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Citizens for Tax Justice

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House GOP Tax and Entitlement Plan Would Raise Taxes on Four Fifths of Americans While Slashing Taxes on the Wealthy

Representative Paul Ryan (R-Wisc.), the ranking Republican on the House Budget Committee, introduced legislation on May 21 that would cut Social Security benefits and create private accounts, end Medicare as it is currently structured, dramatically reduce the revenues available to fund federal public services, and radically reduce the fairness and revenue sufficiency of the federal tax system.

On the tax side, the bill, H.R. 6110, would repeal the alternative minimum tax (AMT), create an "alternative *maximum* tax" that taxpayers could choose to pay if it is lower than their regular income tax, abolish the corporate income tax and impose an 8.5 percent value-added tax (VAT) that would have the same regressive effects as a sales tax.

The table below illustrates that the tax provisions in this legislation would increase taxes on the poorest four-fifths of taxpayers while dramatically reducing taxes on those at the top of the income scale. The upper-income tax cuts would far outweigh the tax increases on everyone else, with a net annual reduction in federal revenues of $286 billion if the plan were in effect this year.

The most expensive component of the plan is the alternative *maximum* tax. It would have two rates, 10% and 25%, a large standard deduction ($25,000 for couples and $12,500 for unmarried taxpayers), and personal and dependent exemptions equal to those under current law ($3,500 in 2008). It would completely exempt capital gains, interest and dividends. The annual cost of this proposal would be $356 billion at 2008 levels.

Effects of Rep. Paul Ryan's House GOP Tax Plan at 2008 Levels

			Average tax changes				
Income group	**Income Range**	**Average Income**	**Repeal Alt. Min. Tax**	**Alternative Max. Tax**	**Repeal Corp. Tax**	**Sales Tax (VAT)**	**Net Tax Change**
Lowest 20%	**Less than $19,000**	**$ 12,200**	$ —	$ –94	$ –76	$ +1,483	**$ +1,313**
Second 20%	**$19,000 – 32,000**	**24,800**	—	–384	–202	+1,936	**+1,350**
Middle 20%	**$32,000 – 52,000**	**40,600**	–13	–871	–389	+2,710	**+1,437**
Fourth 20%	**$52,000 – 87,000**	**67,400**	–181	–1,894	–744	+3,825	**+1,006**
Next 15%	**$87,000 – 179,000**	**118,500**	–1,505	–3,950	–1,738	+5,896	**–1,296**
Next 4%	**$179,000 – 481,000**	**263,900**	–6,902	–8,692	–8,077	+9,834	**–13,836**
Top 1%	**$481,000 or more**	**1,597,600**	–13,672	–94,772	–114,264	+27,159	**–195,550**
Revenue effect in 2008 ($-billion)			$ –95.0	$ –355.8	$ –340.0	$ +505.1	**$ –285.7**

Source: ITEP Tax Model, July 3, 2008

Almost as expensive, and even more regressive, is the proposed repeal of the corporate income tax, which would cut revenues by $340 billion a year at 2008 levels.

Partially offsetting the cost of the bill's tax cuts is the proposed value-added tax, which can be thought of as a more administrable version of a national sales tax. It would raise the price of almost all goods and services purchased by American consumers by 8.5 percent. In this way, it would have the same regressive effects as a sales tax, which takes a much larger share of poor and middle-class families' income than of wealthy people's income. Wealthier families have the luxury of directing most of their income toward investments which are not affected by a sales tax, whereas poor and middle-income families typically spend most or all of their incomes.[1]

The Ryan Plan May Lead to Massive New Tax Avoidance Schemes

Our estimates of the cost of the Ryan proposal may be far too low, because of new tax avoidance opportunities that it would seem to provide.

Under the Ryan plan, there would be no tax on corporate profits or dividends received by individuals from corporations (assuming the alternative maximum tax is chosen). So, a corporate executive now earning a million-dollar salary could set up his own little corporation, which would sell the executive's services to his former employer. To be sure, the payment for those services would be subject to the proposed 8.5% value-added tax. But no corporate income tax would be due on the payment, and no personal income tax would be paid when the little corporation pays the money to its owner as a dividend.

Similarly, unincorporated business income that is now taxed under the personal income tax could also be sheltered by incorporating the businesses, and paying the owners tax-free dividends.[2]

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[1]Our analysis does not include a change in the tax treatment of health care that is also part of Rep. Ryan's plan. His bill would end the exclusion from taxable income of employer-paid health insurance and replace that tax benefit with a refundable credit for health insurance. The credit would be equal to $5,000 for couples and $2,500 for unmarried people. (These changes would apply to both the regular income tax and the alternative maximum tax.) This proposal would lose substantial revenues initially, but raise substantial revenues in the long run. This is because the tax credit would be indexed only for overall inflation, while health costs are expected to grow much more rapidly than that. Because of this fact, evaluating the health insurance component of the plan at 2008 levels would dramatically distort its long-term impact.

We should also note that under current law, the cost of the alternative maximum tax will be much larger after 2010, when the Bush tax cuts are scheduled to expire, and the regular income tax will thus be much higher. Since it is hard to predict what the regular tax law will actually be after 2010, we cannot provide estimates of the cost of the alternative maximum tax in future years.

[2]In fact, a similar tax-avoidance scheme is already widely employed on a much smaller scale under the current income tax. High-priced lawyers, for example, have incorporated their law firms as "Subchapter S" corporations, which are passthrough entities that are exempt from the corporate income tax. Instead, the owners of these special corporations pay personal income tax on their share of the corporations' profits. The advantage of incorporating is that it facilitates avoidance of part of the self-employment tax. For example, a lawyer making $1 million would pay both personal income tax, the 12.4% Social Security tax on his first $102,000 in earnings, and the 2.9% Medicare tax on his entire million dollars in earnings. By incorporating as a Subchapter S corporation, however, some lawyers have paid themselves a relatively paltry salary, say, $200,000. They then claim that the remaining $800,000 is not earned income, but profit unrelated to working, and thus exempt from the 2.9% Medicare tax.

In 2004, it was revealed that Democratic vice-presidential candidate John Edwards had done exactly this with his law firm, and had thus avoided hundreds of thousands of dollars in Medicare taxes. Yet despite this highly publicized exposure of the loophole, it remains open.

In other words, besides exempting capital gains, interest, dividends and corporate profits from tax, the proposal would also appear to set a top tax rate on most other types of income of only 8.5%!

It's possible that complicated anti-avoidance rules could mitigate this problem, but the plan does not provide any such rules, and they would probably be extremely difficult to implement.

If the Ryan plan were adopted without effective anti-tax-avoidance rules, then its cost could be hundreds of billions of dollars a year more than the already staggering cost shown in our table on page 1.

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