

November 7, 2005

The Honorable < >  
<United States Senate or United States House of Representatives>  
<Address>  
Washington, DC

Dear <Representative or Senator>:

The New York State Society of CPAs has reviewed the recently-issued report by the President's Advisory Panel on Federal Tax Reform, and we are very concerned about its potential impact on New Yorkers.

Homeowners in New York State would be especially hard hit if President Bush implements the Panel's recommendation to reduce the cap on mortgage deductions. This – along with other Panel recommendations to replace multiple savings accounts and eliminate existing education incentives – would have a dramatic effect on New Yorkers, who already bear a disproportionate tax burden in comparison to the rest of the country.

The Panel's recommendations come, as you know, in response to the President's mandate that any revisions to the Federal tax code include the elimination of the Alternative Minimum Tax, which is indeed an excellent starting point. But the NYSSCPA has developed a much better solution to generating the revenues lost from its dissolution.

Early this year, the NYSSCPA convened a blue-ribbon panel of tax experts that developed a proposal for fundamental tax reform by creating a simple, exact, and transparent tax system: the SET tax. The SET tax will obviate the need for an AMT (both corporate and individual) and provides an elegant, revenue-neutral solution to make up the lost revenues: Congress can easily define exclusions to raise revenues from the same (or different) taxpayers, in a transparent, easy-to-understand way.

The SET tax is a single-rate, progressive system. Unlike all other single rate tax reform proposals – generally referred to as flat or flatter tax proposals – the SET tax can continue taxing higher incomes at higher rates. It can also maintain current provisions directed at special-interest groups to provide fairness, savings, and investment incentives for economic stimulus and it will provide appropriate federal government revenues based on income-tax principles and rules we already use successfully.

We submitted our SET tax proposal to the President's panel earlier this year. We strongly believe that our proposal provides New Yorkers and the nation with a viable solution that is fair and transparent and that can be structured to be revenue-neutral.

We have enclosed a copy for your review. The SET tax can also be accessed at <http://www.nysscpa.org/pdfs/set.pdf>.

I hope you will use your significant influence in Congress to help garner more attention for the SET Tax. A panel of New York's most eminent tax experts strongly believes it is the solution to the nation's tax issues. We would be happy to arrange meetings with you or your appropriate staff to discuss this solution in greater detail.

Sincerely,



Stephen F. Langowski, CPA  
President

Enclosure

*new york state society of*

**NYSSCPA**

*certified public accountants*

3 park avenue, new york, ny 10016-5991  
[www.nysscpa.org](http://www.nysscpa.org)

## **The SET Tax**

### **A Tax System for Our Future**

## **The New York State Society of CPAs**

The New York State Society of Certified Public Accountants (NYSSCPA) has published this position paper as a guide for our political leaders and others interested in practical issues raised by fundamental tax reform. The NYSSCPA is the largest and oldest state-based society of CPAs in the world. Its membership of 30,000 ranges from partners in the largest of international accounting firms to the one-person CPA firm down the block. In addition, a little over a third of its membership is employed by businesses (other than accounting firms) ranging from banks to brokerage firms and insurance companies, retail establishments to wholesalers, to government, colleges and universities.

NYSSCPA members are responsible for the preparation of millions of business and individual tax returns. They are active in tax planning and planning for retirement. With their knowledge base, CPAs are uniquely qualified to lay out in pragmatic, commonsense terms the issues raised by fundamental tax reform.

The NYSSCPA Committee on Practical Reform for the Tax System prepared this position paper and the Society's President John J. Kearney has approved it. The paper represents an official policy position of the NYSSCPA.

### **Committee on Practical Reform for the Tax System**

David A. Lifson, *Chair*

Joseph L. Charles

Alan J. Dlugash

Robert L. Goldstein

Laurence Keiser

Leon M. Metzger

Stephen A. Sacks

Maryann M. Winters

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## Introduction

Our current income tax system suffers from serious problems. First, it has become increasingly difficult for the average taxpayer to understand the complex rules and applications of the Internal Revenue Code. Second, the reward for expending more effort to comply with those complex inner workings is often a higher tax bill. The result is a dangerously declining compliance rate that could eventually undermine our highly evolved self-assessment system. This system is the linchpin that supports the functionality of our entire income tax process. Legislators and policymakers must act now to fix a system that has not only become too complex but has also lost needed transparencies, to assure taxpayers that our system of taxing the citizenry is fair and is based on politically agreed upon social policies of the day.

Examples to illustrate the complexity and confusion are numerous. Perhaps the most decried example of complexity is the alternative minimum tax (AMT), a clear example of taxes gone wild in a dysfunctional system. Although not intended to do so, this provision relies upon the good faith of taxpayers to calculate their income tax twice and to pay the higher tax, based on two difficult calculations using two sets of rules. Sounder tax-policy initiatives would save complex tax calculations for tax benefits that are efficient, fair and easily monitored. Countless more examples of complexity and confusion are embedded in the current Internal Revenue Code.

The New York State Society of CPAs has a solution to the complexity and confusion inherent in the current tax system. This paper will present that solution within the context of both political and historical perspectives. Before considering changes for the better, all of us, even the experienced tax policy maker, the tax professional, and the student of tax, should review and evaluate:

- The environment and people our income tax system serves;
- how the system has evolved;
- critical flaws in today's income tax system;

- What goals are important to a good income tax system, and how they stack up against where we are today—especially since the goals exist in a constant state of changing tension and, only then,
- How to accomplish those goals.

## Executive Summary

Fundamental tax reform surfaces every decade or so, accompanied by widespread disenchantment with the *status quo*, but rife with conflicting ideas on how to change what the tax code has become.

The latest reform call, one of President George W. Bush's second-term domestic priorities, faces a deeply polarized electorate separated along a red-state/blue-state (Republican/Democratic) divide. Most proposals currently vying for public attention fail to bridge that political and philosophical division.

The NYSSCPA proposes the Simple Exact Transparent Tax, or SET Tax, as the solution to the dysfunction of the current tax system. The SET Tax would tax all incomes over a generous threshold established by our political leaders, reduced by government-approved exclusions, at an economically appropriate and socially acceptable single rate. There will be no need for conflicting tax systems and cumbersome credits and deductions.

The SET Tax appeals to both the red and the blue among us by infusing the tax system with transparency, while leaving intact the ability to collect revenue in order to fund according to the social and political priorities of the day. It reduces the "clutter" of complex tax calculations to a simple formula that most taxpayers will be able to understand, applies a fair and universal tax rate, and allows everyone to know exactly what taxes the government is taking to support identifiable programs and initiatives.

The SET Tax system is a neutral tax tool for use by policymakers. With it, they can deliver an understandable tax to the taxpaying public. The SET Tax will provide much greater assurance that all taxes are collected, so tax cheats will be losers and honest taxpayers will be winners. It can also efficiently change who is bearing our income tax burden without the complex, difficult to understand, and sometimes highly unpredictable results produced by the current Internal Revenue Code.

The SET Tax addresses all the key issues in today's debate on tax reform and proposes a solution – transparency – that could help future generations make the right decisions about taxes. The SET Tax is **fair**, **simple**, and **pro-growth**. Perhaps most important, it can remove the inappropriate complexity and distortions out of the Code

while meeting today's current economic need for **revenue neutrality**. By addressing intentional and unintentional tax compliance failures, it can be designed to produce a "compliance bonus" that can provide government with greater flexibility in future policy decisions.

Before explaining the details of SET Tax implementation, it is important to look at political influences in play today and to review how our current system of taxation evolved.

***However, to readers who want an explanation of the SET Tax solution first, please turn to page 27 of this paper.***

## **PART ONE: THE ENVIRONMENT AND PEOPLE OUR INCOME TAX SYSTEM SERVES**

### **One State, Two States, Red States, Blue States**

Coverage of recent federal elections portrays the electorate in starkly contrasting terms as red states – where majorities vote for Republican presidential candidates – and blue states – where majorities vote for Democrats. (Of course, in most states a significant minority of the opposite hue exists.) The voting dichotomy is tied to different philosophies of government in the red and blue states. In the red states, there is a heartfelt belief that reliance on free enterprise and individualism over time leads to a sounder, more prosperous society. In contrast, the majorities in blue states believe that the market needs to be nudged along. Blue staters have less faith in the market, and emphasize the importance of the role of government to support society's less fortunate people.

These starkly different political philosophies result in vastly different approaches to tax and fiscal policy, typically with red states opting for market solutions to public problems and lower, less progressive tax systems, while blue states choose publicly financed policy solutions and generally higher and more progressive taxes.

The divergent views also color the outlook of each part of the electorate toward the other. Blue staters often emphasize that their states are paying into the federal government more than they receive, based upon the assumption that government distributes the difference to the red states. Red staters, on the other hand, look at the tax benefits blue staters derive from itemized deductions for mortgage interest and state and local taxes, and conclude that red states are subsidizing the higher interest and taxes paid by blue staters.

## **PART TWO: HOW THE SYSTEM HAS EVOLVED**

### **What the Code Is and How It Got That Way**

In order to understand the NYSSCPA SET Tax as the fix to address the dysfunction in the current taxation system, it is important to look at how taxation came about and changed over the first few centuries of our country's history. The NYSSCPA SET Tax fixes the transparency that was lost as both political issues and state and federal taxation decisions steered the country away from a tax system based on a set definition of income with clear deductions.

In early America, the federal government relied almost exclusively on customs receipts (tariffs) and the sale of public lands for its revenue. In periods of emergency, such as the War of 1812, the government added excise taxes. During the Civil War, when customs receipts again were insufficient to support the government, Congress imposed an income tax. By the end of the war, a tax of 5% was imposed on income from \$600 to \$5,000; 7.5% from \$5,000 to \$10,000; and a top rate of 10% was imposed on incomes exceeding \$10,000.<sup>1</sup> Following the Civil War, the government repealed the income tax and returned to reliance on customs receipts and excise taxes.<sup>2</sup>

Sectional differences in how the federal government should tax are not new. In the 19<sup>th</sup> century, the Northern states favored the tariffs because they offered protection from European competition. The Southern states, however, opposed the tariffs because they added to the cost of products. Later in that century, the South and West favored an income tax, shifting the burden of paying taxes toward the industrial North. This illustrates a parallel to the red/blue dichotomy of today.

With the rise of populism and the resurgence of the post-Civil War Democratic Party, interest in the income tax grew, and in 1894, a coalition of Democrats and Populists pushed a new income tax through, only to see it declared unconstitutional by the Supreme Court. The decision hinged on an obscure provision in the Constitution that "direct" taxes needed to be apportioned among the states based on their respective populations. This wouldn't work for an income tax, because residents of one state would find themselves subject to tax at a different federal tax rate than those in another state.<sup>3</sup>

The push for an income tax subsided until 1909, when both major parties agreed to enact a corporate “franchise tax” based on corporate income. President Taft supported individual income tax as well, but required that it first be permitted through a Constitutional amendment. While he may have thought that this would indefinitely delay an individual income tax, the process took only four years, and the income tax amendment, the Sixteenth, was added to the Constitution. Subsequently, Congress imposed an income tax through the Revenue Act of 1913. That law imposed a “normal” tax of 1% on income over \$3,000 (\$4,000 for married couples) and a “surtax,” ranging from 1% on net income from \$20,000 to \$50,000, up to 6% for income exceeding \$500,000.<sup>4</sup> According to Bittker and Lokken, the “distinction between the flat rate normal tax and the progressive surtax was based on the theory that the former was a permanent feature of the federal fiscal landscape but that the surtax was a temporary expedient, imposed on upper-income taxpayers only in times of special need.” The distinction was abandoned in 1954 for individuals and in 1978 for corporations.

World War I saw a renewed reliance on the income tax to fund a war. Rates rose significantly during the war, but there were only 4.4 million returns from a population of 59 million. During the Roaring 20s tax rates dropped, but not to pre-war levels. Only 5 million returns were filed annually from a population that ranged from 65 to 70 million. Then in 1932, notwithstanding the aftermath of the Great Depression, a fiscally hawkish Congress raised rates approximately to World War I levels. The revenue of Americans had so trailed off by that time, however, that the tax revenues dropped from \$86.8 billion in 1929 to \$42.8 billion in 1932. The year 1935 saw increased progressivity on both corporate and personal income taxes, with corporate rates ranging from 12.5% to 15% and individual rates as high as 75% on incomes over \$5 million. 1937 saw tax reforms targeted to tie down certain tax avoidance schemes. These reforms included disallowance of losses from sales between family members, taxes on unreasonable retention of income in a corporation, and restrictions on personal holding companies.

The year 1939 was a big year for tax legislation. In that year, the tax laws, which had been spread throughout many volumes of federal statutes, were codified. This first Internal Revenue Code of 1939, with occasional amendments, would remain in force until 1954.

The period from 1940 to 1945 included the use of income tax to fund yet another war. But just as significantly, the income tax became a tax of the masses during this

time. In 1939, fewer than 4 million returns were filed; by 1943 that number had increased to nearly 43 million returns. 1942 saw the introduction of payroll withholding at source. With the 1939 codification and the conversion of the income tax into a mass tax, the income tax had come of age.

It is also important to note that as the roles of state and local government have mixed over the last 50 years, the taxes the various levels of government have relied upon have also mixed. Up until the Great Depression and World War II, the federal government handled defense and foreign relations and, to a small degree, internal improvements, while the states handled policing, regulation, education, and other local issues. Each level of government had its traditional revenue sources: the federal government had tariffs and the income tax; the states had sales and property taxes. Post-World War II and into the Great Society, the government took a larger and larger share of what traditionally had been state functions (public housing, education, policing) and became less concerned about the encroachment on traditional state sources of revenue. The erosion of the state tax deduction is an example. Simple local taxes to provide services, state taxes to handle major projects such as highway construction, and federal taxes to support war efforts became marbled, as deductions, exemptions, and credits made it more unclear than clear where tax dollars were actually going.

The tax system allows Congress to steer the economy in a direction that is favorable for the times. For example, when Congress believed that manufacturing needed encouragement, we had the investment tax credit; when the residential rental market needed a boost, depreciation rules were liberalized.

The SET Tax addresses a return to transparency, while allowing the taxation system to remain an instrument of social policy.

## **PART THREE: CRITICAL FLAWS IN TODAY'S INCOME TAX SYSTEM**

### **Periodic Reinvention of the Internal Revenue Code Adds Complexity**

The Internal Revenue Code (the "Code" or "IRC")<sup>5</sup> contains the sum and substance of the federal government's tax systems: not just the regular income tax, but a plethora of other taxes including the alternative minimum tax, estate and gift taxes, employment taxes, excise taxes, penalties, and fees.

Every generation or so, the Code goes through an overhaul; 1939, 1954, 1986 being perhaps the most memorable, each having resulted in a renaming of the Code. (The Code in its present form is the Internal Revenue Code of 1986.) Following each overhaul, a process begins anew to tinker with the Code, and over time, grand new tax policy ideas are added, together with a multitude of special interest provisions. These provisions often reflect different approaches to implementing tax policy, such as using tax credits instead of deductions to stimulate an activity, or caps instead of phase-outs to limit tax benefits.

The following examples illustrate the kind of confusion and complexity that exists in the current tax system.

**Tax Credits Versus Deductions.** A deduction is a reduction to arrive at taxable income, the "base" on which your tax is computed. A tax credit is a direct reduction in taxes. Both these techniques are used in the Code to stimulate a desired activity. In a progressive tax rate system like today's, each higher layer of income is taxed at progressively higher rates. Deductions are therefore generally "more valuable" to the wealthy because they provide tax savings at a higher tax rate than do the tax savings produced for the less fortunate at their lower tax rates. Tax credits are perceived to be more egalitarian because, rich or poor, a tax credit reduces the same amount of tax regardless of income level.

Calculations become even more obtuse when Congress struggles to decide whether the excess deduction can be carried forward or back into another tax year's calculation and whether the credits are refundable, lost, or carried forward or back if they cannot be used in the current year. The tension between offering a

credit versus offering a deduction to deliver tax policy initiatives introduces a lot of interactive complexity that makes today's code needlessly obtuse in many areas that require simplification.

Even in the simplest of examples, credits versus deductions at different times with different tools and different goals in mind can introduce unnecessary confusion. For instance, Congress decided that it wanted to encourage businesses to conduct research. Before 1954, the state of the law was unclear, and taxpayers didn't know if research expenses could be deducted from income or if they needed to be capitalized—that is, added to the cost of an asset, but not permitted as a deduction.

Code section 174, which was first enacted in the Code in 1954, permits taxpayers either to capitalize the expenses or to write off 100% of expenditures falling within the Code's definition of research expenses. Moreover, if the expenses are capitalized and the taxpayer can't determine a specific useful life for the expenditure, the taxpayer may elect to amortize the research expenditure over a period of 60 months.

To further encourage research expenditures, Congress in 1981 enacted what now is section 41, which permits businesses to take a tax credit based on the amount that their research expenses increase from one year to the next. The credit is 20% of the cost of any basic research plus 20% of the increase in costs over a base year of any other research performed.

This is a good example, too, of complication in the Tax Code. Sections 174 and 41 use different definitions for research. Also, section 41 contains a sunset date that needs to be reset every year or so, making it difficult to include the economic effect of taxes in planning decisions involving research, which tends to defeat the reason for the credit in the first place.

**Caps Versus Phase-outs.** A cap is an overall limit on a deduction. An example in the Code is the limitation on the deductibility of salary paid to highly compensated individuals. Code section 162(m) limits to \$1 million the deduction that any publicly traded businesses may take for compensation (other than performance-based compensation<sup>6</sup>) paid to any CEO or other employee whose

salary must be reported to the shareholders pursuant to the Securities Exchange Act of 1934.

A phase-out, on the other hand, is a deduction or credit that vanishes as income rises. An example of this is personal exemptions, included in Code section 151. In 2004, taxpayers can deduct \$3,100 for every dependent in their household. However, as taxpayers' income rises, this deduction phases out. The phase-out is 2% for every \$2,500 (or fraction thereof) that the taxpayer's adjusted gross income exceeds \$142,700 (\$214,050 for married taxpayers filing jointly). So a single taxpayer whose adjusted gross income is \$167,700 must reduce his or her personal exemptions by 20%,  $[(\$167,700 - \$142,700) / \$2,500] \times 2\%$ . This feature of the Tax Code also illustrates one of its unfair characteristics. In the example, if the taxpayer's adjusted gross income was just \$1 more, \$167,701, the reduction is kicked up from 20 to 22%,  $[(\$167,701 - \$142,700) / \$2,500] \times 2\%$ .<sup>7</sup>

Sometimes, caps and phase-outs are combined. For instance, Code section 221 permits individuals to deduct up to \$2,500 (cap) of interest on qualified education loans. However, if the taxpayer's "modified adjusted gross income" exceeds \$50,000 (\$100,000 for married taxpayers filing jointly), the deductible interest is reduced by a fraction, the numerator of which is the amount the modified adjusted gross income exceeds the levels cited, and the denominator of which is \$15,000 (for married filing jointly, \$30,000). In other words, the deduction phases out as the taxpayer's modified adjusted gross income rises from \$50,000 to \$65,000 (for married filing jointly, from \$100,000 to \$115,000).

This example also illustrates how complicated the Code has become. Note that the personal exemption phase-out hinges on "adjusted gross income," while the education loan interest phase-out depends on "*modified* adjusted gross income." When phase-out techniques are relied on in drafting tax laws, it is important to make sure the phase-outs are applied in a particular order so that the taxpayer can ascertain how much of each credit is used and how much, if any, remains available for carryback or carryforward. While it is true that this can be deftly designed into tax preparation software, these tax-design approaches greatly lessen transparency, making the Code a "bad" tax in light of the criteria discussed later.

These different tax policy approaches eventually build up a great deal of Code clutter, which is the cause of much of the Code's complexity and opaqueness today<sup>8</sup>.

A simplified system of subtractions from gross income and a single tax rate are the foundations of the SET Tax system. All the concepts contributing to code clutter—deductions, credits, caps, phase-outs based on multiple income measurements, and more—can be merged into a single set of more understandable operating principles.

### **AMT: The Phantom Menace**

Perhaps no specific element in the Code exemplifies the snowball effect of clutter better than the individual alternative minimum tax. Congress enacted the add-on minimum tax, the predecessor of the AMT, to ensure that high-income individuals could not use deductions and exemptions to eliminate their tax liability altogether. Everyone whose income exceeded a threshold would have to pay something. This exploitation of the tax system, was the result of taxpayers using Congressionally approved benefits designed to encourage specific activities. Many had argued that the benefits should be curtailed instead of imposing an alternative tax system. This policy justification—that everyone should pay something in income tax—carried forward to the AMT, which was enacted in 1978. A few years later, this needless complication was introduced to corporate taxation, for most of the same tax policy reasons. We will focus on the individual AMT to show you why we call it “The Phantom Menace.”

The individual AMT is no longer a net to snag a few high-income individuals perceived as exploiting the system. Over the years, rather than a way to catch tax avoiders, the AMT became a system to *increase* taxes on those with high incomes who already were *paying* taxes. It is a separate system, parallel to the regular income tax part of the Code, with its own complex rules and with a flawed design. It now ensnares not just a few high-income taxpayers paying little or no tax, but many more people than its creators could ever have intended.

Consider that, according to the Internal Revenue Service, in 1970, only 19,000 people paid an alternative tax (under rules for a precursor to the AMT). Under the current AMT, that number has proliferated to 3 million people today, and if things don't

change, as many as 33 million taxpayers might pay additional taxes under the AMT by 2010.

How is it that so many taxpayers fall into AMT? A recent editorial in *The New York Times* succinctly stated that the AMT is triggered when taxable income—the net amount after adjustments, deductions, and exemptions are made—surpasses certain maximum allowances for exemptions.<sup>9</sup> One problem is that income brackets and exemptions designed to remove the middle class from this tax calculation headache and payment burden were never indexed to inflation, as so many critics like to point out. Consequently, the AMT driftnet snags an increasing number of individuals as our economy grows over time. Many individuals earning economically middle-incomes today are high-income individuals for tax purposes, making AMT a kind of “tax out of time.”

Lawmakers know this is a serious problem, and from time to time, they attempt to make quick fixes to match AMT rates to contemporary realities. Eliminating the AMT at once would prove costly: \$600 billion over 10 years, according to a Congressional Budget Office report.<sup>10</sup> And there may also be institutional resistance to stanching a reliable revenue source; AMT currently rakes in about \$18 billion. It is not surprising, then, that alterations to the AMT exemption have been piecemeal and often temporary.

Lawmakers have raised the AMT exemption several times since 1978. Congress in 2001 determined that an individual (single, head of household) with an adjusted gross income of \$35,750 was wealthy enough to fall into the AMT. The Jobs Growth and Tax Relief Reconciliation Act of 2003 raised that figure to \$40,250 (while setting the exemption at \$58,000 for joint filers and surviving spouses, and \$29,000 for married individuals filing separately), which reverts to the 2001 level this year if Congress doesn't move to extend the AMT exemption.

Some have questioned even these higher exemption figures as an unrealistic anachronism. Bart Fooden and Lawrence Shoenthal, both CPAs who have written about AMT, wonder how a single parent could expect to feed, clothe, shelter, and medically provide for a family of five and also pay the AMT, with such a relatively low exemption.<sup>11</sup>

However, problems that are more fundamental vex the AMT. Its characterization of deductions and exemptions as “loopholes” can have the unfortunate appearance of punishing higher-income individuals (though not the highest in today's terms) for earning a living. State and local tax deductions, miscellaneous itemized deductions, and

personal exemptions add up to trigger the AMT. This has obvious ramifications for those who live in high-tax areas or where the cost of earning a living is onerous, making AMT a “tax out of place.”

The AMT undermines the usefulness of deductions for some individuals who deign to employ them. As Fooden and Shoenthal point out, if an individual pays a lawyer a fee for collecting back wages, the legal fee is a miscellaneous deduction. But under AMT, that fee, a cost of earning income, is no longer an expense; the deduction is negated. So if an individual pays a lawyer \$300 for collecting \$1,000 of back pay, netting \$700, the AMT taxes the individual on the full \$1,000.

While the AMT affects a majority of individuals and families who earn more than \$100,000, its impact can be potentially damaging to others, such as retirees on a fixed income. For example, an employee who was compensated by his or her company in qualified stock options, because it had no cash to pay salaries, could owe taxes, even if the exercised stock option produced no regular taxable income.<sup>12</sup> Another aspect of the AMT is that it not only increases the complexity of the tax law, but also dramatically increases the compliance costs. The average time to complete an individual tax treturn has been estimated as 6 hours and 40 minutes. However, it is not only those who *will* be required to pay the AMT who must fill out AMT forms, it is anyone who *may* be required to pay. In May 2001, Congress’ Joint Economic Committee (“JEC”) estimated that 4.4 million taxpayers filed the form, while only about 880,000 had to pay additional taxes. The JEC estimates that compliance costs were \$360 million dollars, while the tax generated \$4 billion in revenue. This rate of 9% of costs as compared to revenue is more than 5 times higher than the 1.6% rate of preparation costs to revenue that pertains to the rest of the income tax.<sup>13</sup>

Finally, the GAO calculates that in 1998 as few as 14,000 taxpayers went from paying no tax to paying some tax because of the AMT. Furthermore, in 1998, per the Joint Economic Committee, only 3,572 of the individuals paying AMT had high incomes (earned \$200,000 or more). In most cases the AMT merely increased the burden on people already paying tax, and did so in a complex, arbitrary, and unpredictable way. It seems highly questionable, from a tax policy point of view, to subject tens of millions of taxpayers to the complications of the AMT in order to collect tax from 14,000 people.

The SET Tax is a better approach. The SET Tax eliminates the AMT (both corporate and individual) and is a system available to raise the same revenues from the same (or different) taxpayers, in a transparent, relatively easy to understand way.

### **Who Designs the Code?**

Our political leaders, after first divining the public's enthusiasm for, or at least tolerance of, competing tax proposals, make the decisions about which policies will be embedded into the Code. They sit in the captain's chair and determine in which direction we are to head as they balance the views of various constituencies.

Because of its eclectic origin, the IRC reflects a balance among many political forces. Macro political theories as well as micro political interests influence the cycle of reforming and re cluttering the Code.

**Illustrations of Macro Theories.** An example of a macro political theory at work in the Code is the belief that the Code is the most efficient means of effecting a social policy.<sup>14</sup> This belief resulted in: (1) the earned income tax credit, a Tax Code alternative to a bureaucratic delivery system for welfare payments; (2) mortgage interest deductions to foster home ownership *en masse*; (3) individual taxation exclusion and deduction for health insurance instead of direct government-sponsored medical care for workers; and (4) IRAs and 401(k)s, a Code-based effort to induce greater retirement savings [including employer contributions in many corporate 401(k)s] and to minimize the need for government-sponsored direct pensions through Social Security.

**Illustrations of Micro Interests.** An example of a Code provision resulting from micro political interests is the provision passed in 1976 [currently Code section 162(h)] that provides state legislators with liberalized rules for deducting their travel away from home. Another example is the "above-the-line" deduction of miscellaneous employment-related expenses incurred by teachers. Still another is the Indian Employment Tax Credit, originally enacted in 1993 and extended in 2004, which gives employers a tax credit to stimulate economic development on Indian reservations.

**Illustrations of Industry-Oriented Code Provisions.** Between these extremes are (1) industry-wide incentives such as the advantageous tax treatment given to

commercial real estate before the 1986 Tax Act and the non–generally accepted accounting methods still permitted to farmers, (2) tax incentives to foster increased research and development, and (3) special depletion methods to encourage oil and gas exploration.

### **Transparency: The Color the Code Lacks Most**

Michael Graetz, in his 1997 book *The Decline (and Fall?) of the Income Tax*, observes that between 1972 and 1979, the public’s confidence in the income tax waned from rating the income tax as the fairest in 1972 to the unfairest in 1979.<sup>15</sup> We maintain that the reason for this particular attitudinal change is the opaqueness that the Code adopted during that decade, and, indeed, over the last 30 years generally. The present Code can be faulted on a number of fronts, but the most serious—and the key to restoring confidence in the tax system—is the Code’s lack of transparency. As a characteristic of a tax system, transparency can be viewed as follows:

*Taxpayers should know that a tax exists and how and when it is imposed upon them and others. Visibility enables individuals and businesses to know the true cost of transactions. It also enables them to see what their total tax liability is and to which level of government it is being paid. When a tax is not visible, it can be easily retained or raised with little, if any, awareness among taxpayers about how the tax affects them.*<sup>16</sup>

Furthermore, we emphasize that transparency gives political leaders a much better grasp on how a tax change will impact their constituencies. It is frustrating for political leaders to believe they are benefiting constituents—say, with the addition of a child credit or marriage penalty relief or lower tax rates—only to learn they have angered constituents because the anticipated benefits had been neutered by the alternative minimum tax or were inapplicable because of phase-outs. Transparency benefits everyone, except those wishing to hide a tax loophole from public scrutiny.

## **PART FOUR: GOALS TO A GOOD INCOME TAX SYSTEM**

### **How to Know a Good Tax When You See It**

In some fashion or other, tax policy writers have a common wellspring to gauge when a tax system is “good.” They refer to Adam Smith’s monumental *An Inquiry into the Nature and Causes of the Wealth of Nations*, published in 1776, where Smith identifies the four maxims for a good tax system, paraphrased as follows:

1. Everyone ought to support the government, through taxes in proportion to their abilities.
2. Tax payments ought to be certain and not arbitrary, with the time of payment clear and plain.
3. Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it.
4. Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the state.

Over the years, these four basic concepts have been analyzed on numerous occasions. An excellent, recent treatment was performed by the American Institute of Certified Public Accountants,<sup>17</sup> which parsed the four maxims into the following ten “Guiding Principles”:

1. *Equity and Fairness.* Similarly situated taxpayers should be taxed similarly.
2. *Certainty.* The tax rules should clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined.
3. *Convenience of Payment.* A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.
4. *Economy in Collection.* The costs to collect a tax should be kept to a minimum for both the government and taxpayers.

5. *Simplicity*. The tax law should be simple so that taxpayers understand the rules and can comply with them correctly and in a cost-efficient manner.
6. *Neutrality*. The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.
7. *Economic Growth and Efficiency*. The tax system should not impede or reduce the productive capacity of the economy.
8. *Transparency and Visibility*. Taxpayers should know that a tax exists and how and when it is imposed upon them and others.
9. *Minimum Tax Gap*. A tax should be structured to minimize noncompliance.
10. *Appropriate Government Revenues*. The tax system should enable the government to determine how much tax revenue will likely be collected and when.

### **Right and Wrong Ways to Achieve Progressivity**

As noted above, one of the “Guiding Principles” for a good tax system is “Equity and Fairness.” Economists talk about horizontal and vertical equity. Horizontal equity is that similarly situated taxpayers should be treated similarly. Vertical equity is that there should be appropriate differentiations between persons on an income level and those above and below.<sup>18</sup>

To achieve vertical equity, our political leaders have, since the Civil War income tax, designed progressivity into the income tax. The most direct way to do this is with a progressive tax rate structure. One problem that resulted from this approach is that taxpayers began to arrange their dealings to shift from higher tax-rate strata into lower ones. This was done by converting income from a type that was taxed at a higher rate (traditionally, dividends and interest) into types that were taxed at a lower, more preferential rate (capital gains or earned income), and from higher-income taxpayers to lower-income tax payers (from parents to children). It was also done by deferring income from one year into the next.<sup>19</sup> To lessen the incentive to game the tax structure, Congress, beginning with the Reagan administration, reduced the degree of

progressivity in the tax rate structure. Top tax rates were reduced and the tax base was broadened, meaning that rates were lowered but more income was subject to tax.

During that same time, Congress has increasingly relied upon other techniques to achieve progressivity, most notably caps and phase-outs, which are used to limit tax benefits to higher-income taxpayers. While caps are relatively straightforward, phase-outs tend to greatly exacerbate the Code's complexity and reduce its transparency.

All techniques to achieve progressivity tend to have disproportionate impact on states with higher costs of living, generally the blue states. "Unequal Burdens: Some States Feasting at the Expense of Others?," *Tax Watch* (Tax Foundation, Winter 2004). The author makes the point with the following example:

Paying higher taxes may seem like a small price to pay for enjoying higher incomes, but unfortunately many states' higher incomes are an illusion once cost of living is taken into account.

For example, an income of \$132,143 in San Francisco buys the same living standard as \$84,111 in Portland because of Oregon's sharply lower cost of living. However, that San Francisco income would result in \$22,812 in federal taxes, while the Portland income would result in just \$10,748, illustrating how states with high per capita incomes get the worst deal from Uncle Sam.

This article makes the point that progressive rates impact a higher percentage of taxpayers in high-income states. Caps and phase-outs are techniques to raise progressivity outside the tax rate structure.<sup>20</sup>

### **Some Principled Thoughts on Simplicity and Complexity**

Simplification of taxes is a very complex phenomenon. The paradox in this statement is the battle to be fought and won when redesigning the Code. Simplification is a word that means different things to different people. The differences are significant, not subtle. Simplification takes on totally different meanings based on each constituency's perspective.

For instance, simplification to most citizens really means, "How do I pay less tax more conveniently?" The SET Tax does not fall into this "less is more" trap. Government must be financed. We have focused on the "more conveniently" motivator while doing our best to manage the "less tax" motivator. It bears repeating: Every government needs to be financed.

On the other hand, simplification to government administrators in a "modern" society means, "How can I collect more tax revenues at a lower cost with less effort?" An optimized, fully functioning "self-assessment" system is essential for the implementation of this philosophy.

Our current self-assessment system is neither optimized nor fully functioning. This is primarily due to the design of tax provisions enacted by Congress. There have been many efforts to “simplify” the income tax process and make these taxes more understandable, but no one has successfully stood back and reexamined the “system” to see if doing the same thing differently could produce better results. Most efforts have focused on polishing and cleaning up all the old tools, rather than looking for new ones. For example, most changes since 1986 (which was the last major overhaul of the tax system) have made the tax system less efficient and, in the process, less simple. Changes in the world economy have also made tax policy and implementation methods that are embedded in the Code from as far back as 1913 far less efficient in the 21<sup>st</sup>-century economy. We must be mindful that our tax laws were enacted at many different times for reasons that were valid for those times but may have conflicted with the underlying rationale of other changes. What is perceived as a “loophole” in the 2000s oftentimes was believed to be a highly beneficial provision in the 1940s.

In the past, due to our political sensitivity to the needs of defined segments of the taxpaying public, these concerns have regularly introduced complexity to narrowly address (and therefore define) certain groups of taxpayers. More often than not, the complexity is a so-called “tax trap” that causes the fully compliant taxpayers to pay more tax than they otherwise would pay. These tax traps (see: alternative minimum tax, phase-outs, Subpart F, etc.) severely challenge the design and implementation of a self-assessment system due to the tax administrators’ and general public’s inability to fully understand and comply with the complexity of the Code. The IRS is, and always will be, underfunded for the task, and the public often has little incentive to use resources to pay more taxes.

Simplification can lead to lower taxes through higher compliance rates. Taxes collected are equal to taxes imposed multiplied by tax compliance rates. It follows that the higher the compliance rate, the lower the tax rate required to produce the same funding for government. Government estimates are that we have the highest tax compliance rate in the industrialized world: about 85%. This level of compliance may well be envied by other countries, but for the US it is still a suboptimal performance. We can do better. If simplification increases our compliance rate 10%, in a revenue-neutral system, all compliant taxpayers could well be granted a 12% tax reduction...and more

discretionary time to pursue interests other than tax compliance. Simple tax rules promote accurate, honest self-assessment of tax.

### **When to Impose Complexity**

People tolerate complexity when it involves minimal cost and effort; in contrast, many endorse it when it leads to a reward. In tax systems, the "reward" is an honestly received reduction in taxes. Whenever possible, an efficient tax system will introduce complexity to enable taxpayers to save taxes. As long as the complexity is sufficiently transparent for the government to administer, and the rules are reasonable for honest taxpayers to implement, the resulting tax system will provide the appropriate net tax to fund the government. The drafters of the Revenue Act of 1913 understood this, in admittedly simpler times.

The Code started with the precursor to the current bedrock of the U.S. income tax, Code Section 61. This short but simple Code section defines what will be taxed: "gross income means all income from whatever source derived." The Code then qualifies this broad statement with a theme that follows in the rest of the current IRC: "except as otherwise provided." The exceptions lead to complexity—generally fair and appropriate complexity—because they introduce economic goals and social policy into the system.

The root cause of inefficient complexity is those exceptions to the exceptions. Congress typically designs them to narrow the focus of the first-level exception, making penalties for some out of rewards designed for others.

**Inefficient complexity.** The AMT is a perfect example, and is the quintessential example of needless complexity that fosters noncompliance. The theory behind the AMT is flawed from both simplification and efficiency perspectives. It was designed as an additional system to tax people who enjoyed too much benefit from the exceptions in the regular tax system. By adding a completely new system, compliance complexity and hard work lead to more tax. Any attempt to enforce this on all but the most sophisticated (and fearful) taxpayers is flawed and inefficient.

**Efficient, Self-policing Complexity.** A more efficient, self-policing complexity would require taxpayers to report and identify to the IRS some targeted or all tax-deductible payments paid to vendors as a condition of allowing the payer a tax deduction. This would entail enhancing the current Form 1099 reporting system, which generally simply provides a \$50-per-event penalty for failure to report certain payments to independent contractors and other unincorporated service providers, and would require modest fairness exceptions (for the genuinely uninformed and less sophisticated) and procedural protections (government receipts for the data, to protect taxpayers from IRS errors). The reward for compliance is the tax savings produced. Bonus: the recipient of the payment has more encouragement to comply voluntarily with the tax laws, and the government has more useful enforcement tools.

**Efficient, Self-policing Complexity.** The donation of a qualified conservation interest in real property, foreign-earned income/housing exclusions, and the requirement to have a letter to further substantiate large charitable contributions are all examples of relatively efficient complexity. Most credits (e.g. welfare-to-work, child and dependent care, adoption low-income housing, community development corporations, Liberty Zone, etc.) also provide rewards rather than higher taxes for hard work, and are more easily tolerated, administered, and monitored in a self-assessment system, even though they are occasionally mind-numbingly complex.

As will be shown later, these provisions are easily translated to exemptions in the SET Code.

### **Change as a Source of Complexity**

Change, in and of itself, adds complexity and is generally considered anti-simplification. Any simplification will require substantive changes to the way we are taxed, so any short-term complexity must be considered the price we pay for long-term improvements and simplification. The price must be worth the results.

## **Simplification and Fairness**

Simplification of our system must be at a fair price. Simplification must balance the taxpayers' and our government's sense of simplification against transactional complexity that is appropriate to the tax benefit granted and the policy goal sought.

At the same time, we cannot be afraid of rounding errors or of insignificant groups or transactions. All too often, tax provisions designed to tax a few people who receive an unintended benefit introduce needless complexity that is bad for the overall system. Former IRS commissioner Fred Goldberg often promoted "rough justice" as a needed compromise to attain the greater simplicity good. Tolerance for rough yet fair justice is possible in an enlightened society.

We need to be brave enough to start afresh and wise enough not to change everything. It is simple: In designing the Code, we should always be addressing who should pay less tax, not who should pay more. The single, high tax rate in the SET Tax approach sets the stage for this perspective. Each section of the Code and each implementation of tax policy embedded in the Code can be reevaluated and restructured without changing the taxes we pay. Report the broadest of tax bases, and all gross income. Then reduce it to be "fair" and to exercise the political will of the people with legislated reductions. Here's an example:

**Foreign Taxes.** Congress invented Subpart F in the early 1960s to ensure that U.S. persons pay tax on their worldwide income eventually. Prior to then, the law allowed U.S. business owners to delay paying tax (indefinitely) by leaving the earnings offshore. Tax must be paid on all "income from whatever source derived," but when? When earned, or when received in the U.S.? Many perceived that these offshore "pocketbooks" were no different from bank accounts in foreign shell corporations, which became subject to current tax in the 1930s when taxpayers discovered this tax-free wealth-accumulation technique.

U.S. businesses pleaded that they needed to deploy capital offshore so that they could build global businesses that would compete efficiently with other global businesses. Congress designed Subpart F to bring some foreign earnings into the current tax system while respecting the needs of U.S. owners of international businesses to compete globally.

Unfortunately, Subpart F taxes some income, but requires the taxpayer to expend enormous resources to compute how much more to pay. Basically, a U.S. owner of a significant portion of a foreign corporation may continue to defer tax on the owner's share of active business income abroad until the income is returned to the U.S., but must pay tax currently on the other income in the foreign corporate structure in the year it is earned. Complex ancillary filing and reporting is required to see if the owner owes more tax. Other than well-informed, major multinational corporations, most taxpayers who own stock in foreign corporations are surprised to learn of this compliance requirement and potential tax responsibility. (In fact, it is the same ignorance of special rules relating to foreign investments that over the years have regularly trapped unsuspecting taxpayers into cleverly marketed but nevertheless fraudulent offshore tax shelters.)

A more efficient self-policing system would be to restate Subpart F by taxing all foreign earnings of U.S. owners and making reductions for earnings from a foreign trade or business, for small shareholdings—i.e., owners of less than 5% or 10% of a foreign corporation—business needs, and other relevant items. It should be easier for the public to understand and accept disclosure (the key to policing a self-assessment system), and taxpayers should work much more willingly to reduce their taxes because they qualify for a reduction of the income that is taxed

### **Revenue Neutrality as Complexity Generator**

Revenue neutrality rules need a commonsense fix to remove needless complexity in the current system. The government uses the cash basis of accounting, and measures results based on the difference between cash received from taxes and cash paid to fund government. Under the current revenue-scoring rules, the change from any old tax to a new proposed tax provision is measured by the change in the expected tax collections over a fixed 10-year period. The fixed period is referred to as a budget window. The combination of cash-basis measurement of results and a fixed budget window inadvertently creates false revenue neutrality in some cases—accountants call them timing differences.

Under the current rules, in order to write legislation that follows those revenue neutrality rules, all too often lawmakers become "creative" and write legislation that accelerates revenues by a day or so, or postpones a cost for a few days or weeks, to accomplish their policy objective at a minimum cost. Examples of financial gyrations designed to provide questionable budget neutrality include:

- estimated tax rules;
- current estate tax law, including projected repeal and reenactment;
- most phase-ins and phase-outs.

These techniques reduce the projected "cost" of many tax law changes by minimizing the "cost" in the budget from the revenue window.

Tax-law provisions that accelerate revenue or defer expenses for a week so that they fall into (or out of) a fiscal year do not, in substance, affect the cost of government. When accountants and lawyers manipulate the timing of income and expenditures this way, it is called an abusive tax shelter; when business does this, it is often scandalous and sometimes criminal; but if the Congress does it, it is not criminal, because the Congress sets the rules.

Federal fiscal rules need to change. Some have suggested accrual accounting, which would require government to match revenues with expenses. While theoretically the right answer, in current times this complexity may raise more new problems than solutions to old problems.

A better way to fix the budget window is to ignore so-called "timing differences" in the budget process that would reverse in the next year. There is even a well-known tax principle that revenue estimators could follow called "the recurring item exception," which allows a taxpayer to easily deduct expenses in the current year that are paid year after year and within a fixed period after the end of the year.

Ignoring timing differences from budget scoring when they turn around in a relatively short period would eliminate hundreds, perhaps thousands, of needlessly embedded complex provisions in the Tax Code. These provisions have been overwhelming in the past 20 years under the reasonable budgetary restraints but flawed rules of revenue neutrality. This would also add greater transparency to budget

estimates, highlighting substantive changes and exposing what are now legitimate accounting games.

## **PART FIVE: HOW TO ACCOMPLISH THESE GOALS**

With this background about what makes a tax a “good” or a “bad” tax, and the crying need for transparency and simplicity, we offer an approach that is the epitome of these “good” tax traits, the Simple Exact Transparent Tax, or SET Tax.

### **What Is the Simple Exact Transparent Tax?**

The SET Tax is a greatly simplified income tax, devoid of unnecessary complexity and alternative tax systems. Congress would select a politically acceptable, economically appropriate single tax rate to tax *income*, and then use only straightforward exclusions of its choosing to accomplish additional public-policy goals, such as

- achieving progressivity;
- encouraging economic behavior, such as saving for retirement, manufacturing in the USA, discovering oil, and developing alternate energy sources;
- accomplishing social policy goals, such as encouraging home ownership, charitable giving, etc.

The only tax credits permitted in this tax system might be refundable credits Congress passes to deliver benefits to low-income taxpayers, and possibly credits to coordinate the SET Tax with economic and social realities, e.g., foreign tax credit, although it is possible to do this with a calculated exclusion equivalent.

In other words, the SET Tax would tax all incomes over a generous threshold established by our political leaders and after other government-approved exclusions at an economically appropriate and sociably acceptable single rate.

### **A New Operating Principle**

The current system identifies taxpayers who should pay more tax. Smart, careful drafters should be able to raise the same tax revenues by starting with a general rule that measures everyone’s annual, realized income in relatively simple, easy to understand,

easy to report terms. Everyone's income tax is calculated starting with this baseline of income, less exceptions both for those who should not pay tax and for public policy initiatives. Mathematically, then:

$$(\text{Income} - \text{Congressionally defined exclusions}) \times \text{Rate} = \text{Tax}$$

In essence, income subject to the tax rate would be reduced by exemptions so designated by the Congress, including, for example, mortgage interest, charitable donations, and foreign holdings. A tax system should be designed so that complexity increases with the sophistication of the transactions entered into by the taxpayer. The complexity should, whenever possible, lead to taxpayer rewards that can be readily monitored by the IRS. As a principle, reducing taxes from a clearly disclosed income baseline is more transparent, easier to administer, more efficient to monitor, simpler for unsophisticated taxpayers, and complex for those who can afford to deal with complicated benefits. As an added bonus, when government reduces taxes, the beneficiaries (taxpayers) are happy.

### **How the SET Tax Would Work**

The SET Tax begins with a single tax rate. Generically, therefore, it is a flat tax. Unlike the proposal referred to as THE flat tax, however, the SET Tax would continue to enable Congress to use the tax laws to accomplish their multifaceted policy initiatives. It does this with "base broadening," which is the term used for defining the income to be taxed. Flat-tax proposals generally lower the tax rate and broaden some segment or the entire tax base to generate sufficient funds for our government and the programs it sponsors. Others broaden the base, promising lower rates, only to add a supplementary system (i.e., VAT or other taxes) to replace the old tax that previously raised funds from now newly untaxed income. It is the often invisible definitions of the tax base that sit at the heart of tax complexity, along with the mechanics of the income tax system. It is not the tax rates that add complexity.

The SET Tax is straightforward. It starts with all gross income, the broadest income tax base possible and the easiest to teach and understand. Existing rules are

used to distinguish between income and loans, gifts, inheritances, support, and so on, as well as to handle issues of when income is “received” in complex situations. The SET Tax then radically simplifies the tools used to implement policy through the tax system, by using a mechanical approach to arrive at taxable income. It does this by introducing a single set of “exclusions” from gross income. Exclusions replace the current cluttered system of deductions, refundable credits and nonrefundable credits, filing status determinations, dependents, exemptions, so-called “nontaxable income,” and the like to distribute the income tax burden among various income groups. The exclusions are based on today’s fundamentally sound tax law concepts. For example, “exclusions” in the SET Tax system could include all of today’s deductions, exemptions, exclusions, credits (reengineered into exclusions), and other reasons to reduce an individual’s or a corporation’s gross income to determine his, her, or its tax base.

The following examples illustrate the simplicity of this process. A simple lump-sum exclusion would eliminate the income tax for people who can least afford it. The simple exclusions would be easy to find and easy to understand. More complex exclusions would require a little more work. The work (and related required disclosure of complex behavior) makes the SET Code easier to administer, and easier for the government to find tax cheaters. Increasingly complicated exclusions would apply as the sophistication of taxpayers, and their income, increases. For example, the exclusion for charitable giving would involve modest complexity. Exclusions for people with income earned by certain businesses, foreign corporations or partnerships, foreign or domestic trusts, or bank accounts in foreign countries might become quite complex. The SET Tax simply makes it easier for taxpayers to understand and comply with the rules. In addition, the SET Tax Code could be designed to tax all the people who are paying the “correct” tax now the same amount, but each taxpayer would find their tax burden easier to understand and easier to calculate.

A redesign of today’s cluttered, unsettling rules should produce simplicity and transparency. Not only will the rules be straightforward and easy to comply with, but taxpayers will also know what exclusions can reduce their taxable income. Most of the complicated parts of the Internal Revenue Code would be retained merely as building blocks and protective mechanisms to address the complex business and financial transactions that are the hallmark of our ever-evolving system of capitalism. Complexity, then, under the SET Code, only burdens people who engage in sophisticated or complex

financial activity. But even then, the complexity becomes self-evident, easier to review and more efficient to monitor.

Wage earners, normal investors in our capital markets (i.e., through marketable securities transactions and bank accounts), and private business operators will find the SET Code clear, lacking needless calculations. The SET Tax eliminates the alternative minimum tax, most, if not all, tax credits, and complex filing-status decisions.

Perhaps most important, the SET Tax principles apply equally to income taxation of individuals and of businesses. If policymakers want, they could seamlessly integrate corporate and individual income taxation through identical SET Code principles.

### **The Compliance Bonus**

A fundamental principle of the SET Code would be that income taxes should be borne by citizens and companies that are relatively prosperous. Accordingly, only one rate is required, the SET Rate. In the following examples, a  $33\frac{1}{3}\%$  rate issued to make the calculations easy to understand and to be clear that the SET Rate would need to be high enough to enable Congress to include a high exclusion to eliminate lower-income individuals and businesses from the burden of paying income tax. The current maximum corporate and individual tax rate is 35%, although complexity caused by progressive rates to recapture a full 35% tax for the wealthiest taxpayers on incomes taxed at lower rates causes some marginal income to be taxed at rates up to 39%. Nevertheless, individual and corporate incomes are arguably taxed in total at no more than a flat 35%. A single rate in the low to mid 30% should be sufficient to produce at least the same, if not more, income tax than is produced through the current Code.

The SET Tax system will be a more efficient tax system and will collect more of the tax that is due, setting off a “compliance bonus.” Although our 85% tax compliance rate is the envy of many of our trading partners, a 90% compliance rate would raise significantly more tax revenue and permit Congress to enact lower tax rates to compliant taxpayers, reduce deficits, increase spending for worthy government programs, or any combination of the three.

## Measuring “Tax Expenditures”

Lastly, the SET Code greatly reduces the complexity of measuring our tax expenditures. Currently, the measurement of tax expenditures is immensely complicated by the fact that benefited taxpayers can be subject to dozens of different marginal tax rates because of the interaction of the progressive rate structure, limitations, and phase-outs. By relying on a single rate and simplifying the methods used to deliver tax benefits, tax expenditures can be measured annually, in a way that Members of Congress can more easily articulate and taxpayers can more easily understand. Hence, there is transparency from the top down, and from the bottom up.

## Achieving a SET Tax

Our leaders should retain the ability to use the Code for the delivery of benefits they determine are needed for the common good. They should rely, however, on an income tax that makes valuation of those constituency benefits clear to all. The Simple Exact Transparent Tax, the SET Tax, would accomplish this.

The SET Tax has four components:

1. **Single rate.** We propose an income tax set at a single, relatively high rate so everyone can understand the maximum he or she would pay in the absence of exclusions. We use 33 1/3% in our examples, to make the illustration of the SET Tax easy to understand. The actual rate is to be determined by our political leadership after receiving input from economists, revenue estimators, and constituents.
2. **Gross income is ALL income.** Income would be measured under existing principles, generally using the cash basis for individuals and small businesses, while most larger businesses (including corporations and partnerships) would be required to use the accrual system to recognize gross income. There would be no omission from realized gross income, only deductions we call exclusions. Interest on tax-exempt bonds, then, would be included in gross income and granted an exclusion, provided Congress continues to believe such interest should not be subject to federal income tax.<sup>21</sup> On the other hand, cash receipts that are not income, like gifts or borrowings, would not be included in gross

income. Similarly, as under current law, various tax-free business creations and reorganizations would not create gross income to owners. Current law definitions will be very helpful in this area, and retained.

3. **Every taxpayer would have at least one exclusion; all exclusions should be as simple as possible.** Every taxpayer should have a personal exclusion. This will draw all income earners into the tax system, through an extremely simple filing process. Exclusions beyond the basic exclusion would be consistently and simply crafted, and could be capped or subject to percentage limitations to accommodate progressivity goals.
4. **Not everybody may pay, BUT EVERYBODY FILES!** While we agree with building vertical equity into the tax system through transparent approaches to transparency, we do not believe it is wise to remove individuals completely from tax reporting, even if they owe no tax. That approach acclimates individuals to inaction in their interaction with the tax system. It forces an individual to undertake significant changes when he or she moves from being untaxed into being taxed. In the process, it nurtures the underground economy and tax-evasive behavior.

Every citizen should become accustomed to interacting with the tax-filing system, either by filing a paper tax form or through telephonic or electronic filing. Also, the income tax system should be so designed that the tax forms and instructions are exceedingly simple for lower-income taxpayers to file without requiring assistance from an accountant. These taxpayers should not be forced by an incomprehensible tax system to seek professional assistance, especially to receive the benefit of such items as the earned income tax credit.

### **Benefits of the SET Tax**

There would be no need for an alternative tax system. Everyone would generally know quickly how much the tax benefits they receive are worth. Tax credits would be avoided as much as possible. We anticipate that occasions may arise where credits are necessary, such as if Congress wants to refund taxes to nontaxpayers, similar to the earned income tax credit, or perhaps in the context of foreign taxation.

This will keep the tax system simple, compliant, predictable—in other words, transparent. It integrates easily with the current system, only is easier to administer. There are no new concepts to learn, and many old tricks and traps are relegated to the dustbin. A very significant SET Tax benefit is that it lends itself to much simpler scoring. Congress can better gauge the cost of tax-policy initiatives, and taxpayers easily identify how much they receive in tax benefits.

Innumerable “complexifying,” opaque drafting techniques would disappear from the Code. There would no longer be a need for:

- phase-outs; the purpose served by phase-outs would be addressed by limiting exclusions;
- credits (except for refundable credits);
- multiple filing statuses;
- alternative tax systems;
- transition rules; and
- artificial constructs like “adjusted gross income”, and “modified adjusted gross income.”

It is important to emphasize that the SET Tax retains for the Congress the flexibility to retain progressivity or reduce it, and to engage in social engineering through the tax system or not. The SET Tax enables the government to raise the same money it does now and with the same income distribution, if that is deemed by Congress to be advantageous.

As an aside, the uncertain results of the flat tax (and, in fact, other fundamental reform ideas, such as the value-added and sales taxes, which would play havoc with the federal system by unbalancing fiscal revenue sources relied on by the states) lead many political leaders to conclude that we need to introduce multiple tax systems to replace the income tax. At first blush this may appear prudent; but on reflection, it multiplies the uncertainties. The SET Tax is a much surer solution, and keeps the country on familiar territory.

### **SET Tax Implementation**

Our political leadership would retain the flexibility to set the rate and identify the amount and types of income to tax. An example of how the tax might work explains the

concept best. The NYSSCPA is not endorsing any of the amounts included in the following examples, nor the 33 1/3% rate mentioned above. That determination must be made in the context of the political process. As mentioned previously, the numbers used and the tax rate are offered for illustrative purposes only.

**Personal  
Exemption:  
Progressivity**

We would recommend that Congress adopt a high personal exemption to achieve progressivity. We use a \$30,000 exemption here, but Congress could conclude that it be much higher, perhaps as high as the Social Security income ceiling. Alternatively, the personal exemption could be lower, say at the official poverty level. The SET Tax accommodates any range of government policy, and clearly informs the people of the resolution of any policies debated in this area.

For purposes of this discussion, however, we assume Congress sets the personal exemption at \$30,000. Every income-earning individual would know that the government was spending \$10,000 on his or her behalf.<sup>22</sup>

If more levels of progressivity are desired, subsequent layers can be benefited with partial exclusions. For instance, the first \$20,000 of income could be 100% excludable and the next \$10,000 could be 50% excludable.

Progressivity of a sort is also achieved by capping exclusions, as illustrated in the examples that follow addressing mortgage interest and state taxes.

In the business context, an exemption mirroring the personal exemption could be granted to all corporate taxpayers, or to all small or new businesses, regardless of their choice of business entity. The exemption could be capped or reduced based on business size, using existing definitions of groups and related parties to prevent entity abuse.

**Caregiver  
Exclusion**

If the political leadership determined that society benefits if a person forgoes gainful employment to raise a couple's children, with

appropriate disclosure, an additional special exclusion (in addition to any other standard exclusion) of, say, \$15,000 could be permitted on the income-earning partner's return.<sup>23</sup> Everyone would know that this would entail a \$5,000 benefit.

**Mortgage Interest  
Exclusion**

If our political leaders determined to encourage home ownership, they could permit an exclusion for mortgage interest up to a certain amount, say \$75,000 of interest, to approximately replace today's \$1,100,000 total debt cap. This is an example of an exclusion cap. Homeowners would know that they were receiving a benefit of one-third of their mortgage interest, up to a total benefit of \$25,000. The amount of the exclusion could even vary annually to take into consideration changing interest rates. It would be up to our leaders to determine that fairness and other policy goals warranted this level of complexity, but each year every taxpayer would know how much of a benefit was available, what he or she got, and, shortly after the end of the next year, approximately what it cost the government to provide the benefit. This is a difficult, controversial calculation for many in today's system.

**State Taxes and  
Charitable  
Contributions**

If the political leadership wants to lessen the burden on taxpayers from their contributions to support state government or charities, similar approaches work simply and transparently. Congress could permit an exclusion for all state and local taxes up to a fixed dollar amount, say \$9,000, or for contributions up to \$30,000. Again, everyone could understand that the federal government was supporting these causes on a per-taxpayer basis up to the extent of \$3,000 and \$10,000, respectively. The concept of adjusted gross income and "above-the-line" versus "below-the-line" deduction classifications with varying benefits for items that are deductible is replaced with a uniform measure of income before some exclusions that may need to be means tested.

**Taxes on Capital**

Suppose our trading partners taxed income from capital at only 15%. If our political leaders decided that the U.S. should meet

**Income** that societal “offer” for capital, they could permit a 55%<sup>24</sup> exclusion of any income from capital (interest, dividends, and capital gains). Everyone would know the amount the nation would be investing in capital formation, the amount of capital income times 55% times one-third. (This is an example of a percentage exclusion.)

**Corporate Double Tax** If our political leaders determine that corporate income should not be taxed once at the corporate level and again at the shareholder level, they could grant a 100% exclusion (or lesser percentage) for dividends paid to shareholders.<sup>25</sup>

**Businesses** An exemption for some (or all) of the annual capital costs incurred in a business, similar to the current Section 179 deduction, could be easily added to the exemption for all ordinary trade or business expenses. A percentage depletion exclusion could simply mirror the current system of depletion allowances supporting the extractive industries.

## **PART SIX: COMPARISON OF THE SET TAX WITH OTHER TAX REFORM PROPOSALS**

### **The SET Tax and the Flat Tax**

Although you could call it a flat tax, the SET Tax is not the flat tax. For example, the current most widely recognized flat tax—that is, the Hall-Rabushka proposal and its progeny—is a single-rate wage tax that eliminates deductions for mortgage interest, property taxes, state and local income taxes, charitable contributions, tax exclusions (such as those for scholarships, fellowships, and employee awards), casualty losses, and additional deductions afforded to the elderly and disabled.<sup>26</sup> It does not tax investment income, such as interest dividends and capital gains. The heart of arguments by fans of the flat tax and supply side economists is that a tax system is better that has a broader base and a single, lower tax rate.

The primary arguments urged in favor of these base-broadening approaches are economic, that these approaches reduce the income tax's drag on the economy, that entrepreneurial initiative will be unleashed, that productivity will rise. Typically, proponents urge that such a tax is simpler. However, the result is not necessarily a more transparent tax.

Unfortunately, the flat tax suffers from being rigid in design, and tries to find the lowest tax rate and broadest tax base. The SET Tax approach starts with a higher rate, and narrows the base transparently. The flat tax removes from our political leadership the ability to use the tax system to accomplish targeted economic and social goals. The SET Tax approach retains needed flexibility. The flat tax also requires a significant leap of faith that it will in fact raise the needed revenue to fund public services.

Most of the debate over the past 25 years relating to so-called flat taxes has circled around lowering the maximum income tax rate and substituting other mechanisms to replace the lost revenues. These proposals have a lot of public appeal because the prospect of lower tax rates is always popular, but we remain concerned about the other mechanisms and their lack of transparency. If the people want to use an income tax to fund government, then all incomes should be considered, and narrowed down to a tax base that everyone understands. Because of the structure and history of our current income tax system, by design and by default, some incomes are invisibly sliced away from the tax base. Equally unfortunately, this sometimes happens in an unpredictable, unintended fashion.

CPAs recognize that the Code's complexity does not result from multiple tax rates—that is, the progressive tax rate structure. Complexity results from how the tax base is defined. Nevertheless, progressive rate structures do obscure the impact of tax provisions. They make estimation of the fiscal impact problematic. A single-rate income tax removes this revenue impact uncertainty. But the SET Tax is not the flat tax.

A serious flaw with the flat tax is that it fails to cope with nearly a century of U.S. history in the making of tax law and the evolution of the Internal Revenue Code. To adopt the flat tax, one must buy it lock, stock, and barrel. Our political leaders must be willing to surrender their flexibility to adjust fiscal policy to the needs of the electorate as they see them. Such a wholesale surrender of political decision-making authority cannot be wise, regardless of whether one is a red stater or a blue stater.

Perhaps the most serious flaw, though, is that the flat tax has the effect, perhaps even a goal, of removing many people from the tax rolls. There is a psychological problem with this. If an individual falls off the tax rolls, he or she loses an important sense of involvement in the government. Once lost, the allure of the underground economy can turn a person into a noncomplier. The SET Tax proposes that everyone with income should file something. For the vast majority, the proverbial postcard return would suffice.

### **The SET Tax and the Consumption Tax**

A great deal of attention has been given to shifting from an income tax approach to a consumption tax (otherwise known as an expenditures tax), such as the Hall-Rabushka flat tax, a national sales tax, or a value-added tax. The respective benefits and detriments of the income tax and consumption taxes have been debated for many years.<sup>27</sup>

Briefly, the benefits of an income tax over a consumption tax include:

- Many consider consumption taxes to have equity problems, because they shift the incidence of taxation to those with a higher ratio of consumption relative to income; that is, there is a shift to lower-income and elderly taxpayers, and large families.
- Because consumption levies tend to tax different expenditures at assorted rates, many believe they affect consumers' purchasing decisions, misallocating economic resources. For instance, in some consumption-tax proposals, buying a house would not typically be seen as consumption, but renting one would be. This could distort the housing market in favor of purchasing homes, well beyond the current distortion created by the deduction for interest and real estate taxes.

Supporters see the following benefits flowing from consumption taxes:

- Income taxes have an adverse impact on savings and investment.

- In certain international jurisdictions, indirect taxes, including sales taxes and value-added taxes, can be refunded for goods that are exported. This makes these taxes more conducive to encouraging exports.
- Consumption taxes focus on what one takes from, rather than what one contributes to, the economy, which is a fairer approach.
- Consumption taxes may do a better job of automatically adjusting to inflation.

Furthermore, although consumption taxes are often touted as being simpler than the income tax, they actually entail a great deal of their own complexity. Both types of tax are prone to tax evasion schemes.<sup>28</sup>

In the tax reform debate at hand, proposals will surface that reflect either blue-state or red-state philosophies. The winning tax-reform approach must be flexible enough to reflect either blue or red policy alternatives going forward, or a modicum of both. The result could be a blend of each, as arguably was the case with the landmark Tax Reform Act of 1986. The NYSSCPA urges that, whatever the final hue, any tax-reform legislation be crafted in such a way as to be transparent. The red and blue influences must clearly shine through. The SET Tax suggests a practical approach to achieve transparency regardless of the tint of the outcome.

### **The SET Tax and the Sales Tax (and VAT)**

Several commentators have proposed that the income tax be replaced with a national sales tax or a value-added tax. To replace the income tax, estimates are that a national sales tax rate would need to be as high as 23% or higher, depending on the exemptions from the tax.<sup>29</sup> In addition to the pros and cons discussed above regarding consumption taxes generally, both a national sales tax and a VAT have a serious additional flaw: they impede the federalist balance between the national and the state governments.

Historically, the states have relied on sales and use taxes, property taxes, and, to a lesser degree, income taxes for their revenue. Imposing so high a sales tax or VAT at the national level would impact state revenues in ways that are difficult to anticipate.

From a public policy point of view, many have argued that a tax system that is inherently regressive should not replace an income tax, which is inherently progressive. Even the staunchest VAT supporters recognize that the VAT, as a tax on consumption, will tax a higher portion of the lower incomes and a lower portion of the upper incomes of American households. Europe has a VAT (we have sales tax), but it has not replaced the income tax systems, it co-exists with them.

Perhaps most distressing of all, the VAT is invisible, even if the VAT amount is printed on the sales slip. Few, if any, take notice of dozens, hundreds, or even thousands of transactions. We think transparency is preferable.

## **Conclusion**

Adoption of the Simple Exact Transparent Tax would focus political debate entirely on what “tax expenditures” the political leadership wants to make, and how much the expenditure should be. Instead of locking Congress into what benefits it wants to encourage—as does the flat tax and other fundamental tax reform approaches—the SET Tax provides Congress and the President with a single, transparent delivery vehicle for tax expenditures. It provides the American people with a straightforward tool to measure their incomes and the taxes they pay.

Everyone would have a better chance to understand how government works and why it makes the fiscal decisions it does. This benefits everyone, regardless of the color of his or her state.

In the end, it is not a matter of whether a tax reform is red or blue that matters, but whether it is transparent. The SET Tax is transparent, not to mention simple, equitable and fair, certain, conveniently paid, efficient, and neutral. It promotes economic growth (to the extent our political leaders determine that is advisable) and results in a minimum tax gap, and results in much easier assessment of fiscal propriety. The SET Tax meets today’s economic need for revenue neutrality. In short, it meets all the prerequisites of a good tax system, while maintaining for political leadership the flexibility necessary to govern and finance government initiatives.

## Notes

<sup>1</sup> Per the calculator found at [www.eh.net](http://www.eh.net), based on consumer price indices, the value of \$600 in 1864 would be \$6,986 in 2003 dollars; \$10,000 would be \$116,436.

<sup>2</sup> B. Bittker and L. Lokken, *Federal Taxation of Income, Estates, and Gifts*, vol. 1, (Warren Gorham & Lamont 1999) pp. 1-2 ff.

<sup>3</sup> See *Pollack v. Farmers' Loan & Trust Co.*, 157 U.S. 429, 158 US 601 (1895).

<sup>4</sup> Per the eh.net calculator, \$3,000 in 1913 would be the equivalent of \$55,478 in 2003; \$4,000 would be \$73,971; \$20,000 would be \$369,855; \$50,000 would be \$924,639; and \$500,000 would be \$9,246,387.

<sup>5</sup> "Internal Revenue Code" is shorthand for Title 26 of the United States Code.

<sup>6</sup> We should note that for performance-based compensation to exceed the cap, the performance goals must be approved by outside directors, the compensation must be approved by shareholder vote, and the performance goals must be certified.

<sup>7</sup> The extra dollar adds "a fraction thereof."

<sup>8</sup> See the testimony of Chairman Alan Greenspan before the President's Advisory Panel on Federal Tax Reform, Washington, D.C. (March 3, 2005).

<sup>9</sup> "Mr. Bush's Stealthy Tax Increase," *The New York Times*, March 13, 2005.

<sup>10</sup> CBO Revenue and Tax Policy Brief No. 4, "The Alternative Minimum Tax," April 15, 2004; <http://www.cbo.gov/showdoc.cfm?index=5386&sequence=0#F3>.

<sup>11</sup> B. Fooden and L. Shoenthal, "A Closer Look at the AMT," *The Trusted Professional*, April 1, 2005.

<sup>12</sup> In addition to the references cited in this section, see R. Harvey and J. Templaski, "The Individual AMT," *The National Law Journal* (September 1997), pp. 453-73; Testimony of Thomas M. Sullivan, Chief Counsel for Advocacy, U.S. Small Business Administration, to U.S. House of Representatives Committee on Small Business, July 23, 2003, [http://www.sba.gov/advo/laws/test03\\_0723.html](http://www.sba.gov/advo/laws/test03_0723.html); "What tax cut? Meet the AMT," CNNMoney, [http://money.cnn.com/2004/02/25/pf/taxes/amt\\_stories/](http://money.cnn.com/2004/02/25/pf/taxes/amt_stories/); and *Comments on Tax Simplification*, NYSSCPA Tax Simplification Task Force, May 27, 2003, [http://www.nyssepa.org/commentletter/task\\_simplification.doc](http://www.nyssepa.org/commentletter/task_simplification.doc).

<sup>13</sup> The Alternative Minimum Tax For Individuals: A Growing Burden (Joint Economic Committee Study, May 2001), <http://www.house.gov/jec/tax/amt.htm>.

<sup>14</sup> M. Friedman, *Capitalism and Freedom* (1962).

<sup>15</sup> M.J. Graetz, *The Decline (and Fall?) of the Income Tax*. New York: W.W. Norton & Company, 1997.

<sup>16</sup> Tax Policy Concept Statement Number 1, Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals (AICPA, 2001).

<sup>17</sup> Tax Policy Concept Statement Number 1, Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals (AICPA, 2001).

<sup>18</sup> Bittker and Lokken, para. 3.1.4.

<sup>19</sup> Bittker and Lokken, para 2.2.

<sup>20</sup> "Unequal Burdens: Some States Feasting at the Expense of Others?," *Tax Watch* (Tax Foundation, Winter 2004). The author makes the point with the following example:

Paying higher taxes may seem like a small price to pay for enjoying higher incomes, but unfortunately many states' higher incomes are an illusion once cost of living is taken into account.

For example, an income of \$132,143 in San Francisco buys the same living standard as \$84,111 in Portland because of Oregon's sharply lower cost of living. However, that San Francisco income would result in \$22,812 in federal taxes, while the Portland income would result in just \$10,748, illustrating how states with high per capita incomes get the worst deal from Uncle Sam.

This article makes the point that progressive rates impact a higher percentage of taxpayers in high-income states. Caps and phase-outs are techniques to raise progressivity outside the tax rate structure.

<sup>21</sup> There are those who think this would require a Constitutional amendment.

<sup>22</sup> By the way, there would be no need for joint reporting by married couples, no marriage penalty; all that complexity results from progressive rates.

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<sup>23</sup> In the alternative, Congress could permit couples, married or otherwise, to use combined reporting to simplify filing, and a care-giver deduction could be allowed there.

<sup>24</sup>  $(33\frac{1}{3} - 15\%) / 33\frac{1}{3} = 55\%$

<sup>25</sup> We understand there are some compelling reasons to choose a credit approach to address the corporate double tax issue, if Congress and the President were to decide to do so. Nevertheless, we urge use of a deduction approach if the SET Tax is adopted, and suggest that corporate and individual tax integration can be accomplished several ways through a whole or partial exclusion.

<sup>26</sup> R. Hall and A. Rabushka, *Low Tax, Simple Tax, Flat Tax* (1983). See also M. Sullivan, *Flat Taxes and Consumption Taxes: A Guide to the Debate* (AICPA 1995) for a concise discussion of the flat tax.

<sup>27</sup> B. Bittker and L. Lokken, *Federal Taxation of Income, Estates, and Gifts*, vol. 1 (Warren Gorham & Lamont 1999), para. 3.7.

<sup>28</sup> S. Karlinsky and H. Burton, "America's Inexorable Move to a Consumption-Based Tax System, or Why Warren Buffett Is Winning the Class Tax War," *Tax Notes Today*, November 2, 2004.

<sup>29</sup> See The Fair Tax Act, S. 25, introduced by Senator Chambliss on January 24, 2005.