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Congress of the United States
House of Representatives
109th Congress
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515-6315

February 16, 2005

Senator Connie Mack
Senator John Breaux,
Chairman and Vice Chairman
The President's Advisory Panel on Federal Tax Reform
1440 New York Avenue NW
Suite 2100
Washington, DC 20220

Dear Senators Mack and Breaux:

I am writing to encourage you, as you examine the complex federal tax code, to endorse one of the key recommendations of the National Taxpayer Advocate regarding the tax deductibility of the Federal Insurance Contributions Act (FICA) tax for the self-employed. In the previous Congress, I introduced legislation on this very issue (HR 1873) and I plan to continue to work on this initiative in the 109th Congress. This is an issue of not just streamlining the tax code but also one of fundamental equity.

Congress has finally allowed the self-employed small business owner to deduct their health care premiums from their taxes as large corporations have done for years. However, the self-employed pay their health care insurance premiums after they have paid their Social Security/Medicare tax. Large corporations do not pay FICA taxes on their contribution to their employee's health care premiums. The tax code does not allow these small entrepreneurs to deduct the cost of their health care premiums from their wage base for self-employment taxes. Not only is this an issue of fundamental discrimination against the very smallest of businesses but also adds to the complexity to the tax code by having two sets of rules apply to different types of businesses based solely on their incorporation status.

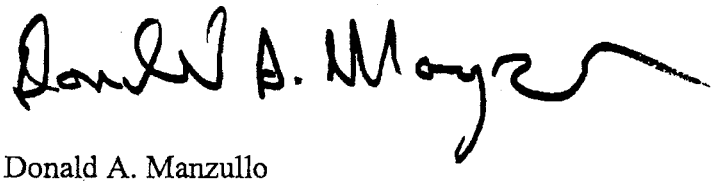
The self-employed already face huge obstacles when it comes to purchasing health insurance and many are forced to forego insurance due to spiraling costs. This issue is not only a case of basic fairness but adopting this recommendation would make it easier for the smallest of our businesses to have the ability to purchase health insurance. The self-employed already face hurdles by paying a "double" Social Security/Medicare tax – 7.65 percent as an individual and 7.65 percent as part of the company's share. Adopting

this recommendation would ease the burden of the self-employed and would provide an immediate 15.3 percent incentive for them to purchase health care insurance.

I strongly encourage you to agree with 69 bipartisan Members of the House of Representatives and the National Taxpayer Advocate to include this proposal in your recommendation to the President for changes in our tax code.

Thank you in advance for your consideration.

Sincerely,



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February 18, 2005

The Honorable Connie Mack
Chairman

The Honorable John Breaux
Vice-Chairman

The President's Advisory Panel on Federal Tax Reform
1440 New York Avenue, NW
Suite 2100
Washington, DC 20220

Dear Senators Mack and Breaux:

First, let me thank you both for agreeing to sit on this important commission. Reform of the tax code is a long-delayed project of critical importance to the economy. However, it will certainly not be an easy task, and it is good that you have agreed to undertake it. Tax reform will only work with cool heads thoughtfully considering ways to reduce the burden on taxpayers.

With this goal in mind, I write today to counsel strongly against any suggestion that the deduction for state and local taxes should be eliminated. The deduction is an important one exercised, in 2002, by over 37 million US taxpayers and more than 3 million people from my home state, New York. It is a major factor in alleviating the crushing tax burden that imposes at the federal as well as the state and local levels.

The amounts claimed are similarly impressive: again in 2002, over $184 billion (and over $24 billion by New Yorkers) was saved from the maw of the tax code by the exercise of this provision.

We are all familiar with the basic problem of the tax code - it is a bizarre mess that forces taxpayers to waste billions of hours (6.4B in 2004) and hundreds of billions of dollars every year ($203.4B in 2004) on tax preparation. Not even experts truly understand the tax code – different preparers, including different IRS professionals, provide different answers.

This is on top of tax rates that consume, on average, half of a person's income. When the income tax was established a century ago, arguments raged over single-digit tax rates. During congressional debate over the 16th Amendment, a proposal to cap the income tax at 6% was rejected because, it was generally agreed, such a provision would encourage Congress to raise the rate all the way up to 6%! Sadly, Congress did not want for encouragement.

We now find ourselves in serious straits. While we were struggling our way out of a recession in this very decade, additional productivity was being lost on literally trillions of dollars of excessive tax liabilities, tax preparation costs and lost man-hours.

The deduction for state and local taxes has substantially eased this burden. The relief from state and local taxes, many of whose codes are nearly as Byzantine as that of the federal, is of major importance. Speaking as a New Yorker, recovery from the twin economic punches of 9-11 and the recession was difficult enough, but fortunately the deduction provided some cushion.

The deduction has existed since the first implementation of the federal income tax in 1913. It has been a crucial point of balance as the income tax rates were steadily hiked throughout the twentieth century.

At various points, I have been enthusiastic to support proposals to slash the burden, both that of overall taxes and of tax preparation. Taxes at the state and federal level need to be cut. What does not need to be cut, I firmly believe, is this provision that serves as a release valve for the system.

I thank you both very much for your attention to this important matter and look forward to hearing from you soon.

Sincerely,

Vito J. Fossella
Member of Congress

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March 18, 2005

The President's Advisory Panel on Federal Tax Reform
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Dear Advisory Panel,

This letter contains comments per the "Advisory Panel's Request for Comments #1" as posted on February 16, 2005.

As requested, our comments at this time focus on the goals of reform as well as aspects of the tax system that are unfair.

Sincerely,

Cassandra Q. Butts
Senior Vice President and Coordinator of Economic Policy

John S. Irons
Director of Tax and Budget Policy

Submitted by the Center for American Progress, Washington DC, on March 15, 2005.

The Center for American Progress is a nonpartisan research and educational institute dedicated to promoting a strong, just and free America that ensures opportunity for all. We believe Americans are bound together by a common commitment to these values and we aspire to ensure our national policies reflect these values.

Aspects of the tax system that are unfair

Recent tax policy changes have moved our system away from the basic principle of fairness. This can be most clearly seen in two areas: first, the tax share has shifted away from those who can best afford to pay and onto the middle class; and second, corporations have largely been able to avoid their obligation to pay taxes, often by shifting operations overseas. The result is an increased reliance on a regressive payroll tax, which falls most heavily on lower- and middle-income taxpayers. Furthermore, income from accumulated wealth is given preferential treatment over income from work in the form of salaries and wages.

During the last 50 years, corporate taxes have fallen from 30 percent of federal revenues to less than 10 percent today. At the same time, the federal government has become increasingly reliant upon regressive payroll taxes, which made up 10 percent of federal revenues 50 years ago and over 40 percent last year.[1] The federal income tax (including taxation on income from wealth) is a more progressive form of taxation; however, it has been scaled back as a funding source over the past few years. These trends are not in line with our history of progressive taxation and the tax reform panel's goal of creating a tax system that "share[s] the burdens and benefits of the Federal tax structure in an appropriately progressive manner."[2]

Tax Shifts

There is little doubt that the benefits of the recent Bush tax changes were dramatically skewed toward benefiting the wealthy to the detriment of the typical American

worker. In 2004, households making more than $1 million received an average federal income tax cut of $123,592, while the average change for those in the middle 20 percent of income was only $647.[3] Increases in the deficit that resulted from these changes mean that these taxpayers will face higher taxes in the future—which will offset many, if not all, of the reductions for middle-income taxpayers.

The tax panel and policymakers need to consider the distributional implications of any proposed reform plan. In particular, a full set of distribution tables showing the tax implications of reform on: 1) various income distribution percentiles, as well as 2) breakdowns by income and wealth classes, must be announced, debated, and fully considered. The Treasury Department should be urged to again produce these tables, which was once standard practice within the department.

Income from Wealth

By focusing many of the tax benefits on passive income from investments, President Bush offered individuals in the top 1 percent income bracket a whopping 34 percent of the benefits from the irresponsible tax cuts.[4] As a result, Bush's tax changes reduced the share of federal taxes paid by the top 1 percent of income earners, while increasing the share paid by the middle fifth of workers. These changes thus shifted the tax code to reward wealth at the expense of work.

Efforts to make recent tax changes permanent and eliminate estate taxes and taxes on capital gains and dividends would further lighten the tax burden of the wealthy and make the federal government's revenues more reliant on middle-class families, making the tax

system even less progressive.

As noted above, the system has become increasingly reliant on the payroll tax, one of the most regressive components of our tax system. It imposes an effective tax rate that is four times larger for middle-income workers than for those in the top 1 percent. The payroll tax only accounted for 23 percent of federal revenue in 1970, but now makes up an astounding 40 percent.[5] The increasing reliance of the federal government on this regressive source of revenue makes the tax system even more unfair.

Corporate taxation

While the middle class is paying a larger share of federal taxes, major U.S. corporations are paying less and less. Though the corporate income tax rate structure maintains a degree of progressivity, it is riddled with loopholes that allow corporations to avoid paying taxes. A recent study found that 82 of the nation's largest corporations paid zero taxes in at least one of the last three years, and 28 corporations did not pay taxes in any of the years despite generating pre-tax profits of $44.9 billion over the period.[6] Part of the increase in corporate tax avoidance is explained by an explosion in the shifting of investment and profits overseas. Profits of foreign subsidiaries of U.S. corporations in major tax havens soared from $88 billion in 1999 to $149 billion in 2002. Profits in zero-tax Bermuda tripled over this short period.[7]

Increased avoidance – both overseas and domestically – has contributed to sending overall corporate tax revenue to historic lows. In 2003, corporate taxes were only 1.2 percent of GDP – their second lowest level as a share of our economy since 1934 (corporate

taxes were 1.1 percent of GDP in 1983).[8] In addition, the role of corporate revenue in meeting our overall revenue needs has fallen in the past four years.

Adequacy

Finally, the tax cuts have resulted in bringing tax revenues to their lowest levels since 1959, at just 16.2 percent of GDP in 2004.[9] This dramatic decrease has resulted in record deficits. *It is unfair for today's policymakers to burden America's younger generation with the obligation of paying back such excessive borrowing in later years.*

While the president has charged the panel with formulating "revenue neutral options," we hope that the panel would resist the call to choose a revenue baseline that assumes extensions of the 2001 and 2003 tax laws. The panel should emphasize the need to fully fund vital national priorities over the long-term, and to explicitly reject the notion that tax shortfalls and large deficits are a good political strategy to reduce overall spending levels.

Overall, the federal tax system has become increasingly reliant on the regressive payroll tax, has shifted the burden of tax payment from the wealthy to the middle class and has allowed corporations to avoid paying their fair share of taxes. The president's stated future goals for the tax system, including making the tax cuts permanent and eliminating taxes on capital gains and dividends, will only exacerbate the degree to which the system has become unfair.

Goals that the panel should try to achieve as it evaluates the existing tax system and recommends options for reform

As a nation, we have established certain fundamental priorities: among them are protecting the safety, security and health of our citizens; ensuring the right to a world-class education; providing vital public services; and preserving the dignity and basic comfort of our elderly. We have realized throughout our country's history that supporting these priorities requires resources that no individual or small group of individuals could ever hope to raise by themselves. The challenge of tax policy is to generate these resources efficiently and in a way that is consistent with our values as a nation. Those values can be summarized by three basic principles for our tax code: *opportunity, fairness and simplicity.*

A successful tax code should encourage economic and job growth, continue to reward ingenuity and hard work, and expand the American middle class. We also need a tax system that raises revenue efficiently – that creates as few economic distortions as possible while still meeting our other national priorities.

Currently, large deficits are threatening our nation's ability to foster opportunity for all Americans. The last four years have seen record budget surpluses turned into massive budget deficits. This is a trend that must be reversed. A new tax code should be judged on its ability to raise adequate revenue to run the government without debilitating deficits.

While some maintain that cutting government spending is the only solution to unacceptable levels of budget deficits, ample evidence shows that the current deficit problem is one of inadequate revenue rather than excessive spending.

At the same time, our tax system has at its foundation a basic notion of fairness.

With the enactment of the Income Tax Law of 1913, the federal government applied the principle that taxes should be levied based upon ability to pay. This idea of "progressive" taxation grows from the belief that those who achieve the greatest wealth also benefit the most from what our nation provides. Our schools, the stability of our economy, and public investments in research and innovation all contribute to the successes of America. As Andrew Carnegie explained, "where wealth accrues honorably, the people are always silent partners."

Finally, Americans have always valued a simple, streamlined role for government in their lives. Complexity in the tax code too often breeds waste and abuse, which erode the fairness and efficiency of our tax code. Tax complexity for both individuals and corporations can create "gray areas" in which some are able to take advantage in ways not foreseen by the code. This favors those wealthier individuals and corporations who can afford tax accountants and professional tax preparers to exploit holes in the system. The perceived unfairness of a complicated tax code can erode the faith people place in our public institutions, and can reduce overall compliance.

A serious tax proposal should be based on these realities. It should strive to raise adequate revenue for the government in as fair and simple a way as possible. At the same time, the goal of tax reform should not be to reduce revenues, as this will worsen the deficit and lead to serious economic distortions.

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