INVESTMENT COMPANY INSTITUTE

MEMO# 7571

January 22, 1996

KEMP TAX REFORM COMMISSION RECOMMENDATIONS

January 22, 1996 TO: PENSION COMMITTEE No. 3-96 TAX COMMITTEE No. 3-96 RE: KEMP TAX REFORM COMMISSION RECOMMENDATIONS ____ The National Commission on Economic Growth and Tax Reform established by Senate Majority Leader Dole and Speaker Gingrich and chaired by Jack Kemp (the "Kemp Commission") has released its report, a copy of which is attached. The report urges, among other things, that the existing federal tax regime be replaced by a single-rate system that eliminates the "bias against saving and investment." The reports foreword, prepared by Senator Dole and Speaker Gingrich, states that the report "will surely serve as a catalyst for congressional hearings and debate." Brief Overview of Kemp Commission Recommendations The Kemp Commission report sets forth a number of principles and policies that its members believe should be followed in reforming the federal tax system, makes a series of "core" recommendations and identifies a number of other issues for consideration. While the report does not present a comprehensive proposal, the Commissions report suggests that recent "flat tax" proposals, such as those advanced by Representative Armey, Senator Gramm, Steve Forbes and others, should be the starting point for tax reform. Among the Commissions "core" recommendations that appear "flat tax" oriented are recommendations for "a single, low tax rate with a generous personal exemption" that eliminates the "biases against work, saving, and investment." Other reforms that received express or implied approval from the Commission include (1) a call for strengthening the incentives for private retirement saving, (2) a recommendation that business expenses be deducted rather than capitalized, (3) a suggestion that only current deductions with "important social and economic consequences," such as the deductions for mortgage interest and charitable contributions, be retained, (4) a recommendation that federal payroll taxes be fully deductible by employers and employees, (5) a recommendation that any increase in tax rates be approved by a two-thirds super-majority vote in the House and the Senate, (6) a suggestion that federal estate and gift taxes be reduced or eliminated and (7) a suggestion that Congress consider taxing only activities conducted within the United States. Issues not covered by the Commission s report include (1) the preferred treatment of municipal bond interest, (2) the mechanisms for measuring the tax bases of different business enterprises, such as financial services firms, (3) the interplay between the new U.S. tax regime and the tax regimes of other countries and (4) the transition rules that would be needed to move from our existing regime to the new one. Eliminating the Bias Against Saving and Investment To eliminate the bias against saving and investment, the report states that the tax system must: (1) "either let savers deduct their saving or exclude the returns on the saving from taxable income;" (2) "end double-taxation of businesses;" and (3) "abolish separate taxation of capital gains." Because these recommendations would effectively remove amounts saved from the tax base, leaving as subject to tax only amounts consumed, they are essentially recommendations for a "consumption tax." The first recommendation -- that savers either deduct their saving, or exclude the returns on the saving, from the tax base -- would effectively result in provisions analogous to unlimited "front-end" or "back-end" IRAs, without penalties for early withdrawals or the need to create special accounts. By effectively eliminating the existing limitations on IRA eligibility as well as the operational burdens of existing IRA rules, this recommendation could substantially increase saving. This recommendation also could have a significant impact on the fund industry because it appears to reflect a preference for individual saving, rather than employer-sponsored retirement saving. Many of the specific tax reform proposals advanced by Congressional leaders and Republican presidential candidates likewise would either eliminate tax incentives for employer-sponsored retirement plans or reduce the relative tax advantage for saving through such plans as compared with saving on an individual basis. * * * * * We will keep you informed of developments. Keith D. Lawson Associate Counsel - Tax Russell G. Galer Assistant Counsel - Pension Attachment

---