NON-INCOME TAX ISSUES AND RELATED REFORMS

Senate Finance Committee Staff Tax Reform Options for Discussion

June 20, 2013

This document is the last in a series of ten papers compiling tax reform options that Finance Committee members may wish to consider as they work towards reforming our nation's tax system. This compilation is a joint product of the majority and minority staffs of the Finance Committee with input from Committee members' staffs. The options described below represent a non-exhaustive list of prominent tax reform options suggested by witnesses at the Committee's 30 hearings on tax reform to date, bipartisan commissions, tax policy experts, and members of Congress. For the sake of brevity, the list does not include options that retain current law. The options listed are not necessarily endorsed by either the Chairman or Ranking Member.

Members of the Committee have different views about how much revenue the tax system should raise and how tax burdens should be distributed. In particular, Committee members differ on the question of whether any revenues raised by tax reform should be used to lower tax rates, reduce deficits, or some combination of the two. In an effort to facilitate discussion, this document sets this question aside.

CURRENT CHALLENGES AND POTENTIAL GOALS FOR REFORM

The federal tax code includes a number of taxes in addition to the individual and corporate income taxes, some of which are used to fund specific programs. These non-income taxes include employment taxes (such as the taxes for Social Security and Medicare), wealth transfer taxes (such as the estate and gift taxes), and a variety of excise taxes. As illustrated in the following table, together these non-income taxes raise almost as much revenue as the individual and corporate income taxes. The overwhelming portion of non-income tax revenue is derived from employment taxes.

Federal Receipts by Source, 2012 (Billions $)

Individual Income Taxes	1,132
Social Insurance and Retirement Receipts	845
Corporate Income Taxes	242
Miscellaneous Receipts	107
Excise Taxes	79
Customs Duties and Fees	30
Estate and Gift Taxes	14
Total Receipts	**2,450**

Tax reform provides an opportunity to review the federal tax system comprehensively, looking at possible improvements through changes in non-income taxes as well as the income tax. The following are some potential broad principles for reform in this area:

- Simplify the law in order to reduce the cost to businesses and individuals of complying with the tax code
- Ensure that the overall federal tax system is fair, while minimizing the negative effect of taxes on economic growth
- Carefully consider whether and how non-income tax measures should account for any positive or negative externalities

Some specific concerns about the tax system that may be addressed, at least in part, through non-income tax measures, include the following:

- **Effect of the tax system on economic disparities:** Some argue our existing payroll and wealth transfer tax rules help to perpetuate the growing gap between the wealthy and those who are not wealthy. For example, they point to the regressivity of the payroll tax and the income tax exclusion for income that is inherited. Others argue that the tax system as a whole is not a significant cause of increasing wealth disparities and should not be used to reduce these disparities because the tax code is already very progressive.

- **Failure to account for the costs of harmful externalities:** Some argue that revenue is best raised by taxing economic activity that has a harmful effect to the extent that the costs of addressing the harm is not reflected in market prices. They argue that it would help the economy to reduce existing taxes by the amount raised by new taxes on activities producing costly negative externalities, such as activities that expose the economy to systemic financial risks. Others point out that measuring and quantifying those externalities is challenging. They also argue that it is not appropriate for the tax code to attempt to shape behavior.

- **Effect of taxes on economic growth:** Some argue that broad-based consumption taxes are more efficient than broad-based income taxes because the former eliminates taxes on savings. For example, one study found that a broad-based consumption tax could increase gross domestic product by more than 9 percent in the long run, but this version of a consumption tax would be less progressive than the income tax and would not include transition relief for retirees. Others argue that broad-based income taxes can generate comparable gains in economic growth, and that broad-based consumption taxes are no more efficient if they are structured to avoid raising taxes on low- and middle-income households or on older generations.

REFORM OPTIONS

I. EMPLOYMENT TAXES

Under current law, employees and their employers, as well as the self-employed, pay taxes that fund Social Security and Medicare. The taxes on employees and employers are called FICA (for the Federal Insurance Contributions Act). The taxes on self-employed individuals, such as independent contractors, sole proprietors, and partners, are called SECA (for the Self-Employment Contributions Act). Together, FICA and SECA, along with the railroad retirement tax and the Federal unemployment tax, are called employment or payroll taxes.

The employee portion of the FICA tax has two components. The first is the old-age, survivors, and disability insurance component (called OASDI or the Social Security tax), which is 6.2% on wages up to $113,700 in 2013. The threshold of $113,700 is called the "Social Security taxable maximum" (or "wage cap") and is indexed for average-wage inflation. The Social Security tax is used to fund benefits that rise with the amount of taxes paid but not proportionately. The second portion of FICA is the Medicare or hospital insurance component (called the HI or Medicare tax), which is 1.45% on all wages. The employee portion of the Medicare tax (not the employer portion) is increased by 0.9 percent on wages over $200,000 for single filers and $250,000 for joint filers. The employer withholds these amounts from an employee's wages, and in addition to the employee's portion, the employer pays an equal amount in FICA tax on the employee's wages.

Similarly, the SECA tax has two components. The Social Security tax rate is 12.4% on self-employment income up to $113,700. The Medicare tax rate is 2.9% on all self-employment income, with an additional 0.9% tax on self-employment income over $200,000 for single filers and $250,000 for joint filers. In calculating self-employment income, a self-employed individual can deduct 7.65% of earnings, which is intended to mirror the fact that employers can deduct the portion of the FICA tax that they pay on their employees' wages.

Although not an employment tax, the Affordable Care Act established a net investment income tax on high income individuals. The tax applies at a rate of 3.8 percent to certain net investment income of individuals above $200,000 for single filers and $250,000 for joint filers.

Employers also must pay a Federal unemployment insurance employment tax (called FUTA for the Federal Unemployment Tax Act) of 0.6% of each employee's wages up to $7,000 (there is no employee portion to the FUTA tax), which is equivalent to $42 per employee per year. The FUTA tax is used to fund federal and state unemployment insurance administrative costs, as well as the federal share of the Extended Benefit (EB) program, loans to insolvent state unemployment compensation accounts, and state employment services.

Some Social Security benefits are subject to Federal income taxes. Individuals generally must pay income tax on part of their Social Security benefits if their income exceeds $25,000 for single filers and $32,000 for joint filers.

A number of employment tax options have been considered in previous papers. For example, the Types of Income and Business Entities option paper contained proposals to reform the treatment of S corporation income received in whole or in part in exchange for services. This section only includes options that were not covered in the other options papers.

1. **Increase FICA and SECA taxes**

    a. Eliminate the Social Security taxable wage cap (S.567 (113th Congress), Strengthening Social Security Act, sponsored by Sen. Harkin; S.500 (113th Congress), Keeping Our Social Security Promises Act, sponsored by Sen. Sanders; Roosevelt Institute, "Budget for a Millennial America," 2011; Testimony of Stephen Goss before the Ways and Means Committee Subcommittee on Social Security, June 23, 2011)

        i. Apply the Social Security tax to all earnings above the current taxable wage cap, either at the full 12.4% or a lower rate

b. Gradually increase the Social Security taxable wage cap over time so that the Social Security tax eventually covers 90% of national wages (National Commission on Fiscal Responsibility and Reform, "The Moment of Truth," December 2010); Domenici and Rivlin, Bipartisan Policy Center, "Restoring America's Future," November 2010)
c. Apply the Medicare tax to all income (wages, investment income and business income) (Burman and Johnson, "A Proposal to Finance Long-Term Care Services through Medicare with an Income Tax Surcharge," Urban Institute, 2007)
    i. Could be combined with repeal of the net investment income tax
d. Increase the Medicare tax rate by, for example, one percentage point (Congressional Budget Office, "Reducing the Deficit: Spending and Revenue Options," March 2011, estimated in 2011 to raise $651 billion over 10 years)
e. Apply the FICA and SECA taxes to certain employee benefits such as:
    i. Employer-provided health coverage (Domenici and Rivlin, Bipartisan Policy Center, "Restoring America's Future," November 2010; Testimony of Stephen Goss before the Ways and Means Committee Subcommittee on Social Security, June 23, 2011)
    ii. Employer contributions to retirement plans (Testimony of William Gale before the Senate Finance Committee, September 15, 2011)
    iii. Contributions to cafeteria plans and qualified transportation fringe benefits (Weller, "Building It Up, Not Tearing It Down: A Progressive Approach to Strengthening Social Security," Center for American Progress, December 2010; Joint Committee on Taxation, "Options to Improve Tax Compliance and Reform Tax Expenditures," January 2005)

2. Eliminate or reduce the FICA and SECA taxes

a. Reduce the employee portion, or both the employee and employer portions, of the Social Security tax rate by, for example, 2 percentage points (Douthat, "Our Enemy, The Payroll Tax," New York Times, November 24, 2012; S.381 (102nd Congress), Economic Growth and Jobs Creation Act of 1991, sponsored by Sen. Wallop)
b. Eliminate employment taxes for individuals age 62 or older (Antos et al., "Fiscal Solutions: A Balanced Plan for Fiscal Stability and Growth," American Enterprise Institute, May 2011)
c. Eliminate the FICA tax (McGrattan and Prescott, "On Financing Retirement with an Aging Population," Federal Reserve Bank of Minneapolis Staff Report 472, October 1, 2012)

3. **Make the Social Security tax less regressive**

   a. Lower the Social Security tax rate on wages below the taxable wage cap (Warshawski, "A Pro-Growth and Progressive Social Security Reform Proposal," Tax Notes, 2009)

4. **Eliminate employment tax exclusions for certain categories of workers**

   a. Extend Social Security and Medicare taxes to all state and local government employees (S.727 (112th Congress), Bipartisan Tax Fairness and Simplification Act, sponsored by Sens. Wyden, Coats, and Begich; Congressional Budget Office, "Reducing the Deficit: Spending and Revenue Options," March 2011, estimated in 2011 to raise about $96 billion over 10 years)
   b. Eliminate the exclusion from Social Security Tax for foreign workers with short-term U.S. visas (North, "How Employers Cheat America's Aging by Hiring Foreign Workers," Center for Immigration Studies, 2012)

5. **Simplify, clarify, and make fairer the FICA and SECA tax rules**

   a. Modify the income tax deduction for self-employment taxes to make SECA taxes economically equivalent to FICA taxes (Joint Committee on Taxation, "Options to Improve Tax Compliance and Reform Tax Expenditures," January 2005)
      i. Under current law, in calculating self-employment income, a self-employed individual can deduct 7.65% of earnings
      ii. This is intended to mirror the fact that employers can deduct the portion of the FICA tax that they pay on their employees' wages, but the current deduction is larger than necessary to provide parity with FICA
   b. Permit the IRS to require prospective reclassification of certain workers as employees (FY14 Administration Budget Proposal; estimated in 2013 to raise $9 billion over 10 years; S.2145 (112th Congress), Fair Playing Field Act, sponsored by Sen. Kerry)
   c. Treat certified professional employer organizations as employers for employment tax purposes (S.479 (113th Congress), Small Business Efficiency Act, sponsored by Sens. Grassley and Nelson)

6. **Reform the income tax treatment of Social Security and Medicare benefits**

    a. Reduce or eliminate the percentage of Social Security benefits that are subject to income tax, for example, by including no more than 50% of benefits in income (S.514 (108th Congress), Social Security Benefits Tax Relief Act of 2003, sponsored by Sen. Bunning)
    b. Provide an income tax deduction for Social Security taxes paid by employees and self-employed individuals (S.A.4008 to S.Con.Res.57 (104th Congress), sponsored by Sen. Ashcroft)
    c. Tax high-income households on part of the value of Medicare benefits (Penner, "Tax Benefits for the Elderly," Urban Institute, 2000)

7. **Improve the solvency of the state unemployment insurance trust funds**

    a. Reinstate and make permanent the 0.2 percent FUTA surtax (FY14 Administration Budget Proposal; estimated in 2013 to raise about $15 billion over 10 years)
    b. Raise the FUTA wage base and lower the net federal FUTA tax rate (low wage base States would need to increase their taxable wage base to conform to the new FUTA wage base) (FY14 Administration Budget Proposal, estimated in 2013 to raise about $51 billion over 10 years)

II. WEALTH TRANSFER TAXES

General Rules

Under current law, individuals do not pay income tax on the value of gifts or bequests received. Instead, a wealth transfer tax may be imposed on the donor of a lifetime gift or on transfers from a decedent's estate.

The wealth transfer tax system has three components: the estate tax, the gift tax, and the generation-skipping transfer (GST) tax. The estate tax is a tax imposed on certain transfers at death. The gift tax is imposed on certain lifetime transfers. The generation-skipping transfer tax is imposed on transfers to someone who is more than one generation younger than the donor (sometimes called a "skip person"). The generation-skipping transfer tax is intended to prevent the inequity of taxing wealth transfers that are made directly to, for example, a grandchild, less heavily than the same transfer if it is first made to the child who in turn transfers the funds to the grandchild.

Currently, the estate tax, generation-skipping transfer tax, and gift tax all have a top tax rate of 40%. Over their lifetime, for 2013, individuals effectively can exclude up to $5.25 million ($10.5 million for couples) in gifts and bequests they make. As a result, no tax applies until the sum of all gifts made during life and all bequests exceeds these exemption amounts, which are indexed for inflation.

Under current law, there is a separate annual exclusion from the gift tax for small gifts. In 2013, the first $14,000 ($28,000 for couples) in gifts to a given individual are not subject to the gift tax and do not count against the lifetime exemption. These amounts are also indexed for inflation.

Basis

There are special rules to calculate the "basis" of non-cash property received by gift or inheritance. Basis generally is the amount that a taxpayer uses to determine how much gain or loss the taxpayer must recognize for tax purposes when they sell an asset. Typically, basis is the amount the taxpayer paid for an asset. In the case of a gift made during the lifetime of the donor, the recipient's basis in the property received generally is the same as it was in the hands of the donor, known as "carryover basis." As a result, any gain that had not been recognized by the donor is preserved and will be taken into account when the gift is disposed of by the donee. If the donor's basis exceeds the fair market value of the property at the time of the gift, the donee's basis is limited to the fair market value for purposes of determining any subsequent loss on sale of the property.

In contrast, in the case of a bequest, the recipient's basis generally is the fair market value of the property at the time of the decedent's death. This is known as "stepped-up basis," and generally means that any gain or loss not recognized by the decedent will never be taxed. The law does not require that the recipient's basis be the same as the value reported for estate tax purposes.

Valuation

There are also special rules for valuing certain types of property. Generally, the value of property for wealth transfer tax purposes is the fair market value of the property as of the date of a gift or the decedent's death. However, taxpayers may discount the value of closely-held businesses, either if there is no active market for the business, or if the donor is transferring a minority interest in the business (sometimes referred to as "lack-of-marketability" and "minority" valuation discounts).

Taxpayers may also discount the value of real estate if it is being used in a trade or business. Fair market value typically is determined based on the highest and best use of land, regardless of the current or intended use. The "special use" valuation rules allow taxpayers who are using land in a business (such as farming) to value it based on the assumption that it will continue to be used in that business, subject to certain limits. For example, taxpayers cannot discount the value of such land by more than about $1 million. The tax benefit may also be recaptured if the heir sells the land or ceases to use it for the business within 10 years of receipt.

Liquidity

To address liquidity concerns, current law allows taxpayers to defer payment of any estate tax due on the transfer of a closely-held, active business for up to five years (called the "deferral period"), and then pay the tax, with interest, in equal, annual installments over the following ten years. In order to qualify for deferral, the closely-held active business must be worth more than 35% of the value of the estate. Under this installment provision, the law imposes a lien on the estate assets for the ten year period immediately following the decedent's death, expiring five years before the due date of the final installment payment.

Trusts

Wealth transfers can be accomplished through gifts or bequests to trusts, as well as through direct transfers. When a donor transfers wealth through a trust, the rules regarding how much tax is due, when it is due, and who is liable are complex and differ based on the type of trust.

One estate planning tool is known as a "grantor trust." A grantor trust is a trust where the person transferring wealth (the "grantor") is still treated as the owner for federal income tax purposes. Taxpayers sometimes structure these trusts so that the trust assets are treated as separate from the grantor for wealth transfer tax purposes. The gift tax then applies at the time the assets are transferred into the trust. This structure ensures that any subsequent appreciation on the trust assets is not subject to the estate or gift taxes, while allowing the grantor to pay the income taxes of the trust.

Another estate planning tool is known as a grantor retained annuity trust ("GRAT"). In a GRAT, the grantor is entitled to annuity payments from the trust assets, while other beneficiaries are entitled to any trust assets that remain thereafter (called a "remainder interest"). The gift tax applies to the value of the remainder interest of the beneficiaries at the time the assets are transferred into the trust. The value of this remainder interest is calculated using certain valuation rules in the tax code. If the beneficiaries ultimately receive more than the assumed value of the remainder interest at the time of the initial transfer, there are no further wealth transfer tax consequences. In some cases, taxpayers structure GRATs so that the remainder interest of the beneficiaries is treated as having zero value, meaning that any assets that the beneficiaries ultimately receive escape wealth transfer tax entirely.

Another type of trust is known as a Crummey trust. Crummey trusts are structured to allow the transferred assets to qualify for the $14,000 annual gift tax exclusion. In general, a gift only qualifies for the annual gift tax exclusion if the beneficiary has the right to use the property immediately (called a "present interest"). To ensure that a transfer qualifies for the exclusion, a grantor may give beneficiaries a temporary right to withdraw property. This temporary right is generally known as a "Crummey power" and has been found to satisfy the present interest requirement.

Transfers between spouses generally are not subject to wealth transfer taxes because there is an unlimited marital deduction. Trusts are sometimes used to preserve the marital deduction in situations where a surviving spouse receives less-than-full ownership of the assets. In a Qualified Terminal Interest Property Trust (or "QTIP" trust), the surviving spouse generally is given an income interest for life, with the remainder of the assets then passing to other beneficiaries. The remaining property is then included in the surviving spouse's estate upon death. If the surviving spouse disposes of part of the QTIP property (including the income interest), sometimes this triggers unintended gift taxes because the partial disposition is treated as a disposition of the entire property.

A final estate planning trust is known as a perpetual dynasty trust. In this type of trust, the grantor allocates their generation-skipping transfer tax exemption to a trust with an unlimited duration. This structure ensures that any subsequent income and appreciation on the trust assets are not subject to wealth transfer taxes.

State Wealth Transfer Taxes

Through 2004, taxpayers could claim a credit for the amount of the state wealth transfer taxes paid for purposes of calculating their federal wealth transfer tax liability. Since 2005, taxpayers have been able to deduct wealth transfer taxes paid to the states instead.

Community Property

In community property states, a surviving spouse may pay less income tax when selling inherited community property than a surviving spouse in a non-community-property state. This is because the basis in the entire property (both spouses' shares) is stepped up to fair market value at the death of the first spouse in a community property state. In non-community-property states, however, only the basis in the deceased spouse's portion of jointly owned property is stepped up to fair market value. Options for reform in this area include the following.

1. **Repeal the estate and generation-skipping transfer taxes**

    a. Repeal the estate and generation skipping transfer taxes, retain stepped-up basis for bequests, and retain the gift tax with a $5 million lifetime exemption and a 35% top tax rate (S.1183 (113th Congress), Death Tax Repeal Act of 2013, sponsored by Sens. Thune and others)

2. **Replace the wealth transfer system with an alternative wealth transfer tax system**

    a. Require the beneficiary to include gifts and bequests in income for purposes of the income tax, sometimes referred to as "income inclusion" (Testimony of Joseph Dodge before the Finance Committee, March 12, 2008)
    b. Impose an inheritance tax on the recipient of a gift or bequest (sometimes referred to as an "accessions tax"), whereby a tax is imposed on the recipient of a gift or bequest (Testimony of David Duff before the Finance Committee, March 12, 2008; Testimony of Joseph Dodge before the Finance Committee, March 12, 2008)
    c. Repeal stepped-up basis and carryover basis and tax accrued gains on gifts and bequests at the time of transfer, possibly with carryover basis or an exclusion for gains on certain assets (Dodge, "A Deemed Realization Approach is Superior to Carryover Basis (And Avoids Most of the Problems of the Estate and Gift Tax)," Tax Law Review, 2001; similar to the law in Canada)
    d. Options (a) through (c) could be coupled with an annual or lifetime exemption for a certain dollar amount of inherited assets or gains on inherited assets

3. Modify the tax rates and exemptions

a. Decrease the exemption and increase the rate for the estate, gift, and generation skipping transfer taxes
   i. Return the wealth transfer tax rates to 2009 levels, setting the top rate at 45% and the exemption at $3.5 million for the estate and GST taxes and $1 million for the gift tax (FY14 Administration Budget Proposal; estimated in 2013 to raise $69 billion over 10 years)
   ii. Return the top tax rate and exemption amount to pre-2001 levels, setting the top rate at 55%, the exemption at $1 million, and reinstating the 5% surtax on estates above $10 million (H.R.3467 (112th Congress), Sensible Estate Tax Act of 2011, sponsored by Reps. McDermott and Rangel)
b. Return the top tax rate to 35% for all wealth transfer taxes (House Amendment to Senate Amendment to H.J.Res.66 (112th Congress), the Permanent Tax Relief for Families and Small Business Act of 2012, sponsored by Rep. Boehner)

4. Reform and simplify the current wealth transfer tax system

a. Harmonize the tax rules for gifts and bequests
   i. Apply the same effective tax rate on gifts and bequests (Joulfaian, "Choosing Between an Income Tax and a Wealth Transfer Tax," National Tax Journal, 2001)
      1. Under current law, the estate tax applies to the amount transferred including the tax due, while the gift tax applies to the amount transferred excluding the amount due
      2. For example, if a donor has $140 to transfer above the lifetime exemption, the tax due under the estate tax would be $56, while the tax due under the gift tax would be $40
   ii. Apply carryover basis to bequests (Joulfaian, "Choosing Between an Income Tax and a Wealth Transfer Tax," National Tax Journal, 2001)
   iii. Require that the basis in property in the hands of the recipient for income tax purposes can be no greater than the value of the property for wealth transfer tax purposes, and require reporting to the beneficiary and the IRS (FY14 Administration Budget Proposal; estimated in 2013 to raise about $2 billion over 10 years)
b. Reform the rules for valuing assets

i. Repeal the dollar limitation on special use valuation discounts (Letter from the American Farm Bureau Federation to Ways and Means Small Business/Passthroughs Working Group , April 2, 2013)

ii. Disallow lack-of-marketability and minority valuation discounts (H.R.3467 (112th Congress), Sensible Estate Tax Act of 2011, sponsored by Reps. McDermott and Rangel)

1. For transfers of an interest in an entity which is not actively traded:

I. Treat non-business assets (e.g., passive investments) as transferred directly to the beneficiary with no valuation discounts

II. Exclude such non-business assets in determining the value of the interest in the entity

2. Disallow minority discounts where the beneficiary and family members control the entity

c. Reform the installment and deferred payment rules

i. Extend the estate tax lien to cover the entire deferral period under the installment rules (FY14 Administration Budget Proposal; estimated in 2013 to raise less than $1 billion over 10 years)

ii. Defer tax due on transfer of farm land until either the farm is sold or transferred outside of the family, or until the family stops materially participating in the farming business (S.A.4727 to H.R. 4853, The Middle Class Tax Cut Act of 2010, introduced by Sen. Baucus; S.3664 (111th Congress), Family Farm Estate Tax Deferral Act of 2010, sponsored by Sens. Feinstein, Bennet, Crapo, Nelson, and others)

iii. Repeal rules allowing for an exclusion for conservation easements, special use valuation discounts for real property, and installment payments; replace with a broader system allowing estates to defer estate tax payments for all assets until sold by heir (American Institute of CPAs, "Study on Reform of Estate and Gift Tax System," February 2001; Letter from Estate Tax Coalition to Ways and Means Committee Tax Working Group on Pensions and Retirement, April 15, 2013)

1. Limit use by adjusting interest rates and deferral periods

d. Reform rules relating to trusts

i. Limit perpetual dynasty trusts

1. Limit allocations of GST exemptions to dynasty trusts to a skip of one generation (Joint Committee on Taxation, "Taxation of

Wealth Transfers Within a Family: A Discussion of Selected Areas for Possible Reform," April 2008)

2. Require the GST tax exclusion allocated to a dynasty trust to expire after 90 years (FY14 Administration Budget Proposal; estimated in 2013 to have a negligible budgetary effect over 10 years)
3. Deny the GST tax exemption prospectively, unless the trust terminates within one of the following periods: (1) 21 years after the death of a life in being; (2) 90 years after creation; or (3) after the death of the last living beneficiary who is no more than two generations younger than the donor (Waggoner, "Effectively Curbing the GST Exemption for Perpetual Trusts," University of Michigan Program in Law and Economics, June 2012)

ii. Require that a GRAT have a minimum term of 10 years and eliminate zeroed-out GRATs (FY14 Administration Budget Proposal; estimated in 2013 to raise $3 billion over ten years)

iii. For grantor trusts, treat any property received by the trust as a result of a transaction between the grantor and the trust as part of the grantor's estate, subject to the gift tax if the grantor ceases to own the trust while alive, and as a gift if distributed to another person during the grantor's life (FY14 Administration Budget Proposal; estimated in 2013 to raise $3 billion over 10 years)

iv. Limit the use of Crummey powers to qualify a transfer for the gift tax annual exclusion (Joint Committee on Taxation, "Options to Improve Tax Compliance and Reform Tax Expenditures," January 2005)

v. Modify the QTIP rules (Klomparens and deLeo, "Proposed Changes to Internal Revenue Code Section 2519," State Bar of California Taxation Section, 2011)

1. When surviving spouse partially disposes of QTIP property, apply the gift tax to the partial disposition rather than the entire property
2. Allow a good faith appraisal so that surviving spouse is not penalized by unintended gift taxes should assets in trust be sold for below fair market value

e. Allow donors to elect to pre-pay the estate tax at a discounted tax rate rather than the estate paying at the individual's death (Sen. Cantwell, "Statement on Estate Tax," February 2010)

5. Miscellaneous simplification reforms

a. Change the unified credit to a unified exemption (American College of Trust and Estate Counsel, "Talking points for Congressional Staff Members," October 2012)
b. Do not require that the election for portability be made on an estate tax return (The American College of Trust and Estate Counsel, "ACTEC Comments on Notice 2011-82," October 2011)
    i. Current law allows the decedent's estate to elect to transfer any unused exemption to the surviving spouse by filing an estate tax return, which is known as portability
c. Expand extensions to more missed elections (The American College of Trust and Estate Counsel, "Comments regarding…Elections and Certain Late Qualified Revocable Trust Elections," April 2013)
    i. Generally, the tax law requires that elections be made by certain deadlines, although the IRS may grant extensions for making an election
d. Treat the basis of community property in the same manner as property held in non-community property states by allowing the transfer of community property to receive a step-up in basis for only the decedent's half of community property, instead of a full step-up in basis for the decedent's half and the surviving spouse's half (Ware, "Section 1014(b)(6) and the Boundaries of Community Property," Nevada Law Journal, 2005)
e. Convert the deduction for state estate taxes into a credit (Thiessen, "The Death of State Death Tax Credit: Can it be Resuscitated?" Marquette Elder's Advisor, 2009)

III. EXCISE TAXES

A number of excise tax options have been considered in previous papers. For example, the Infrastructure, Energy, and Natural Resources options paper contained proposals to reform excise taxes used to fund infrastructure-related trust funds and to establish a tax on carbon emissions. The Economic Security options paper contained proposals to modify the excise taxes on medical devices and high-premium health insurance plans, and to establish or modify excise taxes on sugary beverages, tobacco, alcohol, and marijuana. The Tax-Exempt Organizations and Charitable Giving options paper included proposals establishing or modifying excise taxes on certain tax-exempt organizations and private foundations. This section only includes options that were not covered in the other options papers.

1. **Introduce a securities transactions excise tax** (Tobin, "On the Efficiency of the Financial System," Lloyds Bank Review, 1984)

    a. Tax financial instruments (including stocks, bonds, and other debts) at a rate of, for example, 0.03% of their fair market value where the security is either cleared through a U.S. exchange or where any party to the security is a U.S. person (S.1787 (112th Congress), Wall Street Trading and Speculators Tax Act, sponsored by Sen. Harkin; estimated in 2011 to raise $352 billion over 9 years)
    b. Tax stock transactions at, for example, 0.1% of their fair market value, and tax derivatives and similar instruments at, for example, 0.01% of the value of the instruments involved in the transaction (H.R.4191 (111th Congress), Let Wall Street Pay for the Restoration of Main Street Act, sponsored by Rep. Defazio; similar to the European Commission scheme being implemented in certain EU countries)

2. **Prohibit the Treasury Department from assisting foreign governments in enforcing taxes on securities transactions occurring on a U.S. exchange** (Protect American Investment Act of 2013, to be introduced by Sen. Roberts)
    a. Treasury does not currently assist in collecting securities transactions taxes of other countries

3. **Impose a levy on large financial institutions**

    a. Could be based on covered liabilities (FY14 Administration Budget Proposal; estimated in 2013 to raise $49 billion over 10 years)
        i. Covered liabilities is risk-weighted assets of the firm less its Tier 1 capital, FDIC insured deposits, and certain loans to small business
        ii. Reduced rate applies to more stable sources of funding, including long-term liabilities
        iii. Applies only to U.S. based financial firms with at least $50 billion in assets and to U.S. subsidiaries of foreign based financial firms with assets in excess of $50 billion.
    b. Could be based on cash flows (Shaviro, "The Financial Transactions Tax vs. The Financial Activities Tax," Tax Notes, March 2012)

4. **Enact or increase sin taxes**

    a. Increase excise taxes on sales of guns and ammunition (H.R.793 (113th Congress), Firearm Safety and Buyback Grant Act of 2013, sponsored by Rep. L. Sanchez; Dwyer, "If Guns Do Not Kill, Tax the Bullets," New York Times, August 9, 2012)
    b. Tax video slot machines at, for example, $1,000 per machine (Cook County Illinois Board President Budget Proposal, 2012)
    c. Impose a 5% tax on all wagering (H.R.2800 (104th Congress), Education Trust Fund Act, sponsored by Rep. Fields of Louisiana)
    d. Legalize and tax all drugs (Miron and Waldock, "The Budgetary Impact of Ending Drug Prohibition," Cato Institute, 2010)

5. **Repeal all sin taxes**

    a. Repealed taxes would include taxes on cigarettes, alcoholic beverages, gasoline, and bullets (Williams and Crist, "Taxing Sin," Mercatus on Policy, 2009)

6. **Enact a tax on the value of land** (Testimony of James K. Galbraith to the Finance Committee, March 8, 2011; Friedman, Interview, the Times Herald, December 1, 1978)

7. **Modify the rum excise tax transfer ("cover-over") to the United States Virgin Islands and Puerto Rico, and limit the total amount of direct or indirect government assistance to rum producers** (S.986, (112th Congress), Investing in U.S. Territories, Not Corporations Act, sponsored by Sens. Menendez, Nelson and Rubio)

IV. CONSUMPTION TAXES

A consumption tax is a tax on income devoted to consumption, essentially taxing consumers on the money they spend on goods and services. In comparing income and consumption taxes, the most important difference is that a consumption tax eliminates the tax on savings. Consumption taxes generally place greater overall burdens on lower-income households than do income taxes because lower-income households tend to save less of their income than higher-income households do. There are, however, ways to design a consumption tax to mitigate the impact on lower-income households.

Consumption taxes commonly take the form of a retail sales tax or a value added tax (VAT). A retail sales tax is a consumption tax levied only at a single stage of production, the retail stage.

The retailer collects a specific percentage markup in the retail price of a good or service, which is then remitted to the tax authorities. Most states have a retail sales tax; however, most countries with consumption taxes, have implemented a VAT instead. Retail sales taxes create enforcement issues because taxpayers can avoid the tax by claiming to be a wholesaler.

A VAT is a tax on exchanges. A VAT is a tax, levied at each stage of production, on the value that businesses add to the goods and services they purchase from other businesses. The value added by a business is the difference between a business' sales and purchases of inputs from other businesses. A VAT is collected by each business at every stage of production. It differs from a retail sales tax only in the sense that is collected in parts along the chain of production rather than all at once at the retail level.

There are two traditional methods of calculating a VAT: the credit-invoice method and the subtraction method. Under the credit-invoice method, businesses apply the VAT rate to their sales but claim a credit for VAT paid on purchases of inputs from other businesses (shown on purchase invoices). The difference between the VAT collected on sales and the credit for VAT paid on input purchases is remitted by the business to the government. Under the subtraction method, a business subtracts the full amount of the cost of their inputs (including the VAT) from their sales, and then pays the VAT on the difference. To the extent the VAT would not be collected on exports, some have raised concerns over whether the subtraction method would be compliant with World Trade Organization rules with respect to that treatment. Most countries use the credit-invoice method. Options for reform in this area include the following.

1. **Enact a consumption tax, while preserving the income tax and employment taxes** (Domenici and Rivlin, "Restoring America's Future," Bipartisan Policy Center, November 2010; Sen. Cardin, "Deficit Medicine: A VAT Tax and a Line Item Veto," Baltimore Sun, 1989; Testimony of Pamela F. Olson before the Finance Committee, March 1, 2011; Testimony of Fred T. Goldberg, Jr. before the Finance Committee, March 1, 2011; Congressional Budget Office, "Reducing the Deficit: Spending and Revenue Options," March 2011, broad-based VAT estimated in 2011 to raise $2,500 billion over 10 years at a 5% rate)

    a. Implement a flat-rate VAT on most sales of goods and services (similar to the law in Canada)

        i. Design issues include:

            1. Whether to adopt the credit-invoice method or subtraction method

        2. Whether to "border adjust" by applying to imports but not to exports
        3. Whether to exempt certain goods and services, such as food staples and health care, or provide a refundable tax credit, in order to reduce the burden on low- and middle-income households and retired and disabled individuals
        4. Whether to make corresponding adjustments to the Social Security tax and benefit rules
    ii. Could be coordinated with state and local sales taxes, as with the Canadian system (Stuckey and Yong, "A Primer on Federal Consumption Taxes," Library of Parliament Research Publications, 2011)
b. Implement a progressive consumption tax (Andrews, "A Supplemental Personal Expenditure Tax," What Should be Taxed: Income or Expenditure?, 1980; Grinberg, "Implementing a Progressive Consumption Tax: Advantages of Adopting the VAT Credit-Method System," National Tax Journal, 2006)
    i. Allow individuals to immediately deduct all net amounts saved or invested, while disallowing all deductions for interest
    ii. Enact a credit-invoice method VAT coupled with a business-level credit for the VAT due on wages paid
        1. Tax all compensation of individuals above a large standard deduction amount at progressive tax rates
c. Could use revenue from the consumption tax to reduce proportion of households or businesses that owe income tax or the amount of income tax owed (Graetz, "100 Million Unnecessary Returns," Yale University Press, 2010)
    i. Implement a flat-rate VAT of, for example, 15%
    ii. Increase the income tax standard deduction to, for example, $100,000, and tax individual income above that amount at graduated rates up to, for example, 25%
    iii. Reduce the corporate income tax rate to, for example, 15%
    iv. Replace the earned income tax credit with payroll tax offsets, designed to offset the VAT's burdens on low-income families
d. Could use revenue from the consumption tax to reduce income tax or FICA and SECA tax burdens (Viard, "Responding to VAT: Concurrent Tax and Social Security Reforms," American Enterprise Institute, 2011; Toder and Rosenberg, "Effects of Imposing a Value-Added Tax to Replace Payroll Taxes or Corporate Taxes," Tax Policy Center, 2010)

2. Replace the income tax with a consumption tax

a. Replace the income tax with a national retail sales tax coupled with a rebate for low-income families (sometimes referred to as the "Fair Tax") (S.122 (113th Congress) The Fair Tax Act of 2013, sponsored by Sen. Chambliss)
   i. Implement retail sales tax of, for example, 30% tax on nearly all goods and services
   ii. Provide all families a monthly "pre-bate" of, for example, \$500 for a two adult household with one child
b. Replace the income tax with a multi-stage, progressive consumption tax, such as a VAT
   i. Enact a subtraction method VAT but allow businesses to deduct wages and other compensation for services
      1. Tax all compensation of individuals above a large standard deduction amount at a flat tax rate of, for example, 20%, sometimes referred to as the "Flat Tax" (S.1040, 110th Congress, Tax Simplification Act of 2007, sponsored by Sen. Shelby; Hall and Rabushka, The Flat Tax, 2007)
      2. Tax all compensation of individuals above a large standard deduction amount at progressive tax rates, sometimes referred to as the "X-Tax" (Bradford, "The X-Tax in the World Economy," 2004; Carroll and Viard, "Progressive Consumption Taxation: The X-Tax Revisited," 2012)

   ii. Enact a credit-invoice method VAT coupled with a business-level credit for the VAT due on wages paid (Grinberg, "Implementing a Progressive Consumption Tax: Advantages of Adopting the VAT Credit-Method," National Tax Journal, 2006)
      1. Tax all compensation of individuals above a large standard deduction amount at progressive tax rates
c. Convert the income tax into a cash-flow consumption tax (S.722 (104th Congress) USA Tax Act of 1995, sponsored by Sens. Domenici and Nunn; Andrews, "A Consumption-Type or Cash Flow Personal income Tax," Harvard Law Review, 1974; McCaffrey, Fair Not Flat: How to Make the Tax System Simpler and Better, 2002)
   i. Allow individuals and businesses to immediately deduct all net amounts saved or invested
   ii. All net income that is not saved is taxed as ordinary income

    iii. Disallow all deductions for interest
    iv. Could apply to individuals and businesses or to individuals alone

d. Could couple consumption tax with a constitutional restriction to increasing the consumption tax without 2/3 of each chamber of Congress voting for such an increase (Section 13, Article 11 of the Constitution of the State of South Dakota)

3. Replace employment taxes with a consumption tax

a. Replace the Medicare tax with a VAT (Viard, "Responding to VAT: Concurrent Tax and Social Security Reforms," American Enterprise Institute, 2011; Burman, "A Blueprint for Tax Reform and Health Reform," Virginia Tax Review, 2008)