

# CCH Tax Briefing:

## FEDERAL TAX REFORM PANEL ISSUES PROPOSALS TO "FIX AMERICA'S TAX SYSTEM"

### Special Report

November 7, 2005

#### Framework for Reform

##### By the Numbers

- ✓ *Form 1040 Simple: 32 lines*
- ✓ *Top Individual Rate: 33%*
- ✓ *Small Business Top Rate: 33%*
- ✓ *Large Business Top Rate: 31.5%*
- ✓ *Capital Gains Top Rate: 8.25%*
- ✓ *Dividends Rate: 0%*
- ✓ *State/Local Tax Deduction: \$0*
- ✓ *Limited Mortgage Credit: 15%*
- ✓ *Individual/Corporate AMT: \$0*

## Tax Reform Panel Calls for Major Changes to Income Tax System; Fewer Brackets/ Deductions But No AMT

Three months after its original deadline, President Bush's Advisory Panel on Federal Tax Reform unveiled its long-awaited recommendations on November 1 to a chorus of cheers from some taxpayers and jeers from others. As expected, the Panel recommends abolishing the individual alternative minimum tax (AMT), converting many current deductions into credits, consolidating tax benefits, and overhauling retirement savings. The Panel did not, as many observers predicted, recommend replacing the current federal income tax regime with a national consumption or value-added tax (VAT). The Panel explored these options but, in the end, decided they were too costly. Reaction varies from "more of the same" to "the right move at the right time."

*the process one step closer to narrowing the possibilities and retaining the income tax system as the main source of federal revenues, albeit in a radically-changed form.*

*The Treasury will make its tax reform proposals to President Bush based on the Panel's report in early 2006. President Bush then will consider Treasury's proposals, and, no doubt, fine tune them further before submitting a bill to Congress. In the meantime, Congressional leaders have ideas of their own that they will put forward.*

### Inside

Reforms Targeting	
Individuals .....	2
Quick View – Changes	
Affecting Individuals .....	5
Reforms For Retirees/	
Other Savers .....	6
Reforms Targeting	
Businesses .....	8
Quick View – Changes	
Affecting Businesses .....	8
What's Next .....	9

**Impact** *The Panel's recommendations are just that. They are not written with the painstaking detail that the tax law would be. The report was prepared for the mass media and consumption by the general public; not tax professionals. It paints a very broad picture of reform. The Treasury is expected to build on the Panel's proposals and refine them. More details will emerge as a tax reform bill evolves from the recommendations. Once a basic direction is set—and other alternatives are discarded—the monumental task of drafting an air tight and effective new Tax Code will begin. The Reform Panel took*

### TWO PATHS TO REFORM

The Panel's recommendations are grouped into two plans. One category is called the "Simplified Income Tax Plan." The other is the "Growth and Investment Tax Plan." The two plans share many features, but there are important differences in the proposals to reform business taxation. Both preserve the basic tax system based on income realized through wages and investments.

#### New forms

In addition to recommending substantive changes, the Panel also suggests some new tax forms. The most streamlined form would be a new postcard-size "U.S. Individual Income Tax Return." "Form 1040-

*Continued on page 2*



*The Growth and Investment Tax Plan would maintain the current 15 percent rate on capital gains and dividends and would extend that rate to interest income. Municipal bonds would continue to be tax exempt.*

**Comment** The Panel believes that lowering the rate for interest income would increase the incentive for ordinary families to save.

**Comment** The Panel considered another proposal, the Progressive Consumption Tax Plan, which would not tax capital income. However, this proposal was not approved by the Panel.

**Impact** *The proposal also opens up the issue of what to allow during a transition period. In any event, present carryover losses can probably be used in either 2005 or 2006 before they become "devalued" by offsetting gain taxes at a significantly lower rate.*

### **New "Family Credit"**

The Panel recommends consolidating the standard deduction, the personal exemption, and the child tax credit into a new "Family Credit," which would be available to all taxpayers. The age-cutoff for the credit would be 18, unless the individual is a full-time student. In that case, the maximum age for the credit would be 20.

**Comment** The standard deduction under existing law for 2005 is \$5,000 for single taxpayers and \$10,000 for married couples filing jointly. The personal exemption provides a deduction of \$3,200 for household members. The child tax credit is currently \$1,000. Phase-outs of both the personal exemptions and child credit now exist; the new Family Credit will be allowed in full for taxpayers in any income level.

**Comment** The Panel also recommends folding in the higher standard deduction for taxpayers with head of household filing status into the new "Family Credit."

Taxpayers would compute the new "Family Credit" by starting with a base amount for their household type and adding amounts for each child and other dependents of the household. The base amount for married couples with children would be \$3,300. The base amounts would be lower for unmarried taxpayers with dependent children, \$2,800, and single taxpayers, \$1,650. Taxpayers would add to the base amount \$1,500 for each child and \$500 for each dependent.

**Example.** Amelia and Anthony are married and have two children, Francesco, age 5, and David, age, 3. Because they are married, their base amount for the new credit would be \$3,300. Amelia and Anthony would add \$3,000 to their base amount (\$1,500 for each child) for a total credit of \$6,300.

**Comment** The "Family Credit" would be indexed for inflation.

**Impact** *All taxpayers would be able to claim the new credit because it would not phase out as a taxpayer's income rises. The "Family Tax Credit," when compared to the benefit of the standard deduction, personal exemptions, and child credit that it replaces, creates a break-even situation for taxpayers currently in the 25-percent tax bracket. Those with higher income would have done better with deductions that offset income taxed at a higher percentage. However, repeal of the AMT offsets much of that disadvantage.*

### **New "Work Credit"**

For low-income taxpayers, the earned income tax credit (EITC) and the refundable

child tax credit would be replaced with a new "Work Credit." The "Work Credit" is similar to the "Family Credit" but with one important difference: it phases out based on income. The Panel recommends setting the maximum age for the credit at 18, except for full-time students when the maximum age would be 20.

**Comment** The "Work Credit" would not be available to anyone who is claimed as a dependent on another taxpayer's return.

**Impact** *Unlike the "Family Credit," the "Work Credit" would be limited to U.S. citizens and residents.*

**Comment** The EITC does not have a good reputation at the IRS or in Congress. Many agency officials and lawmakers believe the credit has been widely abused. They also fault its complexity, which they argue drives taxpayers to use paid return preparers to compute the credit. The Panel believes that its simplified "Work Credit" would encourage more taxpayers to compute the credit without paying a return preparer. Taxpayers would also have the option of allowing the IRS to calculate the "Work Credit" based on information provided on the return and "Family Credit schedule."

### **Home ownership**

*The Panel recommends that the deduction for mortgage interest be replaced with a new "Home Credit." The credit would equal 15 percent of mortgage interest paid by a taxpayer on a loan secured by the taxpayer's principal residence and used to acquire, construct, or substantially improve that residence. Moreover, the deduction for interest on mortgages for second homes and interest on home-equity loans would be eliminated completely.*

Currently, home mortgage interest is deductible if it is qualified residence interest. Qualified residence interest is

interest on up to \$1 million of acquisition indebtedness and interest on up to \$100,000 of home equity indebtedness that is secured by the taxpayer's primary or secondary residence. The Panel's recommendations, if adopted, would change this approach. The Panel favors capping the maximum debt eligible for the "Home Credit" at 125 percent of the median sale price for the county in which the residence is located. According to the Panel, this would result in current limits between approximately \$22,147 and \$411,704.

**Impact** *\$1 million mortgages are not uncommon in many parts of the country as housing prices have skyrocketed. The Panel's proposal would severely curtail the tax benefits of homeownership for taxpayers in high-cost localities.*

**Impact** *With interest rates at record lows, many homeowners have refinanced recently. The Panel recommends phasing in the new "Home Credit" over a five-year period for pre-existing home mortgages. Even with that phase-in, some homeowners will find themselves in big financial trouble if their incomes do not rise quickly. This especially will be the case for homeowners with interest-only mortgages keyed to a variable rate.*

**Comment** The National Association of Realtors® (NAR) told CCH that it is "startled" that the Panel would even consider reducing the cap. NAR shared with CCH a letter it wrote to Treasury Secretary John Snow urging "extreme caution" in his deliberations because the "mortgage deduction is the single most important tax provision for the nation."

*Jonathon L. Kemper, CEO of the Mortgage Bankers Association*

*noted "When [President Bush] established this bipartisan Panel, he gave clear direction that any reform must simplify the Tax Code, be fair, bolster economic growth, and support homeownership. Unfortunately, the recommendations issued today [November 1, 2005] that relate to the housing market fail to meet these criteria. And, lets face it – no matter how you dress this up it's a tax increase for a lot of working Americans."*

**Comment** Congressional reaction has not been favorable. Rep. Tom Tancredo, R-Colo., disagreed with the Panel's recommendations on the mortgage deduction, noting, "this tax increase would be aimed right at the middle class."

**Comment** The Panel would keep the current exemption for gains from the sale of a principal residence, but would increase the time frame from two out of five years to three out of five years.

### Charitable giving

When President Bush organized the Panel, he gave it very limited marching orders. One order was for the Panel to keep in mind the traditional generosity of Americans and the importance of encouraging charitable contributions.

The Panel wants to expand the deduction for charitable contributions, which is currently limited to taxpayers who itemize their deductions, to all taxpayers. Contributions exceeding one percent of income would be deductible.

**Comment** The Panel did not say, but it can be inferred, that taxpayers who give more than one percent of their income to charity would have to continue to substantiate their contributions.

Taxpayers over age 65 would be able to make tax-free gifts from traditional IRAs directly to charitable organizations.

Taxpayers would not have to go through the two-step reporting process of including the amounts in income only to deduct them as a charitable deduction.

**Comment** This proposal has been made before by the White House and members of Congress. Most recently, it was discussed when Congress was crafting the Hurricane Katrina relief bill.

In a related proposal, taxpayers would be able to sell property without recognizing gain and receive a full charitable deduction if they donate all of the proceeds to a charity. Proceeds must be donated to a charitable organization within 60 days of the sale.

Finally, charities would be required to report large gifts to the IRS and to the taxpayer. Large gifts would be gifts of \$600 or more.

**Comment** The Panel also recommended improved rules for appraisals of property and that Congress review standards for qualifying for and maintaining tax-exempt status of charitable organizations.

### Health insurance coverage

Employer-provided health insurance coverage is currently not taxed. It is not subject to payroll taxes and recipients do not have to include it in their incomes. Employers also benefit. They can deduct the costs of health insurance coverage provided to employees.

The Panel initially considered eliminating entirely the exclusion for employees. Instead, the Panel decided to cap it. The exclusion for employer-provided health insurance would be limited to \$11,500 for families and \$5,000 for single individuals (the projected national average for premiums in 2006). These amounts would be indexed for inflation.

**Comment** Like its recommendation to prune the mortgage interest deduction, the Panel's proposed cap for health insurance coverage has

generated a negative response from groups representing employers and insurers. Bonnie B. Whyte, President of the Employers Council on Flexible Compensation, noted that limiting the employer provided health insurance coverage will “be a tax increase for middle-income workers and will only increase the

out-of-pocket health expenses for Americans.” Karen Ignagni, President of America’s Health Insurance Plans, stated that “our polling consistently shows that voters want Congress to strengthen, not weaken, tax incentives that help individuals and employers afford health care coverage”

**Comment** The Panel was very much aware of the rising cost of health care and the practice of providing excessively generous plans to high-income employees. The Panel predicted that capping the exclusion would “make workers more cognizant of the amount they spend on health insurance...and

### Quick View - Changes Affecting Individuals

<b>Tax Provision Impacted</b>	<b>Simplified Income Tax Plan</b>	<b>Growth and Investment Tax Plan</b>
<b>Households and Families</b>		
Tax Rates	Four Tax Brackets (15 percent, 25 percent, 30 percent, and 33 percent)	Three tax Brackets (15 percent, 25 percent, and 30 percent)
Alternative Minimum Tax	Repealed	
Personal Exemption	Replaced with Family Credit, which is available to all taxpayers. Allows a \$3,300 credit for married couple; \$2800 for unmarried individuals with a child; \$1650 for singles; and \$1,150 for dependent taxpayers (additional \$1,500 credit for per child, and \$500 for each “other” dependent).	
Earned Income Tax Credit	Repealed, replaced with Work Credit (and coordinated with the Family Credit). The maximum credit for a working family with one child is \$3,570. For families with two or more children, it is \$5,800.	
Marriage Penalty	All tax brackets, family credits, and taxation of Social Security benefits for couples will be double the rate for singles.	
<b>Other Major Credits And Deductions</b>		
Home Mortgage Interest	The new Home Credit will be equal to 15 percent of mortgage interest paid, and available to all taxpayers. The mortgage is limited to the average regional price of housing (from \$227,000 to \$412,000).	
Charitable Giving	Deduction will be available to all taxpayers who give more than 1 percent of their income. Rules implemented to curb abuses.	
Health Insurance	All taxpayers may purchase health insurance with pre-tax dollars up to the amount of the average premium (approximately \$5,000 for individuals and \$11,500 for a family).	
Education	Taxpayers will be able to claim the Family Credit for some full-time students. Proposal creates simpler savings plans.	
State & Local Taxes	State and local taxes will not be deductible	
<b>Individual Savings and Retirement</b>		
Defined Contribution Plans	Consolidated into Save at Work Plans with simple rules. Implements “AutoSave” features to help workers save.	
Defined Benefit Plans	No change recommended	
Retirement Savings Plans	Will become Save for Retirement Accounts, which are available to all taxpayers and capped at \$10,000 per year.	
Education Savings Plans	Will become Save for Family Accounts, which are available to all taxpayers and capped at \$10,000 per year. Will cover education, medical expenses, new home costs, and retirement savings needs.	
Health Savings Plans		
Dividends Received	Will exclude 100 percent of dividends if U.S. companies paid from domestic earnings.	Taxed at 15 percent rate.
Capital Gains Received	Will exclude 75 percent of corporate capital gains of U.S. companies paid out of domestic earnings.	Taxed at 15 percent rate.
Interest Received (other than tax exempt mutual bonds)	Taxed at regular income tax rates.	Taxed at 15 percent rate.
Social Security Benefits	Will be a simple deduction instead of three-tiered structure. Married taxpayers with less than \$44,000 in income, and singles with less than \$22,000 in income (indexed for inflation) will pay no tax on Social Security benefits.	

lead some workers to reduce the amount of insurance purchased and pay more health care costs directly.”

**Uninsured individuals.** The Panel recommends giving uninsured individuals a new tax deduction to help pay for the cost of health insurance. Families without employer-provided insurance would be eligible for an \$11,500 deduction. Single taxpayers could claim a \$5,000 deduction.

**Comment** This case is one of the few where the Panel recommends a deduction rather than a credit.

### Education benefits

Congress has used tax incentives to encourage education and help students (and parents) pay for higher education. The result is a plethora of tax breaks. The Panel discovered what many practitioners already know: taxpayers do not understand how the various education tax credits and deductions work and they often fail to maximize their tax breaks.

The Panel recommends eliminating the HOPE and Lifetime Learning Credits, the above-the-line deduction for education expenses, and the deduction for interest paid on student loans. In their place, the Panel proposes a new “Family Credit,” \$1,500 credit for all families with full-time students age 20 and under.

### State and local taxes

Another proposal fueling significant controversy is the Panel’s recommendation to abolish the current deduction for state and local taxes. The Panel concluded that these expenditures should be treated like any other non-deductible personal expense. According to the Panel, residents of low-tax jurisdictions should not have to subsidize government services provided in high-tax areas.

**Comment** In 2004, Congress allowed taxpayers to elect to deduct state and local income taxes or state and local sales taxes. The Panel appears to favor eliminating the deduction for both.

**Impact** Some immediately complained that this recommendation clearly favors “red” over “blue” states. As federal revenue sharing decreases, states will continue to feel pressure to raise taxes. Real estate and income taxes are the flash points here. This and the mortgage interest deduction pose the most difficult challenges to making this plan work.

### Fringe benefits

The Panel recommends eliminating the current tax law preferences for employer-provided fringe benefits. The Panel specifically mentioned child care, life insurance and education fringe benefits.

**Comment** According to the Panel, the “favorable tax treatment of fringe benefits results in an uneven distribution of the tax burden as workers who receive the same amount of total compensation pay different amounts of tax depending on the mix of cash wages and fringe benefits.”

**Impact** *The Panel’s recommendation in this area will definitely need to be elaborated on by the Treasury. The Panel appears to have lumped all types of fringe benefits into one catch all category.*

### REFORMS FOR RETIREES/ OTHER SAVERS

Although the Panel’s recommendations for overhauling IRAs, 401(k)s, and other savings vehicles did not get

as much media attention as some of the other proposals, they would be sweeping in their scope. The current alphabet soup of savings plans would all disappear. In their place, taxpayers could choose from “Save-at-Work,” “Save-for-Retirement” and “Save-for-Family” plans.

**Comment** The Panel’s recommendation to abolish IRAs, 401(k)s, 403(b)s and similar plans appears to be rooted in a dislike of their complicated and often conflicting rules. No one set of rules governs all retirement savings vehicles. However, even under the Panel’s recommendation, differences would have to be addressed. The Panel seems to recognize this when it recommends that small employers (10 or fewer employees) be given some flexibility; for example, not having to file annual returns.

**Impact** *“Without the upfront deduction, we believe many workers currently saving in their 401(k) will choose not to save,” Brian Graff, Executive Director and CEO of the American Society of Pension Professionals and Actuaries, predicted.*

### Save-at-Work

“Save-at-Work” accounts would replace 401(k)s, SIMPLE 401(k)s, Thrift plans, 403(b) plans, governmental 457(b) plans, SARSEPs, and SIMPLE IRAs. To encourage employees to save, the Panel recommends a feature it calls “Auto Save.” Among other things, employees would automatically become participants in their employer’s Save-at-Work plan unless they choose actively not to participate.

**Comment** According to the Panel, “Save-at-Work” plans would follow the “existing contri-

bution limits and rules for 401(k) plans but the plan qualification rules would be greatly simplified.” For 2005, taxpayers can elect to defer up to \$14,000 in a 401(k).

**Comment** Under the “Simplified Income Tax” plan, the “Save-at-Work” accounts would be structured like traditional IRAs. Contributions would be deductible. Withdrawals would be taxed as ordinary income. Under the Growth and Investment Tax Plan, contributions would be made on an after-tax basis and withdrawals would not be taxed.

### Save-for-Retirement

These accounts would replace traditional IRAs, Roth IRAs, nondeductible IRAs, deferred executive compensation plans, and what the Panel calls, “tax-free inside buildup of the cash value of life insurance and annuities.” Taxpayers would use “Save-for-Retirement” accounts to supplement their “Save-at-Work” accounts. Taxpayers would be able to save up to \$10,000, or the amount of earnings if less, in these tax-free plans. Contributions would be made with after-tax dollars and earnings would grow tax-free.

The Panel recommends indexing the annual contribution limit for inflation.

**Impact** “Save-for-Retirement” accounts would be open to all taxpayers. The Panel recommends no income threshold, as exists for many current savings plans.

**Impact** The obligations on employers to continue existing retirement accounts, although no further contributions may be made to them, is unclear. Employers thinking of starting retirement plans for employees either in 2005 or 2006 may decide to sit on the sidelines until administra-

*tive responsibilities, and their attendant expenses, are sorted out.*

**Impact** Roth IRAs would be automatically converted to “Save-for-Retirement” accounts. Other accounts, such as traditional IRAs, would be converted into “Save-for-Retirement” accounts by subjecting the value of the accounts to taxes once, similar to how traditional IRAs are converted at the present time to Roth IRAs.

“Save-for-Retirement” accounts would retain one important feature of IRAs. Individuals could withdraw funds tax-free only after the age of 58 or in the event of death or disability.

**Comment** No minimum distribution rules would apply.

### Save-for-Family

These accounts would replace Coverdell Education Savings Accounts (ESAs), Qualified Tuition Plans (529 plans), Archer Medical Savings Accounts (MSAs), Health Savings Accounts (HSAs), and Flexible Spending Arrangements (FSAs). Contributions would be made on an after-tax basis. Earnings would grow tax free.

**Comment** Taxpayers could also use “Save-for-Family” plans to supplement their retirement savings.

Distributions would be tax free if they are used for:

- Health or medical costs;
- Education or training expenses; and
- Purchases of a primary residence.

Funds would be available tax free at any time to taxpayers who are age 58 or older. The Panel also recommends allowing all taxpayers to withdraw up to \$1,000 tax free each year for any reason. However, amounts over \$1,000 that are not for health or medical costs, edu-

cation or training expenses, or purchases of a primary residence would be subject to an additional 10 percent tax.

**Comment** No minimum distribution rules would apply to “Save-for-Family” accounts.

### Refundable saver's credit

For lower-income taxpayers, the Panel recommends replacing the current credit for qualified savings contributions with a new refundable “Saver’s Credit.” The credit would reward taxpayers for saving. Single taxpayers with incomes of \$25,000 or less would qualify as would married couples with incomes of \$40,000 or less. The maximum annual contribution eligible for the credit would be \$2,000 and the maximum credit rate would be 25 percent.

### Social Security benefits

Individuals would not be taxed on their Social Security benefits if their income is less than \$44,000 for married couples and \$22,000 for single taxpayers. Individuals with incomes above these amounts would include between 50 and 85 percent of their benefits in their taxable incomes depending on their income level.

**Comment** The Panel deliberately made the threshold amount for married couples twice the amount for single taxpayers to help erase the “marriage penalty.” The amounts would be indexed for inflation.

**Impact** Taxable retirement plan distributions may make Social Security benefits taxable in many cases. It is also unclear whether the \$44,000 and \$22,000 cut-offs will be an all or nothing proposition. This provision may take back much of the benefits of qualified deferred compensation plans for those taxpayers who may otherwise escape tax on Social Security benefits.

## REFORMS TARGETING BUSINESSES

“The tax rules for business ... have become a complicated mess,” the Panel discovered. Businesses are required to keep elaborate and burdensome records, especially for inventories and depreciable assets. For small business, the compliance burden is heavy, especially relative to income. Reducing recordkeeping and paperwork will encourage more small business activity, the Panel predicted.

**Comment** Under Rev. Proc. 2002-28, some small businesses with gross receipts less than \$10 million can already use cash-basis accounting.

Two alternatives: The Panel’s proposals for business tax reform for business tax are grouped under the Simplified Income Tax Plan and the Growth and Investment Tax Plan. Both plans would remove impediments to saving and business investment, but use different approaches. The treatment under the Simplified Income Tax Plan would be close to the current system, while the treatment under the Growth and Investment Tax Plan follows a consumption tax model and would be more far-reaching. Though different, the two systems would rely on similar principles:

- Simplifying the Tax Code for small business;

- Eliminating the double taxation of U.S. corporate earnings;
- Providing more equitable treatment for different types of business investment; and
- Updating the international tax rules to reduce distortion and improve fairness.

**Comment** Martin Regalia, chief economist of the U.S. Chamber of Commerce in Washington, D.C., told CCH that “the Chamber is neutral while we evaluate the [Panel’s] recommendations.”

### Simplified Income Tax Plan

Under this plan, the tax system would be simplified, subsidies for favored industries and activities would be removed, and business income would be taxed more uniformly at a lower overall rate. Businesses would be divided into three categories for tax purposes:

- Small businesses
- Medium-sized businesses
- Large businesses

**Comment** An entity’s gross receipts would be averaged over three years to determine the business’ category.

**Small businesses.** Businesses with under \$1 million in gross receipts would be taxed at individual rates (top rate of 33 percent); would use simplified cash-basis accounting for most items (other than land and buildings); and could immediately expense investments, such as

tools, software, and equipment (other than land and buildings).

**Comment** According to the Panel, allowing small businesses to use the cash method of accounting would simplify taxes for more than 22 million small businesses, over 95 percent of all businesses. Companies could use their existing records to establish income and expenses.

**Medium-sized businesses.** Businesses with \$1 to 10 million in gross receipts would use the simplified cash method but would be required to depreciate equipment and other capital expenditures. Only businesses in inventory-intensive industries would be required to use an inventory method.

Rules concerning contributions, distributions, allocation of income, and liquidations would be simplified and made more uniform for pass-through entities, such as LLCs, partnerships and S corporations with receipts under \$10 million. This recommendation also applies to small businesses.

**Large businesses.** For large businesses that have over \$10 million in gross receipts:

- The top tax rate would be 31.5 percent (down from 35 percent);
- Simplified accelerated depreciation would be used for investment, using fewer rates and asset classes;
- No change in the treatment of interest paid or received;

### Quick View - Changes Affecting Businesses

Tax Provision Impacted	Simplified Income Tax Plan	Growth and Investment Tax Plan
<b>Small Business</b>		
Tax Rates	Businesses will be taxed at individual tax rates.	Sole proprietorships taxed at individual rates, but other small businesses will be taxed at 30 percent.
Record Keeping	Simplified cash-basis accounting	Business cash-flow tax
Investment	Calls for immediate expensing except for land and buildings covered by the Simplified Income Tax Plan.	
<b>Large Businesses</b>		
Tax Rates	31.5 percent	30 percent
Investments	Calls for simplified accelerated depreciation	Expensing for all new investments
Interest paid	No change recommended	Not deductible (except financial institutions)
Interest received	No change recommended	Not taxable except for financial institutions.
International Tax System	Territorial tax system	Destination-basis (border tax adjustments)

- The corporate AMT would be repealed; and
- International income would be taxed under a territorial tax system.

**Pass-throughs.** Pass-through entities with income over \$10 million would be taxed at the entity level like corporations. About 150,000 active businesses come within this category. Owners would not be taxed on distributions of U.S. income and would exclude 75 percent of the capital gains on the sale of an interest in the entity. Entities with income below \$10 million could choose to be taxed as a corporation. Passive investment entities, such as mutual funds, would be treated the same as under current law.

**Impact** *This treatment would substantially reduce the use of partnerships and other pass-through entities as tax shelters. It would also simplify the individual income tax return of an entity's owner.*

**Elimination of business tax credits and deductions.** Over 40 business tax breaks, such as the research credit and the new domestic manufacturing deduction, would be eliminated, including the deduction for state and local taxes. Accelerated depreciation would remain available. This simplified depreciation system would reduce the number of asset categories from nine to four and provide level depreciation for each category.

**Foreign Income.** Active business income earned abroad generally would not be taxed. Dividends paid by a controlled foreign corporation from "active" earnings would be tax free; payments that are deductible abroad, such as royalties and interest, would be taxable in the United States. Domestic expenses that generated foreign income could not be deducted against U.S. income. The Panel noted that this treatment of foreign income would not divert investment abroad.

**Comment** To address the problem of corporate inversions, the Simplified Income Tax Plan would treat a business as a U.S. resident if its place of "primary management

and control" is located in the United States, regardless of the country where the entity is formed.

### **Growth and Investment Tax Plan**

**Small business:** For small businesses (gross receipts under \$1 million), proprietorships would be taxed at individual rates, and other small businesses would be taxed at 30 percent. The Panel recommends the immediate expensing of investments.

**Mid- and Large-size businesses:** For large and mid-sized businesses, the Panel recommends:

- A 30 percent tax rate on all businesses, regardless of their legal structure;
- Expensing of all new investment expenses;
- Making interest not deductible and interest earned not taxable (providing equal treatment of debt and equity financing);
- Repeal of the corporate AMT; and
- Taxing international income under the destination-basis (border tax adjustments) system.

**Impact** *For most businesses, existing net operating losses will be devalued, unless Congress comes up with a straightforward rule.*

Under the Growth and Investment Plan, a business tax would be imposed on the difference between cash received and cash paid out. This is known as the subtraction method. This method is closer to current methods of accounting, compared to the credit method consumption tax.

**Impact** *The business tax rate (30 percent) would be the same as the top individual tax rate under the Growth and Investment Tax Plan, reducing tax planning aimed at shifting income.*

**Comment** By allowing the expensing of all new investment, the new system would not discriminate between different types of assets and would provide the same deduction for a dollar invested.

**Impact** *Eliminating the interest deduction eliminates the distinction between debt and stock financing. However, interest earned would be taxable for financial services businesses.*

**Losses.** Losses would not be refundable but interest would be provided on loss carryforwards. The Panel considered but rejected a proposal to allow the trading of losses from one firm to another, because this could encourage tax avoidance schemes.

**International Taxation.** The "destination-basis" scheme of international taxation treats all domestic consumption equally. This imposes the same tax on consumption that occurs in the United States, regardless of where the good was produced. Income from abroad (export sales) is excluded and a manufacturer receives a "border tax adjustment" that provides a rebate of the tax on the production cost.

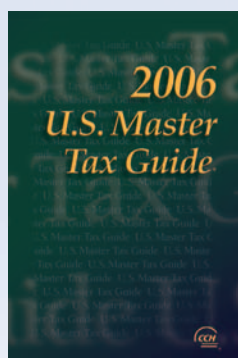
### **What's Next**

Rather than being the metaphorical deer frozen in headlights, taxpayers are hoping to have enough warning of pending changes to anticipate how they might best react. Transitional rules will be needed to minimize the windfall—and shortfall—that some taxpayers will experience from any major shift in the income tax system. The question remains how precisely those transition rules will need to be drafted.

Transitional effects would be more of an issue under the Growth and Investment Plan, so the tax Panel recommends that transition relief be provided under this plan. Transition from the current system to a dramatically different tax system has been a major concern of tax reformers from the beginning.

Taxpayers that can anticipate where the tax benefits (and traps) will appear during transition periods will be rewarded. It appears that even absent significant transition rules, most tax reform provisions will not take effect before 2007, making 2006 an extremely critical year to stay on top of proposals and structure transactions accordingly.

The crucial information you need to make the right decision every time...  
order these essential CCH federal tax resources today!



**2006 U.S. Master Tax Guide (89<sup>th</sup> Edition)**—Provides the most current updates on federal taxation changes that will affect 2005 returns. Significant new tax developments are conveniently highlighted and concisely explained for quick reference and understanding. Includes a free copy of *Top Federal Tax Issues for 2006 CPE Course*. **Price:** \$62.50 per copy. *Est. pub.:* Nov. 2005, about 864 pages. **Book #: 05956301** [Click here to order!](#)



CCH  
a Wolters Kluwer business



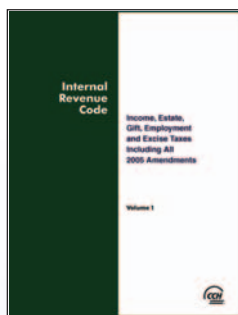
**1040 Express Answers**—*1040 Express Answers* is a spiral-bound quick reference guide designed to help you and your staff prepare 1040 returns quickly and accurately. Includes a free copy of *Top Federal Tax Issues for 2006 CPE Course*. **Price:** \$35.00 per copy. *Est. pub.:* Dec. 2005, about 500 pages, spiral bound. **Book #: 04518301** [Click here to order!](#)

**1040 Preparation and Planning Guide (2006)**—

Provides precise guidance on all the essentials of individual income tax return preparation. Includes a free copy of *Top Federal Tax Issues for 2006 CPE Course*. **Price:** \$89.00 per copy. *Est. pub.:* Jan. 2006, about 608 pages. **Book #: 05458301** [Click here to order!](#)

**Taxation of Individual Retirement Accounts, 2005**—

*by David J. Cartano, J.D.*—Provides a comprehensive analysis of all the tax laws applicable to individual retirement accounts. **Price:** \$249.00 per copy. *Pub.:* March 2005, 1,088 pages. **Book #: 05766401** [Click here to order!](#)



**Internal Revenue Code: Income, Estate, Gift, Employment and Excise Taxes, Including All 2005 Amendments**—Full, unabridged text of the complete Internal Revenue Code in two volumes. Updated to include all legislative changes through 2005. **Price:** \$92.50 per copy. *Est. pub.:* Feb. 2006, about 4,785

pages in two volumes (publishes twice each year). **Book #: 04800201** [Click here to order!](#)



**Taxes—The Tax Magazine**—

Written by top tax experts, this monthly publication provides comprehensive and insightful analysis of current tax issues, trends and legislative developments. **Price:** \$259.00 per one-year subscription. *Pub.:* monthly, about 48 pages.

**Offer #: 09510001** [Click here to order!](#)

**Federal Tax Course: A Guide for the Tax Practitioner, 2006**—*by Susan Flax Posner, J.D., LL.M.*—

This practical volume offers the knowledge and know-how to deal effectively with current developments and changes in the federal tax structure. **Price:** 239.00 per copy. *Est. pub.:* Nov. 2005, about 1,800 pages, loose-leaf binder. **Book #: 06011401** [Click here to order!](#)



**Journal of Tax Practice and Procedure**—

This CCH journal offers practical, timely analysis of current issues and trends in IRS practice, from initial contact through litigation. **Price:** \$240.00 per one-year subscription. *Pub.:* bi-monthly, about 48 pages. **Offer #: 11593001** [Click here to order!](#)

# 4 EASY WAYS TO ORDER



Mail this order form to:  
**CCH Tax and Accounting**  
 P.O. Box 5490  
 Chicago, IL 60680-9808  
 Call 1 800 248 3248

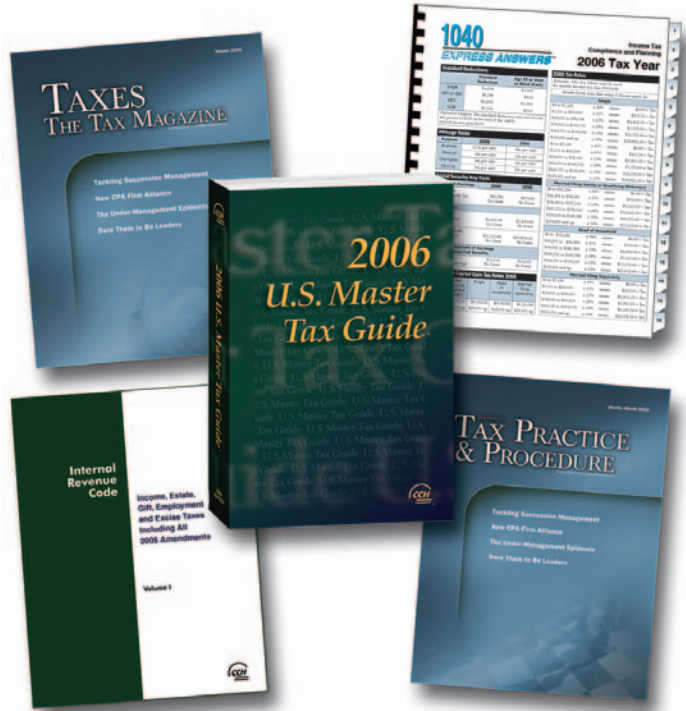


Fax your order to **1 800 224 8299**  
 Visit [Tax.CCHGroup.com/Books](http://Tax.CCHGroup.com/Books)

**YES!** Please place my order today and ship my books hot off the press!

Standing Qty. Order  Item

- 2006 U.S. Master Tax Guide (05956301)
- 1040 Express Answers (04518301)
- 1040 Preparation and Planning Guide (05458301)
- Internal Revenue Code: Income, Estate, Gift, Employment and Excise Taxes (04800201)
- 2006 Federal Tax Course (06011401)
- 2005 Taxation of Individual Retirement Accounts (05766401)
- Taxes—The Tax Magazine (09510001)
- Journal of Tax Practice and Procedure (11593001)



**YES!** Please send me new editions of the items I've checked above automatically, as they are published.

## SHIPPING INFORMATION

Name and Title \_\_\_\_\_  
 Company \_\_\_\_\_  
 Address \_\_\_\_\_  
 City, State, ZIP \_\_\_\_\_  
 E-Mail Address \_\_\_\_\_

## BILLING INFORMATION

SHIP VIA (check one):  UPS or ground parcel  First Class  
 Charge my:  VISA  MasterCard  AMEX  Discover  
 Card # \_\_\_\_\_ Exp. Date \_\_\_\_\_  
 Phone \_\_\_\_\_  
 Signature \_\_\_\_\_  
*(Required to Process Credit Card Order)*

Or charge my CCH Account  
 Customer No. \_\_\_\_\_  
*(Current CCH Customers Only — Customer No. Required)*

Applicable shipping, handling and sales/use tax will be added to each order.  
 Prices quoted apply only on the U.S. and are subject to change.