MEMO# 19336

November 4, 2005

RECOMMENDATIONS OF PRESIDENT BUSH'S ADVISORY PANEL ON FEDERAL TAX REFORM

 [19336] November 4, 2005 TO: TAX MEMBERS No. 28-05 PENSION MEMBERS No. 52-05 529 PLAN MEMBERS No. 17-05 ADVISER DISTRIBUTOR TAX ISSUES TASK FORCE No. 13-05 RE: RECOMMENDATIONS OF PRESIDENT BUSH'S ADVISORY PANEL ON FEDERAL TAX REFORM The Advisory Panel on Federal Tax Reform appointed earlier this year by President Bush has released its recommendations in the Report entitled "Simple, Fair, & Pro-Growth: Proposals to Fix America's Tax System."1 As urged by the ICI,2 the Report recommends the removal of impediments to saving and investment. Two different plans -- the Simplified Income Tax Plan and the Growth and Investment Tax Plan -- are recommended in the Report. Structural Features The two plans have many similar or identical structural features. Both plans, for example, would: • provide fewer tax brackets; the Simplified Income Tax Plan would have four tax brackets (15%, 25%, 30%, and 33%) and the Growth and Investment Tax Plan would have three (15%, 25%, and 30%); • repeal the alternative minimum tax; • replace personal exemptions, the standard deduction, and the child tax credit with a Family Credit; • replace the home mortgage interest deduction with a capped home credit equal to 15% of mortgage interest paid; • allow all taxpayers to deduct charitable contributions in excess of 1% of income; • cap the purchase of health insurance with pre-tax dollars; and • disallow deductions for state and local taxes. 1 This Report, which is approximately 280 pages long, is located at http://www.taxreformpanel.gov/final-report. 2 See Institute Memorandum (18672) to Pension Members No. 15-05 and Tax Members No. 8-05, dated March 21, 2005. 2 Savings Programs The two plans have many comparable savings provisions. Three new programs -- "Save at Work" plans, "Save for Retirement" accounts, and "Save for Family" accounts -- would be created to replace existing savings programs. Each plan also would provide a new refundable Saver's Credit. The existing rules for defined benefit plans would be maintained under both plans. Save at Work Plans These plans would consolidate defined contribution plans (i.e., 401(k), SIMPLE 401(k), TSP (Thrift Savings Plan), 403(b), governmental 457(b), SARSEP, and SIMPLE IRA plans). The existing contribution limits and rules for 401(k) plans would be followed, but the plan qualification rules would be simplified. In addition, special rules would be provided for small employers (with 10 or fewer employees); these plans would be similar to current law SIMPLE IRAs. The contribution and distribution rules for Save at Work plans would vary under the two proposed tax regimes. Under the Simplified Income Tax Plan, contributions would be deductible from current income and distributions would be taxable. Under the Growth and Investment Tax Plan, contributions would not be deductible,

but distributions would be tax- free. All Save at Work plans would be permitted, but not required, to have “AutoSave” features (automatic enrollment, automatic increase in contribution percentage, default investment, and automatic rollover); employees would be permitted to opt out of these features at any time. The Panel also recommended that the law be clarified to ensure that no state payroll law would prohibit automatic enrollment and that plan fiduciaries who institute default investment options receive the same protection provided under ERISA section 404(c). Save for Retirement Accounts Save for Retirement accounts would be taxed identically under both plans. These accounts would be available to all individuals with earnings. Contributions could not be deducted from income. The annual taxpayer contribution limit would be $10,000 (indexed for inflation) or total earnings, if less. Withdrawals made by taxpayers age 58 or older would be tax-free. Any withdrawals made before age 58 would be treated as taxable income, to the extent attributable to earnings, and subject to an additional 10% tax -- except in the case of death or disability. The current-law, early-withdrawal exceptions for education, first-time home buyer expenses, and medical expenses would not be available. No minimum required distribution rules would apply. Save for Retirement accounts would replace individual retirement savings plans (e.g., IRAs, Roth IRAs, and Nondeductible IRAs). Roth IRAs would be converted automatically to Save for Retirement accounts. Existing traditional IRAs could be converted to Save for 3 Retirement accounts by incurring tax (similar to the current rules for converting a traditional IRA into a Roth IRA, but without an income limit). Save for Family Accounts Save for Family accounts would be taxed identically under both plans. These accounts would be available to all individuals. Contributions could not be deducted from income. The annual contribution limit would be $10,000 (indexed for inflation). Withdrawals would be tax- free, so long at the withdrawals were for permitted expenditures. • Tax-free withdrawals for health or medical costs, education or training expenses, and purchases of a primary residence could be made at any time. • Tax-free withdrawals also could be made at any time for any purpose by taxpayers who are age 58 or older. • Tax-free withdrawals of up to $1,000 (in total) could be made each year for any other reason.3 No minimum required distribution rules would apply. Save for Family accounts would replace existing education and health savings plans (e.g., Section 529 Qualified Tuition Plans, Health Savings Accounts, and employer-provided Flexible Spending Accounts). Existing education and health savings plans could be converted to Save for Family accounts. Refundable Savers Credit The existing savers credit, scheduled to expire after 2006, would be made permanent and refundable. The maximum annual contribution eligible for the credit would be $2,000 and the credit rate would be 25%; contributions could be made to any of the three new savings programs described above. Eligibility for the credit would be phased out for those with income between $30,000 and $40,000, if married, and between $15,000 and $25,000, if single. Defined Benefit Plans Both plans would maintain defined benefit plans without change. Taxation of Other Savings Dividends, interest, and capital gains received would be taxed differently under each plan. Under the Simplified Income Tax Plan: • dividends received from U.S. companies (paid out of income earned in the U.S.) would be excluded from taxable income (while dividends received from foreign companies would be fully taxable); 3 Withdrawals in excess of $1,000 for non-qualified expenses would be treated as taxable income, to the extent attributable to earnings, and subject to an additional 10% penalty. 4 • interest received would be fully taxable (unless received by individuals on tax- exempt municipal bonds); and • 75% of capital gains from the sale of stock in U.S. companies would be excluded from income (resulting in an effective tax rate of 3.75% to 8.75% on these gains). • all other capital gains (including gains on bonds, foreign stocks, and derivative instruments) would be taxable at ordinary rates. Under the Growth and Investment Tax Plan, all dividends, interest (other than interest received by individuals on tax-exempt municipal bonds), and capital gains would be taxed at a 15%

rate. Insurance products purchased in the future4 would be taxed identically under both plans Specifically, annual increases in the value of insurance products (known as “inside build-up”) would be taxed currently unless the product is: • life insurance that cannot be cashed out; or • a life annuity (that provides regular, periodic payouts of substantially equal payments until the holder’s death). Treatment of Business Income and Expense The two plans, with one exception described below, would tax businesses to a greater or lesser extent under a “cash flow” system. Under a pure cash flow system, taxes would be paid on the difference between gross receipts and the cost of production (including capital, goods, and wages). The Simplified Income Tax Plan and the Growth and Investment Tax Plan vary in the degree to which amounts paid for goods are fully expensed in the year of acquisition, rather than capitalized and depreciated over specified periods. Simplified Income Tax Plan Under the Simplified Income Tax Plan, small businesses (with gross receipts of $1 million of less) and medium-sized businesses (with gross receipts of between $1 million and $10 million) would operate under a modified cash flow system. Small businesses would capitalize and depreciate only land and buildings. Medium-sized businesses would capitalize and depreciate land, buildings, equipment and other capital expenditures; those medium-sized firms in “inventory intensive” industries also would use inventory methods for physical inventories. For all firms, regardless of size, the tax treatment of interest expense and income would not be changed. The taxation of large businesses (with gross receipts of $10 million or more) would change the least. These businesses would capitalize their investments and depreciate them under a new simplified accelerated depreciation schedule. The current tax regime for regulated investment companies would be maintained under the Simplified Income Tax Plan. 4 Existing annuities and life insurance arrangements would continue to be taxed under current-law rules. 5 Growth and Investment Tax Plan Under the Growth and Investment Tax Plan, all businesses would be taxed under the cash flow system. For all businesses except financial institutions, interest expense would not be deductible and interest income would not be taxable. Rules transitioning businesses from the existing rules to the new rules would be provided. The tax treatment of regulated investment companies is not specifically addressed under the Growth and Investment Tax Plan. In addition, the Report acknowledges, the suggested tax treatment of financial firms should be considered in greater detail if this plan is implemented. Keith Lawson Senior Counsel - Tax Law