Individual Tax Reform

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Input for the Senate Finance Committee Working Group on Individual Income Tax

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The following suggestions are offered to make the tax system better follow principles of good tax policy and reflect today's ways of living and doing business. For additional details and ideas, please see reports and testimony at http://www.21stcenturytaxation.com/Federal.html.

1. If any education incentives remain in the law, define education broadly.

   If education benefits are to be retained in the tax law, they should not only address higher education (college) but also formal job training programs, and costs of continuing education to maintain job skills or retool for a new job or career.

2. Support modern entrepreneurship

   Several trends indicate that workers today are more likely to be self-employed, telecommute or work in their home, and have continual needs for new technologies (such as for hardware and software). Many existing tax rules though, work contrary to support these trends. For example, worker classification rules are unclear causing some employers to label all workers as employees, making it difficult for a self-employed entrepreneur to succeed. Strict home office deduction rules, particularly the exclusive use requirement, make it almost impossible for workers and self-employed individuals to qualify for the deduction. Thus, they are not able to properly calculate true taxable income because some valid business expenses are not deductible.

   Additional reforms should be considered to help young people obtain initial funding to start a business. For example, existing tax rules could be modified to provide incentives for established businesses to donate to entrepreneur grant programs where individuals could submit business plans with the hope of being awarded a tax-free start-up grant. The reforms to help fund such grant programs could come from a lowered tax rate on

[1] This URL is to a website maintained by Annette Nellen for the purposes of promoting modernization of tax systems and consideration of the principles of good tax policy, with opportunity for readers to post comments. Views represented at this website and in this submission are Professor Nellen's views only and may not represent those of her employer or professional organizations of which she is a member.

repatriated earnings that go into the fund, or an enhanced charitable contribution deduction for donations to such grant programs.

3. Improve retirement savings provisions

   Bring greater equity to retirement savings rules and better enable young people to save for retirement. Possible approaches include:

   - A simple system to enable all workers (employees and self-employed individuals) to have a retirement savings account. This should occur for both part-time and full-time workers and even if an employer does not help with administration or contributions.
   - Retirement savings contributions should be coordinated with payroll tax deductions. A system to enable self-employed individuals to also make contributions along with self-employment tax payments should be considered.
   - Find ways to help individuals improve their financial literacy.
   - Portability. Be sure the system allows for contributions to be made to one account even if a worker changes employers or also has income from self-employment.

     Example of a new approach: The first time an individual receives a W-2 or pays self-employment tax (whichever happens first), the government could set aside a set dollar amount in a retirement account for that person. This would constitute the start of their retirement account that would be used for all future contributions; there would be only one account. When the individual works for an employer who also wants to contribute to employee retirement accounts, such funds are placed in the individual's existing account. Also, for each paycheck or quarterly estimated tax payment of a self-employed individual, an amount would be contributed to their retirement account. Individuals could be allowed to transfer their retirement account to a commercial broker for management or let it stay with the federal government. The federal government could be allowed to transfer management to third parties for a fee.

     Annual reporting would be required to let individuals know their account balance and other details. Rules would continue to exist, but in more simplified form, governing how much could be contributed annually, how much employers could also contribute, the age when distributions may begin, hardship withdrawals, etc.

     Benefits of this type of approach:

     - All individuals who work would have a retirement account. This single account would be used whether they are an employee or sole proprietor or both.
     - The initial contribution from the government ensures that all workers start a retirement account.
     - The initial contribution from the government may also encourage individuals to be tax compliant from the start of the time they begin earning money.
     - The system ties to payroll tax withholding and so should not be burdensome to any size employer since they already are required to comply with payroll tax rules.

- For low-income workers, the annual contribution could be made via part of the earned income tax credit (EITC) the worker receives.

4. Itemized deductions for home ownership

   Greater equity is needed such as by some combination of (a) reducing the current generous deductions for home ownership to allow for lower rates for everyone, and (b) spreading the cost of these expenditures over a larger group of individuals, particularly for those who truly need assistance to purchase a home. Today's mortgage interest rules favor high income individuals. Research indicates that the rules mostly serve to enable higher income individuals to buy a more expensive home. Also, home ownership rates in the U.S. are similar to those of other industrialized countries (such as the UK and Canada) that don't have these tax subsidies.

   Suggestions:

   - Phase-out the deduction for mortgage interest on home equity debt.
   - Phase-out the deduction for mortgage interest on a second home (there is no reason for the tax law to support ownership of a second home or debt to acquire such a home).
   - Phase-down the deduction for real estate taxes on a home to only allow what property taxes would be in that state on one moderate size home. If an individual wants to and is able to own several homes or just one large home, there is no reason for the government (other taxpayers) to subsidize the property tax expenses on the excess living arrangements.
   - Use part of the savings for a first-time homebuyer credit for low-income individuals.

5. Greater equity for health insurance costs

   The best tax deal is employer-provided health insurance because the employee avoids both income and payroll taxes on what their employer pays. This is the largest tax expenditure in the tax system. It only benefits the roughly 60% of individuals with this type of coverage. In 2014, the Premium Tax Credit was added for individuals without employer-provided health insurance. The PTC is not as generous as the employer-provided health coverage rule. For example, once an individual's income exceeds 400% of the Federal poverty line, they lose their PTC. In contrast, regardless of income level, an employee will not lose any tax benefit of the exclusion for employer-provided health insurance.

   Suggestions:

   - Better equalize the tax benefits of all health coverage. This might include taxing a percentage of the employer-provided health exclusion (perhaps 15%). Or, the exclusion could be converted to a credit.
   - Remove the cliff from the PTC and instead use a more gradual phase-out. But, for greater equity, do the same for the employer-provided health coverage exclusion (and convert it to a credit).

6. Review all fringe benefit provisions to determine how greater equity and simplification can be achieved. There is no reason, for example, for some employees to get free lunch while others do not. The exclusion for meals provided for the convenience of the employer should not be allowed for individuals not involved in public safety or who make above minimum wage.
7. Repeal the Net Investment Income Tax (Section 1411) – it is too complex and reduces transparency as to an individual's true tax rate.
8. Repeal the AMT – this will simplify compliance. Also, there should be just one minimum tax (and that should be the regular tax).
9. Repeal the kiddie tax. It is too complex, violates the transparency principle and, with lower rates, is not needed.
10. Create a rule similar to Section 988(e) to allow individuals with a small amount of virtual currency to not always have to track its tax effects.
11. Eliminate the use of longstanding, temporary rules.
12. Tax administration changes to help individuals

    Suggestions:

    - Find ways to use today's technology to simplify compliance. Filing most individual returns should be as simple as ordering from Amazon.com.
    - Modify 31 U.S.C. Section 330 to allow the IRS to regulate all paid return preparers including to require compliance with specified ethical standards and continuing education requirements. This will better ensure individuals get better tax assistance.
    - Review all penalty provisions with objective of reducing the number.