and trusts for supplemental unemployment compensation and black lung disability.
      7. Repeal special treatment of incentive stock options.
      8. Repeal exclusion of employee awards.
      9. Repeal exclusion of certain military compensation, with offsetting adjustments in military pay schedules.

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10. Repeal exclusion of rental allowances or rental value of a minister's home.

b. Wage Replacement Payments

1. Repeal tax-exempt threshold for unemployment insurance compensation.
2. Repeal tax exemption of workers' compensation, black lung, and certain veterans' disability payments, but make all such income eligible for the credit for the elderly, blind, and disabled.

c. Other Excluded Sources of Income

1. Repeal exclusion of scholarships and fellowships in excess of tuition.
2. Repeal exclusion of awards and prizes.

2. Preferred Uses of Income

a. Repeal the itemized deduction for state and local taxes.
b. Repeal the above-the-line deduction for charitable contributions.
c. Limit itemized deductions for charitable contributions to those in excess of 2% of gross income.
d. Limit deduction for charitable contributions of appreciated property to indexed basis.
e. Repeal 50% and 30% limits on individual contributions.
f. Repeal 10% limit on corporate contributions (but retain 5% limit in certain cases).

D. Tax Abuses

1. Business Deductions for Personal Expenses

a. Deny all entertainment expenses including club dues and tickets to public events, except for business meals furnished in a clear business setting. Limit deduction for business meals on a per meal per person basis.
b. Limit deductions for meals and lodging away from home in excess of 200% of the Federal per diem. When travel lasts longer than 30 days in one city, limit deductions to 150% of the Federal per diem.
c. Establish bright-line rules to separate indefinite and temporary assignments at one year.
d. Deny any deduction for travel as a form of education.
e. Deny deductions for seminars held aboard cruise ships.
f. Deny any deduction for travel by ocean liner, cruise ship, or other form of luxury water transportation above the cost of otherwise available business transportation with medical exception.

2. Income Shifting

   a. Revise grantor trust rules to eliminate shifting of income to lower rate beneficiaries through trusts in which the creator retains an interest.
   b. During creator's lifetime, tax trusts at the creator's tax rate and allow deductions only for non-discretionary distributions and set-asides. After creator's death, tax all undistributed trust or estate income at the top marginal rate.
   c. Tax unearned income of children under 14 at the parents' rate (to the extent such income exceeds the child's personal exemption).
   d. Revise income taxation of trusts.

E. Further Simplification

1. Non-filing system, in which IRS would compute taxes for many taxpayers.

2. Repeal individual minimum taxes (only if basic reforms are fully implemented).

3. Move miscellaneous deductions above the line, combine with employee business expenses, and make subject to a floor.

4. Repeal preferential treatment of capital gains.1/

5. Repeal political contribution credit.

6. Repeal presidential campaign checkoff.

7. Repeal deduction of adoption expenses for children with special needs, and replace with a direct expenditure program.

8. Disallow income averaging for taxpayers who were full-time students during the base period.

9. Repeal $100/$200 exclusion for dividend income. 1/

F. Other Miscellaneous Reforms

1. Increase limits on moving expenses.

2. Special rule for allowing deduction of some commuting expenses by workers (*e.g.*, construction workers) who have no regular place of work.

1/ Discussed at greater length in Chapter 6.