Agriculture & Business Management Notes ..

Colorado State University Extension

An Overview of Four Concepts For Tax Reform

Quick Notes...

Tax revenues are one source of funding for the government.

Tax reform inherently involves value-laden questions. A change to existing tax law may be fair and desirable for one group, yet unfair and undesirable to another group.

Lawmakers, policy analysts, and private citizens are debating four concepts for generating revenues for the U.S. government: (1) a value-added tax, (2) a national sales tax, (3) the "10%" tax, and (4) a flat tax.

Tax policies are always changing and the impact of those policies affects individuals differently. People should carefully review their individual financial situations before making any decisions regarding tax legislation or liabilities. Professional counsel should be sought to answer questions and clarify specific issues.

No one likes to pay taxes, but tax revenues are needed to pay for the services provided by government. Any modification to the current tax law which reduces income to the federal government from one source must be offset with increased tax revenues from other sources and/or decreased government spending.

Tax reform inherently involves questions of fairness and equity. Changes to existing tax laws that are considered desirable and fair by one group may be deemed undesirable and unfair. The reforms favored by an individual depends on that person's level of income, income sources, wealth, spending and saving patterns, and family issues.

Part of what makes tax reform politically complex is that each alternative results in winners and losers--that is, some people are better off once the reform is implemented while others are worse off.

Some people may want certain federal programs to continue as currently funded, and thus, would oppose any tax reforms which jeopardize future funding of these programs. For others, it may be critical that tax rates be kept as low as possible. The current system taxes income. Other revenue generating concepts favor taxing consumption.

Tax Reform Ideas

The existing tax code is continually being changed with new legislation. Different interpretations of the laws by the Internal Revenue Service and Tax Courts make the application of the code more complex.

Tax reforms being debated by lawmakers, policy analysts, and citizens usually involve systematic and fundamental changes to the

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methods in which government generates revenue. Four such concepts are a: (1) value-added tax; (2) national sales tax; (3) "10%" tax; and (4) flat tax. Other reform proposals combine various aspects of these ideas and the current tax system.

Value-Added Tax. A value-added tax (VAT) is a tax levied on the increased value of an item at each stage of the process to becoming a consumable good or service. Several European countries have been relying on various forms of a VAT as a major source of revenue for decades.

A VAT may appear to simply be a national sales tax that increases prices at the retail level. However, unlike a sales tax that is levied only at the retail level, a true value-added tax is levied at each stage in the production process.

For example, a farmer would pay a tax based on the value of wheat produced less the cost of the inputs (value added by the farmer). A miller would pay a tax for converting the wheat into flour based on the difference between the value of the flour and the value of the wheat (miller's value added). A baker would pay another tax based on the increased value of the flour when converted into bread. Finally, the grocer would pay a tax based on the difference between the wholesale and retail values of the bread.

A value-added tax has the effect of increasing prices of goods and services at the retail level. Since low income earners tend to spend a larger share of their incomes and save less, a value-added tax would likely fall more heavily on the poor than the current income tax structure. By exempting certain goods, such as food from the tax, the impact on the poor can be reduced.

The political problem becomes one of determining which goods and services should be exempt from the tax. Since goods and services are more expensive with a value-added tax, this approach applied nationally has the economic impact of discouraging consumption while increasing savings.

There is no current legislation being considered that proposes to replace the existing tax code with a VAT.

National Sales Tax. A national sales tax (NST) is a single rate tax on the purchase of goods and services at the retail level. To protect against "cascading" effects – imposing multiple levels of taxation on the same product – sales tax policies typically exempt inputs at intermediate stages of production from a tax.

A NST, like a value-added tax, tends to increase the prices of retail goods and services. To reduce the impact of higher prices on the poor, certain goods (such as food) could be exempt from the tax.

Representatives Dan Schaefer and Billy Tauzin sponsored legislation (H.R. 3039) proposing to replace the current tax code with a national sales tax. It would replace all revenues from individual and corporate income taxes, transfer taxes, and most non-trust-fund excise taxes. A few key features of this legislation are:

- A 15 percent sales tax on the final purchase of goods and services at the retail level.
- An annual rebate exempting consumption up to a specified level – $18,588 for a family of four.
- Reimbursement to states and retailers of the cost of collecting the national sales tax.
- Abolition of the Internal Revenue Service. States would bear the primary responsibility for administering the NST. The Social Security Administration would enforce and collect payroll taxes.

Under H.R. 3039, most individuals who are not business owners nor self-employed would no longer have to file tax returns. Business-to-business purchases would be exempt from tax.

Vendors would simply need to keep on file copies of purchasers' exemption certificates. Retailers would be required to determine the sales that they made to consumers. Furthermore, the NST would eliminate the alternative minimum tax, multiple depreciation schedules, complex international tax provisions, complex pension and deferred compensation rules, and uniform capitalization rules.

10 Percent Tax. The "10 percent tax" is a proposal to amend the current federal tax code with different marginal tax rates and the elimination of many deductions, credits, exclusions, and adjustments. Representative Dick Gephardt sponsored H.R. 6320 which legislates the 10% Tax.

Income would include the same revenue sources as the current law with certain exclusions (state and local tax refunds) and inclusions (tax exempt interest, fringe benefits other than health insurance, and employer pension contributions). Adjustments to net revenues would include alimony paid, a portion of self-employment tax, penalties on early withdrawals from IRA's, investment interest, and job related expenses. Credits would also be limited.

Standard deductions would be $9,000 for people married and filing jointly, $6,600 for filers that are heads of households, and $4500 for single filers. The proposed personal exemption is $2900.

Marginal tax rates would begin at 10% and increase to 20%, 26%, 32%, and 34% depending on the tax payer's level of taxable income. (See Table I for more detail.)

Table I. Marginal tax rates on taxable income within the "10% Tax" proposal.

Marginal Tax Rates
Marginal Tax Rate of 10%: Married: $0-46,000 Head of Household: $0-32,000 Single: $0-23,000
Marginal Tax Rate of 20%: Married: $46,000-80,000 Head of Household: $32,000-40,000 Single: $23,000-40,000
Marginal Tax Rate of 26%: Married: $80,000-150,000 Head of Household: $40,000-75,000 Single: $40,000-75,000
Marginal Tax Rate of 32%: Married: $150,000-275,000 Head of Household: $75,000-137,500 Single: $75,000-137,500
Marginal Tax Rate of 34%: Married: Income over $275,000 Head of Household: Income over $137,500 Single: Income over $137,500

Flat Tax. A flat tax is a single rate tax on earned-income with no deductions. By eliminating the deductions common to the existing tax code, thus broadening the taxable income base, the flat tax rate is lowered while retaining the same amount of revenue. To the extent that popular deductions are included in a flat tax policy, the flat tax rate would need to be higher on all individuals. Also, by exempting a portion of income from taxation, there would be a reduced negative impact on people having low incomes.

Representative Dick Armey and Senator Richard Shelby, have proposed legislation (H.R. 1040 and S. 1040, respectively) that repeals the current tax code and replaces it with a single rate income tax. Key features include:

- Individuals pay 17% of all wages, salaries, and pensions after subtracting personal allowances.

- Personal allowances for individuals would be $11,600 for single filers; $23,200 for married people filing jointly; and $5,300 for each dependent child.

- Businesses would pay 17% of the difference, if positive, between revenues and expenses. Expenses are defined as purchases of goods and services, capital equipment, structures, land, wages, and contributions to employee retirement plans. No deductions would be allowed for fringe benefits, interest or payments to owners.

- There would be an immediate expensing of all capital purchases.

- There would be no estate tax nor capital gains tax.

- A supermajority (three-fifths vote of the Members of the U.S. House of Representatives) would be required to increase the tax rate, reduce the standard deductions or provide any exclusions, credits, etc.

Comparison of the "10% Tax" and the "Flat Tax" Proposals

Following are four simplistic comparisons of the two income tax proposals currently being discussed in the U.S. Congress – "10% Tax" and "Flat Tax." There is no current legislation regarding a VAT and the NST proposal is not a tax on income; hence, they are not included in the comparison.

The "10% Tax" and "Flat Tax" proposals are compared using five case scenarios developed by ABM economists at Colorado State University. The families and their business operations are fictional, but the information represents typical scenarios in Colorado.

Tables II lists the standard deductions and personal exemptions for 1998 under the current tax code. Table III shows the income tax schedules for 1998 for married people filing a joint return.

Table II - Standard deductions and personal exemptions allowed by existing tax code.

	1998
Standard Deduction (MFJ)	7,100
Personal Exemptions (per person)	2,700
Level of Adjusted Gross Income (at which personal exemptions begin to phase out)	186,800
Additional exemption amounts for persons greater than 65 of age or blind.	850

Table III. Income tax schedules for 1998 for married people filing joint returns.

Year	Income Range		Tax (on base amount)	Percent Tax
1998	0 -	42,350	0 +	15%
	42,351 -	102,300	6,353 +	28%
	102,301 -	155,950	23,139 +	31%
	155,951 -	278,450	39,770 +	36%
	278,451 -		83,870 +	39.6%

Additional assumptions were made by the authors to simplify the analyses:

1. No cases had net operating losses (NOL) carried forward nor back;

2. No family had itemized deductions exceeding the standard deduction; and

3. IRA contributions were made only when the family could take advantage of the entire $4,000 contribution; i.e., phase-out amounts were ignored.

Conclusion. The comparisons of the two tax proposals with the existing tax code suggest that each proposal benefits different groups of people. In all but one case, the proposed changes caused lower tax liabilities than did the existing tax code.

Interest is a primary factor in determining which tax proposal is advantageous. Business interest expense is a deductible business expense under the current tax code and the 10% Tax proposal. This causes business profits to be lower, and thus, a lower federal tax liability. Business interest expense is not deductible in the Flat Tax proposal.

Conversely, interest income is not considered as taxable income in the Flat Tax proposal. It is considered taxable under the current tax code and 10% Tax proposal. Hence, people with high levels of interest income would pay fewer taxes with a Flat Tax than under either the current tax code or the 10% Tax.

The "10% Tax" proposal tends to benefit those people (married filing a joint return) having less than $46,000 of taxable income. The marginal tax rate increases from 10% to 20% at this level of taxable income. Income, under the "10% Tax" proposal, is adjusted by 50% of self-employment tax which in turn reduces taxable income.

The "Flat Tax" proposal tends to benefit those people having businesses with capital sales and purchases. Money spent to purchase a capital asset is considered an immediate deduction – no depreciation. Since there are no capital gains under this proposal, the revenues generated by capital sales is not included with taxable income. For people having taxable income exceeding $46,000, the Flat Tax is preferable to the 10% Tax. This is the point at which the marginal tax rates remain at 17% under the Flat Tax but increase to 20% or more under the 10% Tax.

Readers should carefully consider their individual situations and seek professional counsel before drawing any final conclusions.

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Wheatland Family. Mr. and Mrs. Wheatland have a sole proprietorship farming operation in southeastern Colorado which produces primarily wheat and weaned calves. They are 61 and 60 years of age, respectively, and have no dependent children. Their taxable income was $10,500 in 1997, $5,050 in 1996, and $29,266 in 1995.

Table IV-1. An estimation of the Wheatland Family's federal tax liability for 1998.

	Current Code	10% Tax Proposal	Flat Tax Proposal
Farm income	286,865	286,865	289,835
Farm operating expenses (excluding interest)	187,642	187,642	187,642
Depreciation			
Pre-1998 purchases	35,200	35,200	35,200
Current year "write-offs" (Sect. 179, etc.)	690	690	25,400
1998 purchases	18,500	18,500	n/a
Interest paid	0	0	n/a
Farm profit/loss	44,833	44,833	41,593
Wages and salaries	0	0	0
Interest income and dividends	1,253	1,253	n/a
Capital gains/losses	2,970	2,970	n/a
Total income	49,056	49,056	41,593
IRA contributions (deductible)	4,000	n/a	n/a
50% self-employment taxes	3,168	3,168	n/a
45% self-employed health insurance	2,295	2,295	n/a
Adjusted gross income	39,593	43,593	41,593
Standard/itemized deductions	7,100	9,000	23,200
Personal exemptions	5,400	5,800	n/a
Taxable income	27,093	28,793	18,393
Federal income taxes	4,064	2,879	3,127
Federal income tax savings if farm income averaging is optimized	0	n/a	n/a
Self-employment taxes	6,335	6,335	5,877
Total Federal Tax Liability	**10,399**	**9,214**	**9,004**

Feeder Family. Mr. and Mrs. Feeder have a sole proprietorship farming operation in northeastern Colorado which produces corn and alfalfa and custom feeds cattle. They are 46 and 47 years of age, respectively, and have no dependent children. Mr. Feeder is quite active in various farm organizations. Their taxable income was $48,284 in 1997, <$59,987> in 1996, and $109,576 in 1995.

Table IV-2. An estimation of the Feeder Family's federal tax liability for 1998.

	Current Code	10% Tax Proposal	Flat Tax Proposal
Farm income	837,000	837,000	837,000
Farm operating expenses (excluding interest)	637,807	637,807	637,807
Depreciation			
Pre-1998 purchases	23,810	23,810	23,810
Current year "write-offs" (Sect. 179, etc.)	18,500	18,500	26,080
1998 purchases	758	758	n/a
Interest paid	38,300	38,300	n/a
Farm profit/loss	117,825	117,825	149,303
Wages and salaries	0	0	0
Interest income and dividends	0	0	n/a
Capital gains/losses	0	0	n/a
Total income	117,825	117,825	149,303
IRA contributions (deductible)	n/a	n/a	n/a
50% self-employment taxes	5,960	5,950	n/a
45% self-employed health insurance	n/a	n/a	n/a
Adjusted gross income	111,875	111,875	149,303
Standard/itemized deductions	7,100	9,000	23,200
Personal exemptions	5,400	5,800	n/a
Taxable income	99,375	97,075	126,103
Federal income taxes	22,320	15,840	21,438
Federal income tax savings if farm income averaging is optimized	980	n/a	n/a
Self-employment taxes	11,899	11,899	21,096
Total Federal Tax Liability	**33,239**	**27,739**	**42,534**

Ranchette Family. Mr. and Mrs. Ranchette are transplants from California who wanted out of the rat race. Neither of them have an agricultural background, but they are willing to learn. Their goal is to establish a viable truck farm and/or horse operation which allows one or both of them to quit their "city" jobs. Their plans are to grow wine grapes on the land currently in alfalfa and to raise Morgan horses for show. They currently own two horses. Mr. Ranchette is 42 years of age, and Mrs. Ranchette is 40. They have one son (age 15) and one daughter 9 (age 10).

Table IV-3. An estimation of the Ranchette Family's federal tax liability for 1998.

	Current Code	10% Tax Proposal	Flat Tax Proposal
Farm income	700	700	700
Farm operating expenses (excluding interest)	3,020	3,020	3,020
Depreciation			
Pre-1998 purchases	1,253	1,253	1,253
Current year "write-offs" (Sect. 179, etc.)	0	0	0
1998 purchases	0	0	0
Interest paid	1,070	1,070	n/a
Farm profit/loss	<4,643>	<4,643>	<3,573>
Wages and salaries	96,000	96,000	96,000
Interest income and dividends	0	0	0
Capital gains/losses	0	0	0
Total income	91,357	91,357	92,427
IRA contributions (deductible)	0	0	0
50% self-employment taxes	0	0	0
45% self-employed health insurance	n/a	n/a	n/a
Adjusted gross income	91,357	91,357	92,427
Standard/itemized deductions	7,100	9,000	23,200
Personal exemptions	10,800	11,600	10,600
Taxable income	73,457	70,757	58,627
Federal income taxes	15,063	9,551	9,967
Federal income tax savings if farm income averaging is optimized	n/a	n/a	n/a
S.E., social security, and medicare taxes	5,893	5,893	5,893
Total Federal Tax Liability	**20,956**	**15,444**	**15,860**

Suburban Family. Mr. and Dr. Suburban live in a large town and have no agricultural businesses. Mr. Suburban is the

manager of a local business, and Dr. Suburban is a professor at the university. The Suburbans take advantage of their flexible schedules to volunteer at their children's (ages 11, 10, and 7) school and coach various sports teams. They plan to convert their IRAs to Roth IRAs in 1998. Dr. Suburban calculates that their IRAs are worth a total of $64,389 with 25% capital gains (approximately $3,826).

Table IV-4. An estimation of the Suburban Family's federal tax liability for 1998.

	Current Code	10% Tax Proposal	Flat Tax Proposal
Farm income	0	0	0
Farm operating expenses (excluding interest)	0	0	0
Depreciation			
Pre-1998 purchases	0	0	0
Current year "write-offs" (Sect. 179, etc.)	0	0	0
1998 purchases	0	0	0
Interest paid	0	0	0
Farm profit/loss	0	0	0
Wages and salaries	79,450	79,450	79,450
Interest income and dividends	1,561	1,561	1,561
Capital gains/losses	3,826	3,826	n/a
Total income subject to taxes	84,837	84,837	81,011
IRA contributions (deductible)	0	0	n/a
50% self-employment taxes	0	0	0
45% self-employed health insurance	0	0	n/a
Adjusted gross income	84,837	84,837	81,001
Standard/itemized deductions	7,100	9,000	23,200
Personal exemptions	13,500	14,500	15,900
Taxable income	64,237	61,337	41,901
Federal income taxes	12,481	7,667	7,123
Federal income tax savings if farm income averaging is optimized	n/a	n/a	n/a
S.E., social security, and medicare taxes	5,613	5,613	5,613
Total Federal Tax Liability	**18,094**	**13,280**	**12,736**