

VIEWPOINT

Fixing The Tax Code

Americans Need A Simplified Tax That Retains Favorite Deductions

Eighth In A Series

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When the members of the President's Tax Reform Advisory Panel were handed America's tax code and asked to fix it, their first reaction probably was to tear it up and start over. And justifiably so.

The present income tax is a mess, and everyone would be grateful if there were some way to replace it with a simple, understandable tax that goes quietly and efficiently about the task of collecting revenue, minding its own business and keeping its hands to itself.

Unfortunately, the magic elixir for which everyone yearns is scarce to nonexistent.

In fact, it is going to be difficult for the panel to find any politically viable replacement for the income tax. Some reformers imagine it would be good to have a "flat" income tax with no deductions.

In reality, flat taxes tend to raise taxes on the middle class and, in some cases, on businesses as well.

Other reformers, in their zeal to get rid of the income tax altogether, propose to replace it with a retail sales tax. But does anyone really think Congress is going to slap a 30% tax on top of the price of every single thing that Americans buy at the store or on the Internet?

Even worse, some have suggested experimenting with a two-track system that combines the characteristics of an income tax and a sales tax.

Wholly apart from their own inherent defects, all these and other similar grandiose schemes appear to be disqualified for another reason: They violate President Bush's instructions to the panel that tax benefits for homeowners and charitable givers be preserved.

The solution may be a more circumspect but powerful bipartisan proposal originally called the USA Tax.

USA was first developed more than a decade ago by Pete Domenici, a Republican senator from New Mexico, and Sam Nunn, who was then a Democratic senator from Georgia. They wanted to "strengthen America" by removing the tax impediments to personal saving and business capital investment.

But they did not want to go off in some radical, experimental direction. Their proposal stayed within the bounds of the familiar and had an impeccable intellectual pedigree, being partly based on concepts developed by David Bradford, a professor at Princeton who died. For a time the USA Tax attracted considerable interest — from members of the Senate, important academics and the Treasury Department.

But the method it used to eliminate the double tax on savings was judged by tax practitioners to be too complicated.

This defect was cured and other important changes were made in the USA Tax by a reform-minded Republican on the House Ways and Means Committee — Phil English.

The resulting Simplified USA Tax—called SUSAT—may be the key to achieving a simple, plain-language tax code that is conducive to economic growth.

SUSAT takes from both the existing tax on net income and from the related concept of a tax on business value added. But it takes only those parts that Americans like and discards the rest.

SUSAT allows taxpayers the familiar personal deductions for home mortgage interest, charitable giving, and the traditional personal and family exemptions.

Personal income is taxed at progressive rates — except that those rates are much lower and flatter. SUSAT leaves out an array of other deductions and credits that apply to some individuals but not to others.

These “special interest” provisions of present law account for most of the size and complexity of the tax code about which Americans complain. And they cause tax rates to be higher than would otherwise be necessary.

Won't Be Taxed Again

SUSAT eliminates the double tax on personal saving by allowing all people the option of setting up a universal savings and investment account (USIA) into which they can put after-tax savings of whatever amount they wish. They can also withdraw it whenever they wish.

Because the amount put into the account has already been taxed once, neither accumulations inside the account nor withdrawals from the account are taxed again.

SUSAT's truly landmark achievement is a complete rewrite of the basic provisions of the current income tax—the ones that people rely on and that are important to them—in simple, plain English. It is less than half the size of the current income tax code.

SUSAT also rewrites the corporate tax, jettisoning hundreds of special rules that are no longer necessary because SUSAT treats all businesses alike, lowers the business tax rate to 12% and allows first-year expensing of capital equipment investments.

It also excludes export income and foreign-source income from tax in order to let American companies compete in the world marketplace on the same basis as their international competitors.

Most versions of SUSAT also include a 12% tax on selected imported goods and services sold into the U.S. market by foreign companies — but only in those circumstances where the effect is to collect a tax from the foreign company without materially increasing U.S. prices.

Heeding WTO Rules

SUSAT's exclusion for exports — which some people previously believed required adoption of a European-style value added tax — is accomplished by two simple amendments that convert the existing corporate income tax into an “indirect tax” within the meaning of World Trade Organization rules. The WTO simply requires that all dividends, interest and wages paid by a business be included in its tax base.

Dividends paid to shareholders are nondeductible under present law and thus are already part of the business's tax base. Wages are now deductible, but the bulk of those wages are, in fact, already included in the business' tax base by virtue of the employer's portion of the FICA payroll tax — which is itself a tax on wages.

Compliance with WTO rules can thus be achieved by making wages nondeductible, but simultaneously allowing a credit against the corporate income tax for the portion of the FICA tax paid by the employer.

The only remaining step required to complete compliance with the WTO rules is to make interest payments on newly issued corporate debt nondeductible.

The resulting inclusion of interest in the payer's tax base — while different from present law — will be offset by the fact that this same interest will be excluded from the bondholder's tax base when received by another corporation or, in the case of an individual, when received in a USIA account. In both cases, interest will be taxed only once.

Thus, while mostly staying within the familiar framework of the existing income and payroll tax system, SUSAT simplifies the existing tax code and achieves major economic goals of tax reform in the domestic and international arenas.

Also, it meets the most important requirement of all: SUSAT can be understood by Congress and the American people and, therefore, stands a good chance of being enacted into law.

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