

Eliminating the Income Tax While Balancing the Budget

by Allen Buckley

Reprinted from *Tax Notes*, September 4, 2017, p. 1271

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In this article, Buckley proposes an alternative to the federal income tax system that would address the need for simplicity while retaining the good aspects of the current system.

I. The Complex Mess

Several years ago, I was griping to a colleague about the complexity of section 409A. I said that Congress had once again missed the boat in terms of balancing desired revenue goals with simplicity. His response: "God bless 'em."

Having worked in the tax field for over 30 years, I know firsthand that the income tax system is a complex mess that only gets more complex as time passes. Many have profited from the complexity of the income tax system, and many would fight to keep it. However, its complexity has become a major drain on the economy.

The current system requires an analysis of whether an addition to wealth is taxable and, if so, when it is taxable, what type of income it is, and the taxable amount. Deductions pose similar complexities, along with the additional need to determine whether capitalization is required. The alternative minimum tax is a tax system in itself. The Affordable Care Act's 3.8 percent tax on net investment income and the related hundreds of pages of regulations called for an additional

accounting system. That's the definition of lost perspective.

The subchapters of the code add enormous complexity. Look at the rules for Roth IRAs and section 401(k) plans. Many single code sections are nightmares — the doctrine of *res ipsa loquitur*¹ applies to section 409A. Consider section 401(a)(9) and its regulations. Add in the incredibly complicated domestic production deduction of section 199 — a cost accountant's treasure chest — and the mess is complete.

Consider the partnership rules concerning the deductibility of losses. Under section 704(d), losses can be deducted only to the extent the partner has adjusted basis in his partnership interest. Under section 465, losses can be deducted only to the extent the partner is at risk on his investment. And under section 469, a partner cannot deduct a loss if the loss is from a passive activity unless he materially participates in the activity. Returning to section 704(d), determining a partner's basis can be a complex task if the partnership has debt, as is often the case. Recently issued regulations on the allocation of partnership debt show that the need for simplicity (particularly for small and midsize businesses) has been ignored.

The corporate income tax system alone boggles the mind in terms of complexity. It's impossible to complete a tax-free spinoff under section 355 for a midsize or larger company in accordance with statutory and regulatory authorities and IRS guidance without working hundreds of hours.

On the low-income taxpayer side, the earned income tax credit is so complex that the ongoing unsolvable question is whether errors are the result of fraud or mistake. According to the 2005

¹ Latin for "The thing speaks for itself."

final report of the President's Advisory Panel on Federal Tax Reform:

These rules [concerning the EITC] are so complex that nearly three-quarters of those families claiming it hire a tax preparer. This makes little sense. These families typically earn less than \$35,000. The extra cost of paying a preparer to claim the EITC benefit may offset a significant portion of the benefit itself — and to the family struggling to stay out of poverty, those dollars are scarce. Policy experts regularly praise the EITC's effectiveness, but as a matter of tax administration, it is complicated and inefficient.²

It's no secret that many of the regulation writers leave Treasury for jobs at big law firms and accounting firms, where they earn substantial salaries and charge large fees to help clients decipher the regulatory messes they've created.

The costs to comply with the tax system are staggering. According to the 2005 tax reform panel, the (then) annual cost of compliance for all taxpayers was approximately \$150 billion.³ In 2016, the Tax Foundation reported that compliance costs were 8.9 billion hours and \$409 billion.⁴ A 2011 Laffer Center article stated that U.S. taxpayers paid \$431.1 billion in 2011, or 30 percent of income taxes collected, to comply with and administer the U.S. income tax system.⁵ We can do better.

According to the Congressional Budget Office, income taxes and payroll taxes comprised approximately 57 percent and 34 percent, respectively, of federal revenue for 2016.⁶ Payroll taxes are primarily covered in a handful of code sections. The income tax is where virtually all the complexity lies.

²President's Advisory Panel on Federal Tax Reform, "Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System," at 3 (Nov. 2005).

³*Id.* at 1.

⁴Scott A. Hodge, "The Compliance Costs of IRS Regulations," The Tax Foundation (June 2016).

⁵Arthur B. Laffer, Wayne H. Winegarden, and John Childs, "The Economic Burden Caused by Tax Code Complexity," the Laffer Center (Apr. 2011).

⁶CBO, "The Budget and Economic Outlook: 2017 to 2027" (Jan. 24, 2017).

This article explores ways to replace the federal tax system with one that is much simpler, while keeping the good aspects of the current system. This proposed system also incorporates a way to balance the budget through the tax system.

II. U.S. Financial Problems

As a percentage of GDP, actual traditional government spending has changed little over the course of many years. That includes expenditures for the armed forces, national roads and highways, the federal legal system, and federal agencies. However, overall federal spending has increased substantially as a percentage of GDP in recent years, and it is expected to rise dramatically in future years. The anticipated growth is attributable to increased entitlements spending.

The growth of entitlements may place the United States' ability to survive at risk. Entitlements accounted for 63 percent of federal spending for 2016. And that percentage is anticipated to grow substantially over the coming years. According to the CBO, Medicare and Social Security now comprise approximately 75 percent of entitlements spending.⁷

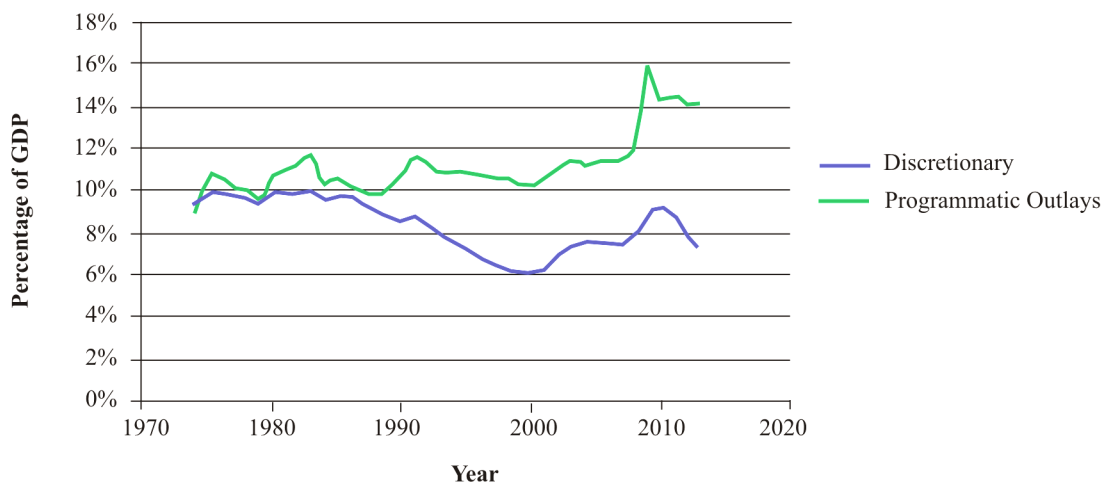
The debt of the U.S. government has been rising as a percentage of GDP for many because federal revenue from taxes and other sources has failed to keep pace with increased spending. In 1980 total federal debt was approximately 33 percent of GDP. Today it is roughly 106 percent. In 2008 debt held by the public was 39 percent of GDP. It is now 77 percent, and the CBO projects that it will be 150 percent by 2047. If public debt alone is considered, all entitlement programs are now insolvent. Thus, federal agencies regularly use the term "unsustainable" to describe our country's fiscal path.

Many reputable financial analysts believe the present value of the U.S. debts and unfunded liabilities exceeds the combined net worth of all Americans. Using the CBO's financial scenario, Laurence Kotlikoff found that the present value of the United States' unfunded liabilities was approximately \$222 trillion in 2012.⁸ That scenario

⁷*Id.*

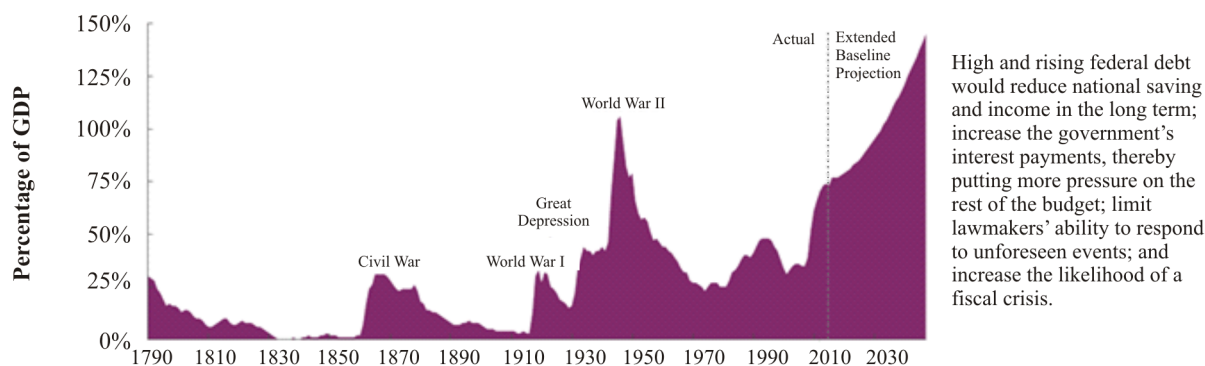
⁸Kotlikoff, "Blink! U.S. Debt Just Grew by \$11 Trillion," *Bloomberg View*, Aug. 8, 2012.

Figure 1. Federal Spending as a Percentage of GDP



Source: Congressional Budget Office.

Figure 2. Federal Debt Held by the Public



High and rising federal debt would reduce national saving and income in the long term; increase the government’s interest payments, thereby putting more pressure on the rest of the budget; limit lawmakers’ ability to respond to unforeseen events; and increase the likelihood of a fiscal crisis.

Source: CBO. For details about the sources of data used for past debt held by the public, see CBO, “Historical Data on Federal Debt Held by the Public” (July 2010).

The extended baseline generally reflects current law, following the CBO’s 10-year baseline budget projections through 2027 and then extending most of the concepts underlying those baseline projections for the rest of the long-term projection period (in this case, through 2047).

assumed that then-current Medicare rates paid to physicians and other healthcare providers would be retained and that expiring tax provisions would continue to be renewed. Since then, the Medicare rates and many of the expiring tax

provisions have been made permanent. The following is a January 2017 CBO chart of the current situation:

In 2013 former Comptroller General David M. Walker tallied the debts and unfunded liabilities

of the federal government at \$73 trillion.⁹ For the first quarter of 2017, the net worth of all Americans combined was approximately \$94.8 trillion.¹⁰ Although the \$222 trillion figure might be high, the present value of the debts and unfunded liabilities at least roughly equals the net worth of all Americans combined. Accordingly, over time, absent a savior, all or virtually all private wealth will need to be consumed to preserve the existing federal system.

In 2007, before the Great Recession, when total federal debt was less than \$9 trillion, Walker as comptroller general testified that the Government Accountability Office's "long-term simulations continue to show ever larger deficits resulting in a federal debt burden that ultimately spirals out of control."¹¹ Ten years later, federal debt is \$20 trillion.

C. Eugene Steuerle, former Treasury assistant deputy secretary, describes the U.S. financial problems:

Social Security, Medicare, and Medicaid (close to half of which goes toward long-term care) dominate the modern history of domestic government. . . . Were all three of these programs fully financed by simple, transparent taxes such as the Social Security payroll tax, rather than financed by multiple taxes and deficit spending, the tax rate required to support them would be about double the percentage of GDP that they now consume. Thus, when spending on these programs was about 2 percent of GDP, about a four-percentage-point tax on Social Security earnings would have been required to fund the programs in their entirety. Today, at about 10 percent of GDP, they would require a 20 percent tax rate. Projections showing that spending on Social Security, Medicare, and Medicaid will reach 20 percent of

GDP would mean about a 40 percent tax rate for these programs alone.¹²

Later, Steuerle notes the possible outcome:

Nations that face exploding debt levels of the kind of problems outlined above often refuse to pay their debts and declare bankruptcy. Because so many nations depend on the U.S. dollar to stabilize world markets, a U.S. default could prompt not just a U.S. crisis, but a global depression. U.S. government bonds and bills have long served as the go-to safety vehicle for investors. A U.S. dollar default would shake the global economy to its core because it would signal that U.S. bonds and bills are no longer the rock-solid investments on which investors around the world have long relied.¹³

In December 2010 the National Commission on Fiscal Responsibility and Reform (the Bowles-Simpson commission) issued its highly anticipated report titled "The Moment of Truth." The preamble stated:

Our challenge is clear and inescapable: America cannot be great if we go broke. Our businesses will not be able to grow and create jobs, and our workers will not be able to compete successfully for jobs of the future without a plan to get this crushing debt off our backs. . . . Over the course of deliberations, the urgency of our mission has become all the more apparent. . . . If the U.S. does not put its house in order, the reckoning will be sure and the devastation severe.¹⁴

The mission segment of the report notes that "by 2025 revenue will be able to finance only interest payments, Medicare, Medicaid and Social Security."

In September 2011 then-Joint Chiefs of Staff Chair Admiral Mike Mullen described the U.S. debt as the country's greatest national security

⁹ See Christina Rexrode, "Nation's Former Top Auditor Sounds the Alarm on Debt," *The Seattle Times*, Aug. 26, 2013.

¹⁰ Christopher S. Rugaber, "Americans' Net Worth Up 1.4 Percent to \$94.8 Trillion," *Chicago Tribune*, June 8, 2017.

¹¹ GAO, "Long-Term Fiscal Challenge: Additional Transparency and Controls Are Needed," GAO-07-1144T, at 3 (July 25, 2007) (Walker's statement before the House Budget Committee).

¹² Steuerle, *Dead Men Ruling* 74 (2014).

¹³ *Id.* at 83.

¹⁴ National Commission on Fiscal Responsibility and Reform, "The Moment of Truth" (Dec. 2010).

concern: “I’ve said many times that I believe the single, biggest threat to our national security is our debt.”¹⁵ That statement speaks volumes.

If, as Steuerle fears, a collapse or worldwide depression occurs with the United States heavily in debt, the stock market would certainly collapse as well. With it would go retirement accounts and IRAs. Adding to the problem is the fact that many states and local governments have significantly underfunded pension plans and other post-retirement employee benefits — an issue that is already hitting home.

The Federal Reserve Bank has printed a tremendous amount of money in recent years, and it has purchased Treasury notes. Most of the interest received by the Fed has been returned to the U.S. treasury, reducing the annual deficits. New debt has been issued at relatively low rates, thus causing the federal government’s interest expense to be relatively low. This strategy works for only so long. In its 2017-2027 outlook, the CBO said it expects the Fed’s “balance sheet will return to a more typical size” by 2023.¹⁶

Simply put, absent a savior, our current federal tax system doesn’t work for our government. Many elected leaders seemingly plan to retain the status quo, with minor sequester tweaks that can easily be repealed, until just before reaching the fiscal abyss — and no one knows when that will be. That’s not a good plan. The country’s financial problems can largely be solved through changes to the tax system. If Americans are forced to pay for their government, they will demand the elimination of unnecessary spending.

Some believe there could in fact be a savior. In 2013 the Institute for Energy Research (IER) estimated the net worth of the U.S. government’s technically recoverable oil and gas resources to be \$128 trillion, about eight times the national debt at the time, and it estimated U.S. coal reserves to be worth an additional \$22.5 trillion.¹⁷ Christopher Matthews of *Time* has suggested that those

numbers be “taken with a grain of salt” because IER advocates for deregulation in the energy industry, and he notes that “any estimate of oil and mineral wealth in unexplored areas is going to be highly speculative.”¹⁸ He adds, however, that “even if the true figure is half what IER estimates, the fact that the federal government owns property worth well in excess of its total debt is instructive in our current debate over government borrowing.” Although IER’s value for oil and gas reserves is relatively high, the estimated potential federal revenue to be produced from them is relatively low — \$14.3 billion in royalties and \$54.7 billion in taxes.¹⁹ This raises the question of what global warming and other forces may do to the value of oil. Another question is whether substantial amounts of land-possessing natural resource rights could be sold in large quantities (that is, many trillions of dollars).

Some will argue that there’s no need to balance the budget each year. Many economists maintain that it’s safe to run annual deficits that don’t exceed 3 percent of GDP. The average budget deficit as a percentage of GDP ratio since 1929 has been 3.1 percent, according to a 2013 article by Evan Soltas, who noted that the CBO had forecast future U.S. economic growth in the range of 2.2 percent.²⁰ He concluded:

We could run a budget deficit forever and even shrink the relative federal debt burden. All we need to do is keep the long-run deficit smaller as a percentage of GDP than the long-run rate of GDP growth. When that happens, GDP outgrows the debt, and the debt-to-GDP ratio declines.

That sounds good, and it works in theory. The problem is that the historical numbers show that the United States is addicted to debt. From 1980 to 2017, the ratio of total debt-to-GDP grew from 0.325 to 1.06. For the 2009-2012 fiscal years, the deficit-to-GDP ratio averaged 8.5 percent. The Great Recession did not last four years. The

¹⁵ Tyrone C. Marshall Jr., “Debt Is Biggest Threat to National Security, Chairman Says,” *Department of Defense News*, Sept. 22, 2011.

¹⁶ CBO, *supra* note 6, at 22.

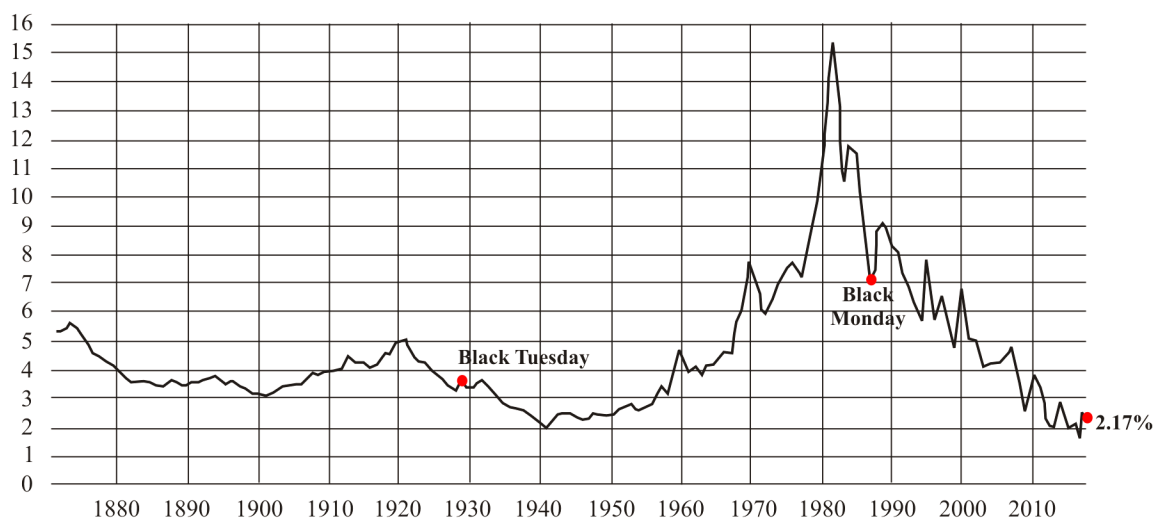
¹⁷ IER, “Federal Assets Above and Below Ground” (Jan. 17, 2013). IER used a \$100 per-barrel value for oil and a \$4 per-thousand-cubic-foot value for natural gas.

¹⁸ Matthews, “The Federal Government’s \$128 Trillion Stockpile: The Answer to Our Debt Problems?” *Time*, Feb. 5, 2013.

¹⁹ Joseph R. Mason, “The Economic Contribution of Increased Offshore Oil Exploration and Production to Regional and National Economies” (Feb. 2009).

²⁰ Soltas, “Balance the Budget? We Can Run Deficits Forever,” *Bloomberg View*, Mar. 12, 2013.

Figure 3. 10-Year Treasury Rate



Current 10-Year Treasury Rate: 2.42%
At market close (Friday, February 17, 2017)

Mean: 4.59%
Median: 3.87%
Minimum: 1.50% (July 2016)
Maximum: 15.32% (Sept. 1981)

Sources: U.S. Treasury for recent 10-year treasury rates. Robert Shiller, "Irrational Exuberance," for long-term historic 10-year treasury yields.

economy now typically grows at a rate of roughly 2 percent per year.²¹

The CBO's estimates of economic growth are often used by policymakers and politicians to forecast. However, those estimates have often been overly rosy, as demonstrated by an examination of the CBO's January 2008 10-year outlook. It noted, "Two relatively reliable indicators of a recession . . . imply that a recession in 2008 is likely."²² Yet the CBO forecast nominal and real GDP growth of 3.6 percent and 1.7 percent, respectively, for 2008. It also forecast nominal and real GDP growth of 4.7 percent and 2.8 percent for 2009. Thereafter, the CBO predicted average annual nominal and real GDP

growth of 5 percent and 3.1 percent for 2010-2013. Although 11 recessions have been experienced since World War II, for no future year did the publication forecast a recession. (The CBO nets recessions in producing its annual growth forecasts.)

On the budget side, the CBO forecast deficits of \$198 billion, \$241 billion, and \$117 billion for 2009-2011, respectively — a total of \$556 billion. The actual deficits for those years were, respectively, \$1,413 billion, \$1,294 billion, and \$1,300 billion — a total of \$4,007 billion. The CBO forecast an \$87 billion surplus for 2012. The deficit for 2012 was \$1,087 billion. Total deficits of \$5,094 billion for 2009-2012 were *11 times* the projected total net deficits of \$469 billion for that period.

Going back to the 1800s, the rounded average interest rate on a 10-year Treasury note has been 5 percent (the actual historical rate is 4.59 percent). Consider if the United States were to transition

²¹ See Bureau of Economic Analysis (BEA), "U.S. Economy at a Glance."

²² CBO, "The Budget and Economic Outlook: Fiscal Years 2008 to 2018," at 32 (Jan. 2008).

back to a 5 percent rate. At \$20 trillion of debt, interest would be \$1 trillion. Total tax revenue for 2016 was \$3.3 trillion. What if the 150 percent of GDP public debt anticipated in 2047 by the CBO applied today, and a 5 percent interest rate applied? With GDP at approximately \$19 trillion, interest expense would be 43 percent of spending ($(\$19 \text{ trillion} \times 1.5 \times 0.05)/\3.3 trillion). Talk about incentive to keep rates low! In reality, absent a bailout from sales of oil reserves, etc., the collapse envisioned by Steuerle would likely be experienced sooner than 2047.

By law (12 U.S.C. section 225A), the Fed has three objectives: maximum employment, stable prices, and moderate long-term interest rates. In recent years, the Fed has reduced its statutory tri-burden by ignoring the moderate long-term interest rates prong and focusing on stable prices and maximum employment. It appears that higher long-term interest rates (potentially greater than moderate) might be forced on the United States, coupled with the Fed choosing between unstable prices (that is, printing money to water down the debt) or high unemployment (because of a recession or worse). Allegedly to prevent a trade disadvantage, a “group print” of western republics’ currencies might be inevitable. Alternatively, or in combination, a downward spiral of stock market values coupled with baby boomer spending contraction could produce a major recession or depression — with a federal bailout not possible.

As entitlements generally increase with inflation, printing of money does nothing to solve the problems except to diminish the burden of existing debt. Printing would also hurt middle class savers invested in CDs and bonds (and “target date” funds used by 401(k) plans put much of seniors’ retirement money in bonds). Rising interest rates diminish the value of existing bonds.

Although there is no absolute need to balance the budget each year in which the United States is not in a recession,²³ doing so would make it possible to handle substantial deficits in recession years (when those deficits will exist). Leaving some “dry powder” makes sense. Clearly, the 3

percent rule doesn’t work long term, particularly when large deficits are experienced in recession years (and the years following a recession, as was recently the case).

If the economy will grow at an average of 2 percent per year, and a 2 percent recession will be experienced every seven years and last a year and a half, balancing the budget in non-recession years would allow for running a 7.3 percent deficit for a year and a half without causing debt to increase as a percentage of GDP. The math for growth is as follows: $7 \times 2 = 14$; $14 - (2 \times 1.5) = 11$. The average is 1.3 percent. For deficits, the math is: $(7 \times 0) + (7.3 \times 1.5) = 11$. The average is 1.3.

In recent years, Congress and the executive branch have relied on the Fed’s ability to print money to get things done. That easy route and procrastination have been the status quo for decades. The sooner the United States gets its financial house in order, the better. The necessary changes should be phased-in. But the longer the wait, the greater the likelihood of financial catastrophe.

In this regard, because the world’s financial system is heavily reliant on the financial stability of the United States (and a lot of wealth will be lost if U.S. finances unravel), many forces around the world will very likely act to help the United States from coming undone sooner than would be the case with a non-dominant nation. Some adverse forces will attempt to hasten the problem.

Probably the best the United States can hope for is, when lenders begin demanding substantially higher interest rates and possibly restrictions to account for increased risk (of various potential bad things), the nation will be able to go “cold turkey” and begin annually balancing the budget without a catastrophic market collapse, etc. In such a scenario, the devastating impact of higher rates could be averted. Could the United States go cold turkey?

With the important exception of pensions and post-retiree medical benefits, state and local governments find a way to annually balance their budgets. Most members of Congress got their start in state and local government, so they know how to produce a balanced budget. The U.S. government should be able to do the same in non-recession years. And the tax system can use algebra to force balanced budgets in those years.

²³ Throughout this article, references to “recession” include worse-than-recession economic periods.

III. Possible Alternative Systems

The income tax system produces most of the revenue for the U.S. government, is the source of the complexity and related costs to the economy and taxpayers, and provides the means for political payback through tax breaks. It needs to be greatly simplified or replaced. The FICA and Self Employed Contributions Act taxes (FICA-SECA tax), which produce substantial revenue, are not part of the complexity problem.

There are a few practical sources to fund the U.S. government, individually or in the aggregate. They are an income tax, a VAT,²⁴ a sales tax, excise taxes (for example, on gasoline purchased), a wealth transfer tax, and a net worth tax. Another source is the government's ability to charge fees for requested services, either under specific federal statutes or the general user fee statute, 31 U.S.C. section 9701. Under 31 U.S.C. section 9701, federal agencies are permitted to charge fees to recover their costs for services performed to grant things of value to persons. The Supreme Court has held that a service recipient must receive a "special benefit" in order to be charged a fee. A special benefit is somewhat akin to consideration in the contract law context — receiving something of value to which one is not entitled. Thus, the ability to charge fees has had limits.

Historically, fees have been charged under the user fee statute for land use rights, oil and gas easements, and license issuance. However, in 2010 Treasury expanded the use of user fees to apply annually to fulfillment of the return preparer tax identification number requirement, which is subject to penalty enforcement. This scheme has been under attack in court. The current challenge is the *Steele* case.²⁵ On June 1, the U.S. District Court for the District of Columbia held in favor of return preparers, requiring that PTIN charges be stopped and that fees already paid be refunded.

If federal agencies can annually charge people to fulfill requirements (that is, as permitted by authorities, the full cost, including overhead allocations, etc.), a tremendous amount of

revenue could be raised. Substantively, in contravention to the U.S. Constitution, agencies would be able to tax.

Income of S corporations, partnerships, and limited liability companies is generally subject to one layer of taxation, but income of domestic C corporations is subject to roughly one and a half layers of tax (one layer on the corporation and half on the shareholders in the form of the tax on dividends at capital gains rates). Why the difference? Should the number of shareholders be determinate? An S corporation can have up to 100 shareholders, but there is no limit on the number of members in an LLC or partnership. Is this logical? Today, unlike the days of John D. Rockefeller and Standard Oil, when the income tax was created (to tax, almost exclusively, the wealthy), most large companies have broad shareholder bases. Ironically, the wealthy can now own businesses through S corporations or LLCs, subject to only one layer of tax.²⁶

A 1997 study by the Joint Committee on Taxation analyzed both a flat income tax and a consumption tax in the nature of a VAT to replace the individual and corporate income tax.²⁷ Several teams of economists presented their views on numerous topics concerning possible transition. The study found the following:

- conversion to either system would save substantially on compliance costs;
- most economic teams saw greater economic growth with a VAT (relative to the 1997 income tax system);
- residential real estate would lose value (one estimate was 15 percent) as a result of conversion to a VAT, mainly because of loss of the interest and state and local tax deduction subsidies; and
- absent effective transition rules, conversion to a VAT would likely result in significant inflation because substantial purchases would be made before implementation (but relatively few would be made soon thereafter).

²⁴ With a VAT, a tax is levied at each level of production and at the final retail sale, with the retail consumer ultimately bearing the burden of the tax.

²⁵ *Steele v. United States*, No. 1:14-cv-01523 (D.D.C. 2017). Disclosure: The author's firm is co-counsel in *Steele*.

²⁶ Converting a C corporation to an LLC can have a significant tax cost.

²⁷ JCT, "Joint Committee on Taxation Tax Modeling Project and 1997 Tax Symposium Papers," JCS-21-97 (Nov. 20, 1997).

Regarding subsidies for home ownership, the 2005 tax reform task force found:

Although the deduction for home mortgage interest is often justified on the grounds that it is necessary for promoting home ownership, it is unclear to what extent rates of home ownership depend on the subsidy. According to the Census Bureau, there are more than 123 million homes in America, with a home ownership rate of 69 percent. There are many countries that do not allow any home mortgage deductions for tax purposes, including the United Kingdom, Canada, and Australia. The rate of home ownership in the United States is higher than that in some countries (approximately 66 percent in Canada), lower than that in others (approximately 70 percent in Australia), and comparable to that in still others (the United Kingdom). Thus, it appears that the level of subsidies provided in the United States may not be necessary to ensure high rates of home ownership.²⁸

Discussed below are alternative potential sources of revenue to completely eliminate the income tax (both individual and corporate, including the AMT) and the estate and gift taxes. In each scenario, it is assumed that the existing excise taxes and historically legitimate fees are retained. And in each case, the Social Security and Medicare trust funds would end.

A. A Simplified Income Tax

There are ways to greatly simplify the income tax. The 2005 tax reform panel proposed two options for a simpler individual income tax system. Its recommendations went nowhere. And the 2010 “Moment of Truth” report by the Bowles-Simpson commission, which essentially proposed reasonable reform of the income tax and Social Security systems, was given less than a moment of serious consideration by Congress and President Obama.

²⁸ President’s Advisory Panel, *supra* note 2, at 72.

One possible solution would be to simplify the individual income tax system by having one or more floating common rates (x , $2x$, $3x$, etc.) tied to spending through an algebraic equation to balance the budget in years when there is no recession or worse. Except for the AMT and the 3.8 percent NII tax (which would be repealed), all current income taxes would be retained.

For example, the individual income tax system could provide for exclusion of half of capital gains and dividends and permit five deductions: (1) a federal poverty-level amount for the household size; (2) a limited home mortgage interest amount (say, \$12,000); (3) a limited retirement savings amount through IRAs or tax-qualified plans (say, \$20,000); (4) a charitable giving amount (such as 25 percent of gross income, with carryforward of excesses); and (5) limited healthcare.

The x rate could be whatever rate was necessary to balance the budget, considering spending and after taking into account revenue from the FICA-SECA tax, the estate and gift taxes, and other revenue sources. The same equation could apply if two rates existed for individuals (for example, x and $1.5x$), with the lower rate applying to taxable income below a specified threshold. Tax credits could be eliminated. C corporations could also be subject to the x rate system on their taxable income.

Subchapter C is probably the most complex aspect of the current system. The corporate income tax generally produces double (or, more commonly, roughly one and a half) taxation of corporate earnings. One way to greatly simplify this area in conjunction with the individual income tax proposal would be to cause all C corporations to be S corporations but permit preferred stock. This would result in current taxation of all earnings to shareholders and would eliminate the corporate income tax (and the two layers of taxation).

Congress could simultaneously simplify foreign taxation by eliminating the foreign tax credit system and instead using a water’s-edge approach to apportionment. Under that approach, every corporation (domestic and foreign) would apportion its taxable income based on sales or perhaps the three-factor income apportionment method used by many states

(sales, payroll, and property). Withholding obligations could be placed on companies for their shareholders' shares of taxable income.

This proposed simplification of the individual and corporate income tax systems would stop the growth of federal debt. If coupled with other simplifications, such as changing section 401(a)(9) to provide for payment over a fixed number of years regardless of whether paid to the account holder or one or more death beneficiaries, significant progress would be made.

B. Expanded FICA-SECA Tax

If it ain't broke, don't fix it. The long-standing FICA-SECA tax system is simple and raises substantial revenue (34 percent of revenue in 2016).²⁹ In its current form or modified, it should be considered as part of an alternative tax system.

One option would be to expand the FICA-SECA tax to cover all the federal government's spending, except for what is covered by excise taxes and fees. The cap on Social Security earnings (\$127,200) would be eliminated. The tax rate would be x , and the x rate would balance the budget in all years except those in which the United States economy is in a recession or worse (in which case reasonable deficits could be run). Employers and employees would both be subject to the tax at the x rate. The self-employed would pay a $2x$ tax rate on self-employment income. To provide progressivity, households could be granted refundable credits equal to the tax rate multiplied by income up to the federal poverty level, based on an annual simple return listing family members. Also, two or more rates could exist, with the higher rate applying to income above a specified threshold amount.

To ensure that individuals who do not work share the tax burden, the FICA tax base could be expanded to include U.S.-sourced passive income, such as real estate income, dividends, and interest, plus profits from partnerships, LLCs, and S corporations (with those latter amounts deemed to be self-employment income). Losses from partnerships, LLCs, and S corporations could be subject to the current basis limitation

rules and the passive loss rules. Trusts' passive income could be deemed SECA income, as could a portion of U.S.-sourced capital gains (say, 50 percent).

Also, given that individuals ordinarily are in a lower tax bracket in retirement than they were while working, only a portion of retirement plan and IRA distributions (for example, 60 percent) could be deemed to be self-employment income. Roth distributions would be exempt. C corporations could be converted to S corporations. The U.S.-sourced portion of businesses' taxable income, passive income, and capital gains could be based on the ratio of U.S. sales to worldwide sales, as explained below. If those additions were made to the tax base, passive income other than capital gains could be subject to withholding. Capital gains could be reported, and the tax would be paid through a return system. While inclusion of U.S.-sourced interest and capital gains in the tax base would be relatively simple, the inclusion of profits from partnerships, S corporations, and LLCs would require retaining some of the complexity of the existing system.

If Congress desired (which is likely), it could expand the refundable credits for home ownership, charitable giving, retirement savings, and healthcare. For example, refundable credits calculated using the x rate might be granted for (1) up to \$12,000 per year of home mortgage interest payments; (2) charitable contributions up to 33 percent of gross income; and (3) up to \$20,000 of contributions to section 401(k) accounts, IRAs, etc. A deduction could be allowed for healthcare coverage that met Congress's criteria (for example, health savings account contributions and high-deductible health plan coverage).

Such a system would essentially be a progressive flat income tax that would tax all income only once.³⁰ A simple return would be necessary to receive credit for the charitable contributions and the poverty-level credit. The home purchase payments, 401(k) and IRA contributions and health insurance and HSA payments could be directly reported to the IRS by the payee organization. A simple return like

²⁹ See Center on Budget and Policy Priorities, "Where Do Federal Tax Revenues Come From?" (Mar. 4, 2016).

³⁰ Jonathan Godbey, Georgia State University Finance Department, deserves partial credit for the expanded FICA-SECA tax idea.

current Schedule C would be necessary for self-employed individuals.

If Congress allowed a uniform deduction under an expanded FICA-SECA tax system for retirement contributions to IRAs and section 401(k) accounts, etc., the requirements for tax-qualified plans could be largely eliminated. However, in that event, it would seem logical to have a substantial excise tax (say, 15 percent) for pre-retirement withdrawals from section 401(k) plans and IRAs for any reason other than disability or death.

Having discussed a simplified income tax and an expansion of the FICA-SECA tax, it's time to focus on two other options for financing the federal government that would be relatively simple and understandable, difficult for Congress to make complex, capable of being cost-effectively administered, resistant to significant tax evasion, and capable of raising substantial revenue. They are a net worth tax and a VAT.

C. A Net Worth Tax

A net worth tax on individuals, either alone or in conjunction with another tax, could be used to balance the budget in non-recession years. The net worth tax rate could be x , with x being whatever rate is necessary to balance the budget. Alternatively, the rate could be higher (for example, $2x$) on net worth above a specified amount. As explained in Section IV.A., a net worth tax would be much simpler and much less costly to administer than the current income tax.

For the tax base, assets of trusts and similar asset-possessing things could be subject to tax. All U.S.-sourced net worth could be counted (as outlined below), but there could be exclusions to provide progressivity for (1) a significant amount of equity in a personal residence (say, \$250,000) (with multiple cohabitating owners eligible to share in only one personal residence exemption); (2) a significant exemption per person (say, \$500,000) for vested retirement or IRA benefits, HSAs, and section 529 plans; and (3) an exemption for furniture, appliances, and clothing up to a reasonable value (say, \$5,000). Each person could be granted a personal exemption, such as \$10,000 for adults and \$5,000 for children and trusts. Also, because their ability to work and save diminishes with age, seniors above specified ages

could receive an additional substantial exemption (for example, \$250,000 at age 60; and \$500,000 at age 70).

Individuals could be permitted to freely transfer retirement, section 529, and HSA assets to one adult. (Congress might permit deemed ownership transfers to one adult for tax purposes.) Future Social Security benefits could be excluded. Future pension benefits could be discounted to present value using a statutorily prescribed interest rate and mortality table. Roth accounts in existence before enactment could be exempt. Foreigners could be taxed on their U.S. assets. Exemption amounts could be indexed for inflation. Under the doctrine of intergovernmental tax immunity, state and local government bonds might well not be taxable.

D. A VAT

The 2005 tax reform panel noted that “the United States is the only major industrialized country that does not impose a VAT.”³¹ That's quite a statement. The United States also has the largest economy in the world — by far. Most industrialized countries mainly use both an income tax and a VAT to fund their governments. Similar to the net worth tax, a VAT is relatively simple compared with the income tax.

A small part of the reason the United States has the world's largest economy is that many foreigners come here to purchase goods (and return home with them). Unlike in their home countries, they need not pay a VAT here, meaning they often pay much less when they buy things in the United States. Simply put, the United States has a competitive advantage. The average VAT rate in European countries is approximately 20 percent. State and local combined sales tax rates in the United States ordinarily range from 5 to 10 percent. Thus, a 5 to 9 percent VAT likely could be added while still providing the United States a competitive advantage over most European countries.

However, the less the differential, the smaller the incentive for foreigners to buy in the United States. Further, as discussed below, adding any VAT would worsen the United States' competitive

³¹ President's Advisory Panel, *supra* note 2, at 38.

stance with Canada. According to data produced by the Bureau of Economic Analysis, there were approximately \$220 billion of sales to foreigners in 2016, out of a base of approximately \$12.8 trillion of retail sales of goods and services.³²

The United States should be concerned about tax competition from its neighbors. Many Canadians find their way south to make purchases. Canada generally levies a 5 percent goods and services tax. However, the Canadian provinces levy provincial sales taxes (PSTs), as well. Sometimes the two are combined as a harmonized sales tax (HST). In Ontario, the HST is 13 percent. For Quebec, the combined GST and PST total 14.975 percent. Mexico maintains a 16 percent VAT.

According to a memorandum by Lindy Paull of the JCT concerning the Fair Tax Act of 1999 (H.R. 2525), “Studies of compliance with sales taxes in other jurisdictions suggest that tax evasion increases rapidly with sales tax rates above ten percent.” A federal VAT would be charged on retail purchases in addition to state and local sales taxes. Particularly where state income taxes don’t exist, many state and local governments already levy sales taxes in the vicinity of 10 percent. For states with a relatively lower sales tax (generally, those with an income tax) — for example, 4 percent — there is greater room for an additional federal VAT of significance with little tax evasion. There is less evasion with a VAT than there is with a sales tax. For this reason, vis-a-vis a sales tax, the United States should (and realistically would) consider only a VAT, and it should do so while considering international competitiveness.

The 2005 tax reform panel report details on how a VAT could be used to replace part of the revenue produced by the income tax.³³ The panel did not reach a consensus on a VAT option, but it deemed the option worthy of further discussion. The report considered a 17.6 percent tax-exclusive VAT (15 percent tax-inclusive) as a way to collect about 65 percent of the revenue collected by individual and corporate income taxes. (With a

17.6 percent tax-exclusive rate VAT, a \$100 pre-VAT sale would cost \$117.60 with the VAT.)

To help match the progressivity of the (then) current system, the tax reform panel considered a VAT that included family credits and work credits. The panel made the following observations concerning the partial replacement VAT:

- all goods and services would be taxed except noncommercial government activities, primary and secondary education, charitable activities, religious activities, and existing residential housing;
- as done by the United States’ major trading partners, the VAT would be removed from exports;
- economic research generally shows that consumption taxes have a positive effect on economic growth compared with an income tax;
- “economists agree that a well-designed VAT imposes a lower excess burden than most other taxes for any given amount of revenue raised”;
- the United States could draw from the vast experience of other industrialized countries in creating a VAT;
- taxpayers’ compliance costs for the current income tax amounted to approximately 13 cents per dollar of tax receipts, whereas compliance costs for European VATs ranged from 3 cents to 5 cents per dollar of tax receipts;
- if states continued their regional sales taxes, the combined federal, state, and local rate using a 17.6 percent tax-exclusive VAT would result in a combined rate of approximately 24 percent;
- tax evasion with a VAT should be lower than evasion with an income tax; and
- international experience suggests that few countries retreat from a VAT, and VAT rates generally do not decline.

A large VAT would place the United States at a competitive disadvantage if prices didn’t decline as a result of elimination of the income tax.

E. A National Sales Tax

From a tax administration perspective, a sales tax would be much less burdensome than a VAT.

³² See BEA, *supra* note 21.

³³ See President’s Advisory Panel, *supra* note 2, at ch. 8.

However, there is a much greater likelihood of evasion with a sales tax. In contrast to a VAT, which is levied at all stages of development of a product, one person or company handles all the tax administration of a sales tax. Measures such as keeping two sets of books could be used to evade tax. And the larger the sales tax, the greater the likelihood of evasion.

Mainly to minimize exposure to tax evasion, most foreign countries have adopted a VAT instead of a sales tax as their consumption tax. As a practical matter, publicly traded companies, which must report their sales and are significantly judged based on sales, would not let a significant retail sales tax system exist unless their private sector competitors were subject to intense scrutiny by taxing authorities to ensure all sales were reported.

I have written numerous articles and a book on the Fair Tax, which is a proposal to replace all current taxes with a 23 percent tax-inclusive national retail sales tax (the rate would be 29.9 percent on a tax-exclusive basis). The problem with the Fair Tax bill is that the numbers don't work — at all. According to the Paull memorandum described above, the tax-exclusive revenue-neutral rate was approximately double the rate in the bill (59.5 percent for the first five years after enactment and 57 percent thereafter). The 2005 tax reform panel similarly concluded that the revenue-neutral rate is much higher than the rate in the bill.³⁴ (The tax system has not changed dramatically since either publication was issued.)

However, a Fair Tax cult exists in some parts of the United States. If enacted in a revenue-neutral manner, the Fair Tax would shift much of the federal tax burden from a relatively small portion of the voting population (the very wealthy and upper-middle-income earners) to a large portion of the voting population (middle-income taxpayers and retirees). Thus, no politician with significant power has pressed for it. Further discussion is unwarranted.

According to Fair Tax advocates, corporations don't pay taxes. Rather, all corporate income taxes are passed on to consumers in the form of higher

prices. If that's correct, a VAT could essentially replace the corporate income tax with little change in consumer prices.

The corporate income tax produced \$300 billion of the federal government's \$3.3 trillion of revenue for the fiscal year ended September 30, 2016. Annual U.S. retail sales of goods and services for 2016 were approximately \$12.8 trillion. Approximately \$0.3 trillion of that amount related to education, approximately \$2 trillion related to residential housing, approximately \$0.7 trillion related to purchases by foreigners in the United States and nonprofits' purchases, and approximately \$1.2 trillion related to federal government healthcare purchases.³⁵ Excluding those amounts and the corporate income tax from the tax base reduces the base to \$8.3 trillion. On that amount, a 3.6 percent VAT could roughly replace the corporate income tax by producing approximately \$300 billion of revenue.

Therefore, replacing the corporate income tax with a VAT would eliminate much complexity without a major change in the composition of the people bearing the tax burden — assuming the corporate income tax burden is, in fact, ultimately paid by consumers. However, reputable sources state that the corporate income tax burden is not borne by consumers — at all.

On that point, Bruce Bartlett, former economic adviser to presidents Ronald Reagan and George H.W. Bush, has said that all economists reject the idea that the corporate income tax is largely paid by consumers.³⁶ He noted that although varying opinions exist, most economists agree that the majority of the burden is borne by shareholders but that some is borne by workers. Bartlett also observed that Treasury economists, who have access to "actual corporate tax returns and far greater detail on corporate finances than available to private researchers," concluded that 82 percent of the burden is borne by capital and that the remaining 18 percent is borne by laborers.

Given those conclusions, if the tax burden is to remain constant among all income groups, the tax burden elsewhere needs to increase to account for

³⁴ President's Advisory Panel, *supra* note 2, at 57.

³⁵ See CBO, *supra* note 6.

³⁶ Bartlett, "Who Pays the Corporate Income Tax," *The New York Times*, Feb. 19, 2013.

the shift of the burden resulting from swapping the corporate income tax for a VAT. Assuming Bartlett is correct, the tax base would be \$8.6 trillion, and a 3.5 percent VAT could cover a forgone corporate income tax.

F. Combinations

There are many ways to combine the FICA-SECA tax (as is, or in modified form), a net worth tax, and a VAT. For example, all three taxes could exist, with both the net worth tax rate and the VAT rate being 5 percent and the FICA-SECA tax rate being x (with x balancing the budget). Instead, the FICA-SECA tax might be fixed or subject to increases based on the growth of spending, with a 6 percent VAT and an x net worth tax rate. Whether two or three taxes were used to replace the income tax (and possibly the estate and gift tax), one or more of the taxes used could be flexible, to grow and contract with federal spending while balancing the budget.

For example, there could be an 8 percent FICA tax, a 4 percent net worth tax, and a 5 percent VAT, with each rate growing (or contracting) by the same percentage necessary to balance the budget. Exemptions aside, that system produced \$3.2 trillion in revenue and spending was \$4 trillion, each tax could be increased by 25 percent to cover the \$800 billion shortfall. Of course, estimated rates would need to exist and be established before each year began. A “true-up” could be made in the following year. For example, if a rate produced a surplus of \$100 billion in a year, the next year’s budget rate could be reduced to account for the surplus.

The alternative system could use only two of the three potential taxes. For example, the Social Security cap could be lifted, and a 12.5 percent FICA tax (and a 25 percent SECA tax) could be coupled with an x rate VAT or an x rate net worth tax to produce the necessary income to balance the budget in non-recession years. As noted above, exemptions could be used to supply progressivity.

If federal spending continues to rise with entitlements growth, as current law provides for, the tax with the flexible x rate (assuming only one rate was flexible) would particularly draw the ire of those exposed to the tax. But that ire would force debt-ceasing reality: If Americans want

entitlements while also preserving the system, they will have to pay for them. Many people would not pay a net worth tax, and many would not pay the current FICA tax, but virtually everyone would pay a VAT. For that reason, it would seem that a VAT should be part of the alternative system and that it should be the (or a) tax subject to the flexible rate — assuming a goal is to make everyone pay some tax. In that case, there should arguably be no income-based exemption or credit from the VAT, so all persons who nominally pay the tax substantively pay the tax and feel the burden of federal spending.

Many lower-income individuals and households annually receive thousands to tens of thousands of dollars of federal entitlements, such that even though they may pay FICA tax, they net out much to the positive after entitlements and refundable credits (such as the EITC) are taken into account. If the goal is to roughly keep those individuals whole, the entitlements system would need to be changed to account for the fact that they are paying tax and no longer receiving the EITC or any other credits.

If a VAT were part of the tax system and its rate were x , the remainder of the system would need to produce enough revenue for the VAT rate to be relatively low so the United States did not suffer from an international competitiveness standpoint. The amount of that revenue would turn on the amount of spending.

If a net worth tax were combined with an expanded FICA-SECA tax, it would seem that expansion of the FICA-SECA tax base (to pick up passive income, etc.) should exclude capital gains. The corpus has likely already been taxed, and the assets would be subject to the net worth tax.

Economists would argue that a net worth tax (with or without a VAT and with or without expansion of the FICA-SECA tax) is not pro-growth. But what tax is? The argument would go: People will try to avoid having wealth in order to reduce tax. Is that logical? Wouldn’t the same logic apply to the income tax? Isn’t income a form of wealth? Has the income tax prevented people from trying to earn more income? What about during the 1950s, when the highest rate exceeded 90 percent?

Assume the net worth tax rate is 5 percent. A person with \$1 million of taxable net worth would

owe \$50,000 for a year, thus reducing his taxable net worth to \$950,000. For the next year, assuming the rate remained at 5 percent, would that person rather have \$980,000 of net worth and pay \$49,000 of tax (leaving a net worth of \$931,000) or have a net worth of \$1.1 million and pay a tax of \$55,000 (leaving a net worth of \$1.045 million)?

G. The X Rate

For any given proposal, the obvious question is: What is the x rate? For some things, such as calculation of a net worth tax, it is difficult to determine exactly what the x rate would be under the scenarios raised above. This is in part because it is hard for federal agencies and others to get a solid handle on who owns what and what the assets are worth. However, for some things, such as computing a VAT, an approximate rate can be calculated.

The following information for 2016 helps in estimating a VAT³⁷: Total federal spending for the fiscal year ended September 30, 2016, was approximately \$3.9 trillion. Total federal revenue for 2016 was approximately \$3.3 trillion. FICA and Medicare taxes combined produced approximately \$1.1 trillion of the revenue. The 2016 individual income tax and corporate income tax produced revenue of approximately \$1.9 trillion. (Approximately \$300 billion was corporate income tax.) Other income for 2016 was approximately \$300 billion.

Assume a new tax system will keep the existing FICA-SECA tax as is but adopt a VAT to replace the income tax and balance the budget. A VAT would need to cover approximately \$2.5 billion of spending, equal to \$3.9 trillion of spending less \$300 billion of miscellaneous revenue and \$1.1 trillion of FICA-SECA tax produced by the current system. Using the \$8.6 trillion base described above (which excludes housing, education, and purchases by foreigners in the United States) and assuming no evasion whatsoever, the tax-exclusive rate would be roughly 29 percent (that is, 2.5/8.6). (To produce federal revenue of \$3.3 trillion for 2016, the necessary rate would have been 22 percent.)

The above analysis assumes full compliance with the law. Thus, actual figures would be different to accommodate for evasion and error. Also, the economic consequences of changed tax laws are not quantified. Thus, the analysis is static, not dynamic. Still, the above rate should be in the ballpark. Practically, a large VAT would reduce spending, but elimination of the income tax would increase spending. At the end of this article, I outline a recommended system and supply estimated rates. For reasons explained below, simply using a VAT to replace the current income tax system is not the best option.

IV. Pros and Cons of Options

For reasons explained herein, at least two of the three options (that is, an expanded FICA-SECA tax, a net worth tax, and a VAT) should be used to replace the current income tax.

A major difference between those options is the primary burden bearer. The existing FICA-SECA tax burdens working people. The burden of a VAT lies mainly with consumers (meaning virtually everyone). With a net worth tax, the more wealth one has, the more tax one would pay. A positive attribute of a VAT — assuming it was pure (with no credits for end consumers) — is that it would force everyone to pay some tax and thereby have some skin in the game.

According to the 2005 tax reform panel report, economists have found that the burden of the employer's FICA tax is largely passed on to employees in the form of lower wages.³⁸ According to the Tax Policy Center, most economists believe the employer's share is fully offset by reduced wages. Assuming that is accurate, most working people would take a large pay cut to fund an expanded FICA tax, if an expanded FICA tax were the sole means of replacing the current income and estate and gift tax systems. Also, many lower- and middle-income individuals would lose the benefit of tax credits. Thus, using an expanded FICA-SECA tax alone to replace the income tax is undesirable.

Using only a net worth tax to replace the income tax would heavily burden those who have saved or accumulated wealth, and it would create

³⁷ See CBO, *supra* note 6.

³⁸ President's Advisory Panel, *supra* note 2, at 29.

no incentive for those who have not accumulated wealth (and the elected officials who represent them) to attempt to control spending and entitlements.³⁹ Because a net worth tax produces somewhat of a double tax, its use (if any) should be limited.

As noted earlier, a high VAT rate could place the United States at a competitive disadvantage. Canada particularly is a concern. Further, a VAT is not a progressive tax, and it would be replacing one. Thus, many lawmakers would oppose using a VAT to fully replace the current tax system. (Relatively few members of Congress have seriously supported the FairTax.) Unless it were implemented over an extended period, installation of a large VAT would likely create substantial inflation before enactment, followed by an economic malaise thereafter. Consistent therewith, as noted in her memorandum, Paull said a 59.5 percent tax-exclusive rate would be necessary for the first five years of enactment of the FairTax, followed by a rate of 57 percent thereafter.

Any replacement system should produce a balanced budget in non-recession years. An algebraic system would create a natural friction between spending and tax rates, which would force Congress to make difficult spending choices. Lawmakers could say to their constituents: Which do you want — more entitlements and more tax, or fewer entitlements and less tax? (Congress would need to do its job to determine if and how entitlements would be reformed.) The growth of debt would cease.

A. Potential Net Worth Tax Administration Issues

A few issues concerning a net worth tax might create complexity.

1. Ownership issues.

With a net worth tax, ownership of assets must be determined. That should present few problems, except for cash. For example, there are deeds for real estate (jointly owned property could be deemed to be owned proportionately), cars have titles, and IRAs have account owners.

³⁹ See CBO, *supra* note 6.

2. Valuation issues.

Many assets have a readily tradable value. Publicly traded investments such as stocks, mutual funds, and exchange-traded funds are valued at least daily. Real estate is valued by local property tax assessors (with homeowners having the right to dispute the value), so local tax assessments could be applied. And cars have Blue Book values (adjustments could be made for extras, etc.). However, nonpublicly traded assets such as equity interests in private companies could raise valuation problems.

Safe harbor formulas could be developed to value nonpublicly traded assets. Also, the law could set the valuation formula for various assets. For example, restaurants could be valued as a percentage of revenue, as they often are. Professional firms could be statutorily valued at a small percentage of recent collections (for example, 3 percent of the average over the two preceding years). Minority and lack-of-marketability discounts, etc., could similarly be established by statute. Some assets might have a diminishing value, such as 10 percent per year, regardless of their fair market value.

Ordinary household furniture, appliances, and clothing could be fully or partially exempted. For example, a flat \$5,000 per-person exemption could apply. And rules could require consistency. For example, there might be a requirement that if a safe harbor were followed, it must be followed for a specific period (such as five years). Taxpayers could be permitted to elect to have a valuation apply for a short time (such as three years), possibly subject to annual inflation adjustments. There have been valuation issues for years as a subset of the current tax system, they could be worked through.

Because the suggested net worth tax includes a substantial exemption for retirement savings, college savings (section 529 plans), and HSAs, many of the current contribution limits for those accounts would have to be retained. The annual contribution limit for HSAs is simple, as is the section 529 plan limit. Because some employers might be inclined to freeze or terminate retirement plans if significant retirement savings have been accumulated for highly compensated employees, there could be a requirement that those plans not be frozen, at least regarding their

deferral feature. Alternatively or in addition, the IRA contribution limit could be raised substantially (for example, to \$15,000 (\$20,000 for individuals over age 50)) to allow individuals to cope with those possibilities. Because of the exemption for retirement savings, the contribution limits for tax-qualified plans and similar plans (section 403(b) plans and section 457(b) plans) would need to remain. However, some rules could be eliminated, such as the top-heavy rules for tax-qualified plans.

3. U.S. net worth.

To tax all U.S. assets of individuals, the U.S. portion of stocks and other business interests would need to be determined and reported. The IRS in recent years has established systems to track foreign assets. However, the taxation of foreign persons and foreign taxes could create substantial complications, as it does under the current income tax system.

In a perfect world with common laws among all countries, every individual would be a citizen and resident of one country. In that perfect world, if each country maintained a net worth tax on its residents only, all net worth would be taxed (subject to exemptions), and it would be taxed only once. Unfortunately, the world is complicated, which makes tax simplicity difficult.

A relatively simple solution to fairly tax only U.S. wealth would be to require all individuals and trusts (but not corporations), both foreign and domestic, to be subject to the net worth tax on the U.S. portion of their assets. Domestic and foreign companies would apportion the value of their stocks or other equity interests to the United States and non-United States based on sales, with only the U.S. percentage of the value owned by individuals and trusts being subject to tax.

All companies operating in the United States could be required to annually report U.S. and worldwide sales for tax administration purposes and to withhold the net worth tax for all shareholders or perhaps only nonresident shareholders and foreign trust shareholders. (Companies could then demand reimbursement from shareholders and possibly reduce shareholdings or dividends to deal with unreimbursed tax withholding payments.) Under that system, mutual funds, etc., could report their respective U.S. interests to their shareholders. An

alternative sales allocation system might be used or permitted, such as the three-factor allocation formula (sales, payroll, and property) used by many states.

The following two examples illustrate how the system would work:

Example 1. Individual A is a U.S. resident who owns stock in a mutual fund. The mutual fund owns stocks of many companies. Those companies would report to the IRS and to the mutual fund their U.S. and worldwide sales. The mutual fund would then report to Individual A its weighted average U.S. value as well as the U.S.-source value of Individual A's interest on the tax valuation date.

Example 2. Individual B, a resident and citizen of France, owns \$100,000 worth of Nestle stock. Assume 25 percent of Nestle sales are in the United States. Also assume Individual B owns no other stocks of companies that do business in the United States. Individual B's net worth potentially subject to the U.S. net worth tax would be \$25,000. Of course, treaties could override such results.

There would be other ways to address foreigners and foreign taxes. The United States could apply a system similar to the current income tax system, whereby U.S. citizens and residents are taxed on their worldwide net worth and nonresident aliens are subject to tax on their U.S. net worth, with credits available to U.S. citizens and residents for foreign net worth taxes paid on foreign net worth (subject to a limit similar to the income source limit of the current income tax system). Given the likelihood that not all countries would change to a net worth tax system and instead would continue to tax net income and retail sales, this approach would be much more complex than the water's-edge approach outlined above.

4. Liquidity.

It might be necessary to allow some taxpayers who own a substantial amount of illiquid assets (for example, small business owners) to pay their taxes over a few years, to deal with ups and downs in business cycles. Perhaps an option to pay over years with interest could be granted to persons whose nonpublicly traded assets (other than their home and retirement plan) exceed a specified percentage of their assets.

5. Timing.

With a net worth tax, a specific valuation date would apply, such as December 31. However, some taxpayers might try to reduce value on the valuation date. If that is a real concern, it could be overcome by having the valuation date fall within the last three months of each year, with the specific date randomly determined (lottery style) in early January of the year following the valuation year. In that case, privately traded assets could be valued as of a month-end date nearest the chosen date to reduce accounting burdens.

6. Means of compliance.

A net worth tax would require an annual return. If the income tax were eliminated, investment companies that regularly provide income information statements would no longer need to issue Forms 1099. However, with a net worth tax, those companies would need to issue U.S. valuation figures on the particular date for which the tax base was determined.

Returns could be due April 15 or any other date. It would seem that an earlier return due date could be the norm, coupled with the same extended due date (October 15) to deal with potential valuation issues. Estimated taxes could be based on the prior year's value or the second preceding year's value. For estimated tax purposes, taxpayers might be given the option of basing the value on an average of values for the immediately preceding three-month period.

7. Roth accounts.

To minimize double taxation, there could be an exemption for Roth accounts in existence when the income tax was eliminated and the net worth tax was adopted. Amounts sourced from a Roth conversion were already subjected to the income tax system. (Thus, the Roth exemption could be in addition to the other exemptions.) Rollovers and contributions to Roth accounts might have to be stopped. And some transition rules might be necessary to prevent excessive conversions or to limit the benefits of conversions executed shortly before elimination of the income tax.

8. Charitable giving.

The incentive to give to charity would continue under a net worth tax system. Although there would not be a significant immediate tax reduction based

on the value of the gift and the taxpayer's incremental rate bracket (as under the income tax system), the reduction of wealth would lower the net worth tax base currently and for all future years.

9. Expatriation.

Would wealthy Americans leave the country to avoid a net worth tax? That might depend on the amount of the tax. With a relatively low tax rate (for example, 4 percent or less), it seems that few would leave, especially if the income, estate, and gift tax burdens have been eliminated. At a higher tax rate, the possibility of expatriation becomes greater. It might be the last straw for individuals who were already thinking about leaving.

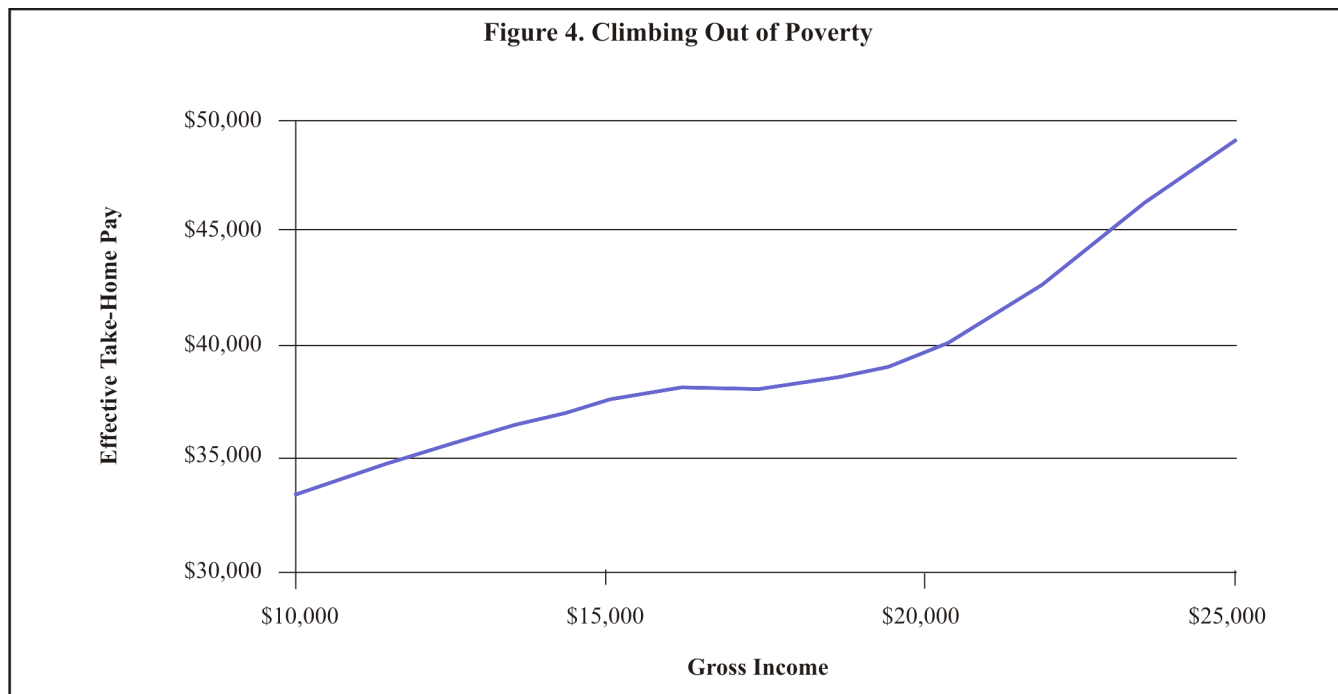
B. What Would the States Do?

Generally speaking, states with an income tax use federal taxable income (or a derivative thereof) as the starting point to compute their income tax base for individuals, corporations, estates, and trusts. If the federal income tax were eliminated, many states would presumably piggyback the FICA tax system for their income tax base. If a federal net worth tax were enacted, some states might eliminate the income tax and piggyback the federal net worth tax return system for individuals (drawing on the same initial tax base). If a FICA-SECA tax also existed, states might use both an income tax and a net worth tax, in both cases piggybacking off the federal systems. If a federal VAT were enacted, many or perhaps most states would replace their sales tax systems with a VAT that piggybacked the federal VAT.

There would be political pressure to create more exemptions to a net worth tax or to a VAT. That is political reality. Adding exemptions should add little complexity. In any event, the administration and compliance work incident to such a system would be much less than such work under the current income tax system. The "God bless 'em" crowd would not be pleased.

C. Constitutionality

Would the U.S. Constitution need to be amended to provide for a net worth tax? What about for a VAT? An amendment would likely be needed for a net worth tax. This is because Article I, section 9, clause 4, provides: "No capitation, or



other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken." Article I, section 2, clause 3, provides: "Representatives and direct Taxes shall be apportioned among the several States . . . according to their respective Numbers."

Is amending the Constitution to add a net worth tax realistic? It's probably less realistic than eliminating the income tax. And certainly the public would demand elimination of the possibility of an income tax (including a FICA-SECA tax) — that is, repeal of the 16th Amendment — in order for a net worth tax to exist.

However, a constitutional amendment would likely not be necessary to add a VAT, since it is a tax on a transaction and not on any person. A VAT is akin to an excise tax, and excise taxes have existed on things like sales of gasoline for many years. So if there were a net worth tax, it is likely that only a VAT could be combined with it, under an assumption that the 16th Amendment would be repealed.

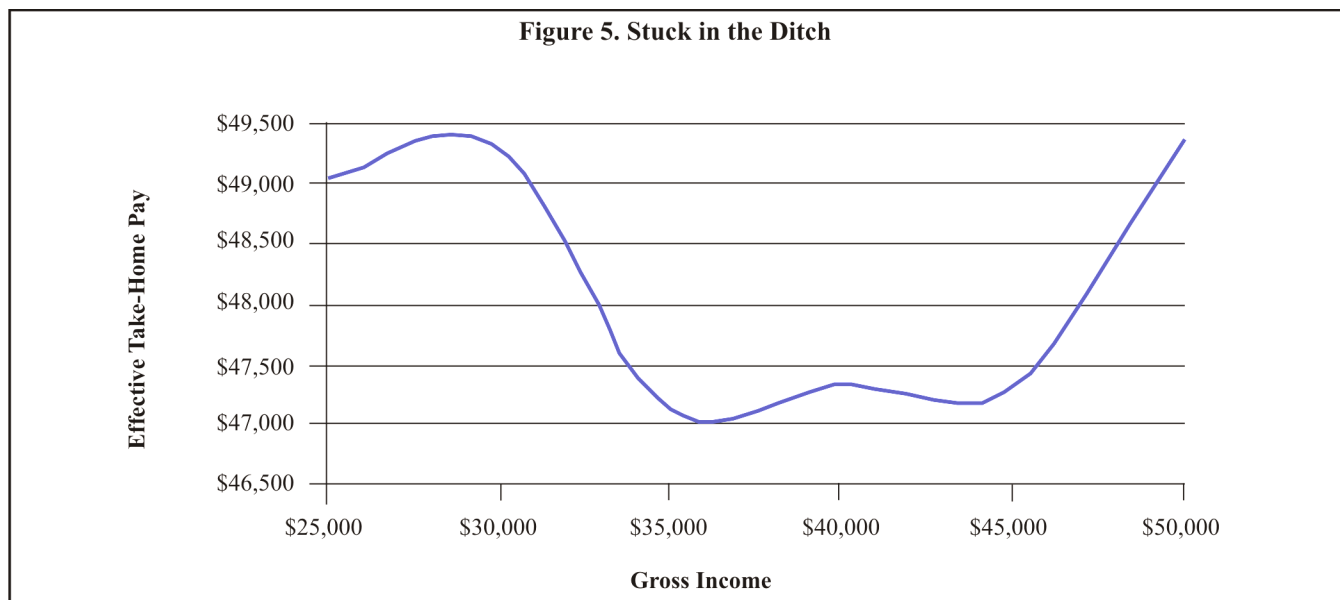
D. Entitlements Coordination

The household standard of living produced by working (take-home pay, minus taxes, plus entitlements and refundable tax credits) generally increases as income increases. Figure 4 shows the

effective take-home pay for a family of four using the 2013 tax and entitlements systems. Effective take-home pay means the amount the family would have for a year based on a given level of earnings if all entitlements other than Medicaid and tax credits were paid in cash. An annual family income of \$10,000 is complemented with entitlements and tax credits (exclusive of Medicaid), bringing the family's effective take-home pay to \$33,446. If total earnings increased to \$25,000, the \$15,000 pay increase resulted in effective take-home pay rising by \$15,572, to \$49,018. The marginal tax rate was negative 3.8 percent.

Although it would likely make more sense if the above line were straight, the general upward path is presumably desirable. Charities help lower-income households, as well.

The above figure is logical, but things start to fall apart for income above a specific level. For some households, standard of living diminishes as gross pay increases. Figure 5 shows the financial figures of a four-person household stuck in "the ditch" — an area in which the standard of living actually diminishes for people climbing out of poverty toward median income. As the family unit increases, its entitlements, tax credits, and effective take-home pay decrease.



Note in Figure 5 that a household with gross pay of \$30,000 has a higher net income than a household with gross pay of \$40,000 or \$50,000. Also, a household with gross pay of \$20,000 has a higher net income than a household with \$40,000 of gross pay. (College aid is not considered.) Table 1 shows the financial figures.

It would seem that the ditch was not intended by Congress but instead came about as a result of the complexity of the entitlements system when combined with the tax system. Perhaps a goal of any alternative system should be to eliminate the ditch. Assume, for example, that Congress wanted to eliminate the ditch without reducing benefits for low- to moderate-income households.

The green and red lines in Figure 6 present options.

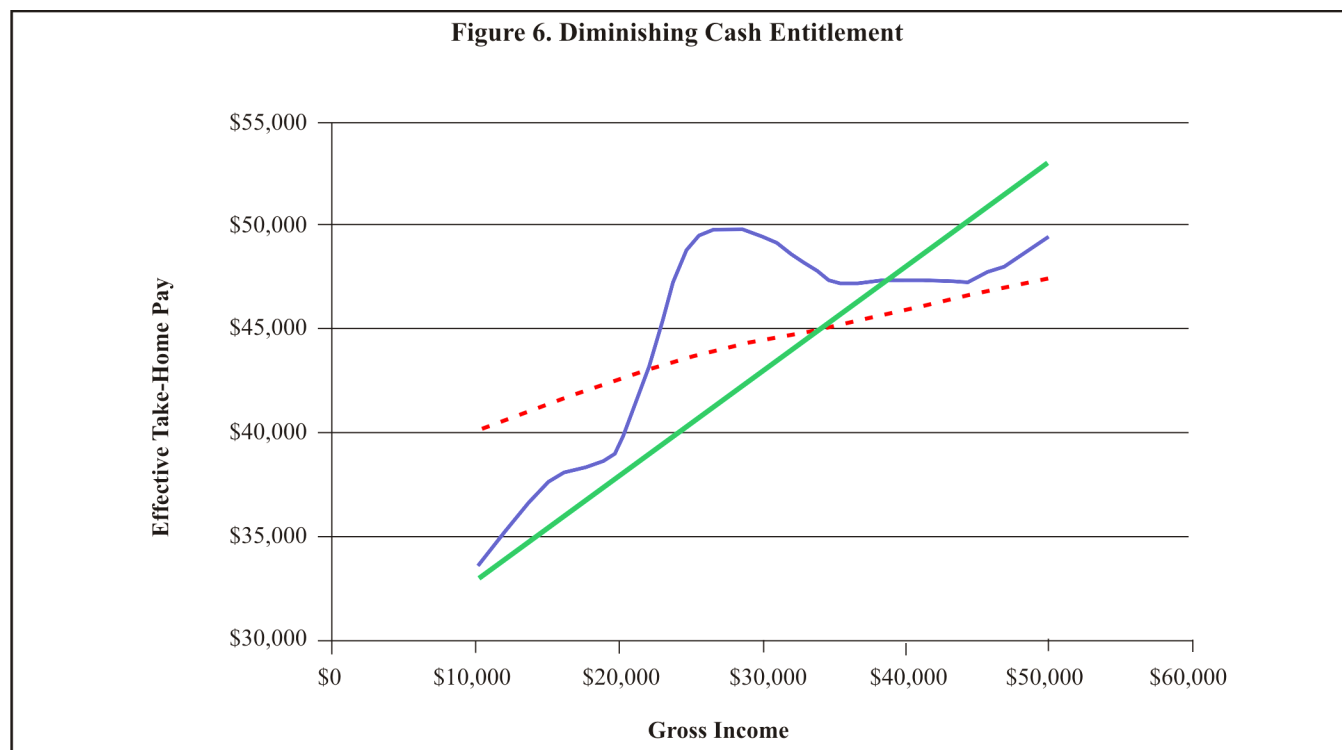
The green line result and the red line result could both be easily produced by applying a simple equation to entitlements and tax credits, relative to gross income. The red line shows how entitlements and credits might be reformed under the current tax system using refundable credits based on a formula of \$30,000 for income up to \$10,000, diminished by 75 cents for each dollar of earnings exceeding the \$10,000. The green line shows a possible reform using a formula of \$23,000 for income up to \$10,000, diminished by 50 cents for each dollar of earnings exceeding \$10,000.

Table 1. Net Income for a Family of Four With ACA Medicaid Expansion

Gross Pay	\$10,000	\$20,000	\$30,000	\$40,000	\$50,000	\$60,000	\$70,000	\$80,000	\$90,000	\$100,000
FICA	\$765	\$1,530	\$2,295	\$3,060	\$3,825	\$4,590	\$5,355	\$6,120	\$6,885	\$7,650
Federal income tax	\$0	\$0	\$221	\$1,223	\$2,441	\$3,941	\$5,441	\$6,941	\$8,441	\$9,941
EITC and child credit	-\$5,060	-\$7,372	-\$5,865	-\$3,759	-\$2,000	-\$2,000	-\$2,000	-\$2,000	-\$2,000	-\$2,000
State tax	\$0	\$69	\$559	\$1,159	\$1,759	\$2,359	\$2,959	\$3,559	\$4,159	\$4,759
Net after tax	\$14,295	\$25,773	\$32,790	\$38,317	\$43,975	\$51,110	\$58,245	\$65,380	\$72,515	\$79,650
Healthcare	\$0	\$0	\$0	\$11,178	\$11,178	\$11,178	\$11,178	\$11,178	\$11,178	\$11,178

Table 1. Net Income for a Family of Four With ACA Medicaid Expansion (Continued)

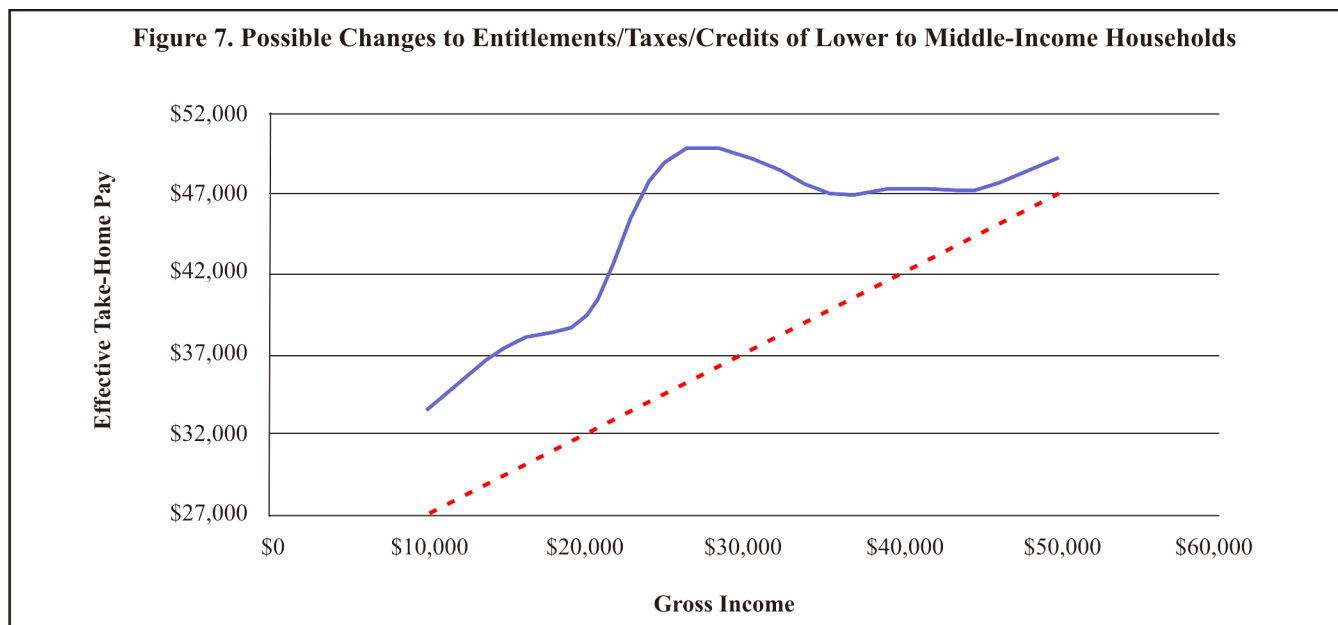
Gross Pay	\$10,000	\$20,000	\$30,000	\$40,000	\$50,000	\$60,000	\$70,000	\$80,000	\$90,000	\$100,000
ACA credit	\$0	\$0	\$0	\$9,213	\$7,813	\$6,265	\$4,584	\$3,578	\$2,628	\$0
Net after ACA	\$14,295	\$25,773	\$32,790	\$36,352	\$40,610	\$46,197	\$51,651	\$57,780	\$63,965	\$68,472
Housing rent	\$2,568	\$5,568	\$8,568	\$13,200	\$13,200	\$13,200	\$13,200	\$13,200	\$13,200	\$13,200
School meals	\$0	\$0	\$0	\$252	\$1,278	\$1,278	\$1,278	\$1,278	\$1,278	\$1,278
Food at home	\$2,307	\$4,707	\$7,107	\$8,799	\$8,799	\$8,799	\$8,799	\$8,799	\$8,799	\$8,799
Cell phone	\$0	\$0	\$0	\$420	\$420	\$420	\$420	\$420	\$420	\$420
Utilities	\$2,070	\$2,070	\$2,070	\$2,070	\$2,400	\$2,400	\$2,400	\$2,400	\$2,400	\$2,400
Net income	\$7,350	\$13,428	\$15,045	\$11,611	\$14,513	\$20,100	\$25,554	\$31,683	\$37,868	\$42,375

Figure 6. Diminishing Cash Entitlement

However, if part of the goal of reform is to keep low to moderate households “whole” while removing the complex credits (including the EITC) from the tax system as a simplification measure (but not eliminating the ditch), entitlements would need to be increased for some households to account for the diminished refundable credits. Cashwise, there

is little or no difference to the federal government between a refundable credit and an entitlement. Both cost money.

If Congress wanted to reasonably reduce entitlements for low- to moderate-income households and eliminate the ditch, it could do something along the following lines:

Figure 7. Possible Changes to Entitlements/Taxes/Credits of Lower to Middle-Income Households

Things in Washington tend to get done in pieces, so one would not expect reform to a significant part of the entitlements system to occur at the same time the tax system is being dramatically reformed. However, the interconnection of the tax system and the entitlements system for low- to middle-income households practically necessitates that they be reformed simultaneously. Thus, logic suggests that Congress tackle tax reform and entitlement reform — at least those entitlements other than Social Security and Medicare — at the same time. Optimally, this would include healthcare reform in the equation. And, reforms to Social Security and Medicare that can pass (with bipartisan support), perhaps such as a gradual increase in the retirement age for both programs to account for increased longevity, would best be enacted when the tax and other entitlements reforms take place.

E. Domestic Partner Considerations

In 2013 the Supreme Court held that the key provision of the Defense of Marriage Act was unconstitutional.⁴⁰ The IRS responded by issuing Rev. Rul. 2013-17, 2013-38 IRB 201, basically declaring that any same-sex marriage is valid for

all federal tax purposes if it was valid in the state where the couple was married. Then, in 2015, the Supreme Court held that same-sex individuals have a right to be married.⁴¹ Those developments further complicated the already complex income tax system.

Both the net worth tax and the VAT would eliminate the same-sex marriage and domestic partner issues. Recall that under the net worth tax proposal, any adult can transfer retirement benefits, HSAs, and section 529 plans to any other adult. The law could provide that a replacement transferee could exist upon the death of the transferee. Similarly, \$250,000 of home equity would be split among all cohabitating owners. Entitlement reform, too, should take into account the fluid family situation in the United States.

F. Transition

Under the current system, unless an asset is subject to estate and gift taxes, its taxation ends upon receipt. In contrast, under a net worth tax, there would be annual taxation and the possibility of double taxation.

Consider a \$100,000 fee received by an attorney for working on a case. Assume the attorney paid \$28,000 in federal income tax and

⁴⁰ *United States v. Windsor*, 133 S. Ct. 2675 (2013).

⁴¹ *Obergefell v. Hodges*, 135 S. Ct. 2584 (2015).

\$6,000 of state income tax on the fee, leaving him with \$66,000. Under the current system, assuming no estate and gift tax implications, only the future earnings on the \$66,000 would be taxed. If the money was invested in tax-exempt municipal bonds, there might be no further taxation. In contrast, if a 5 percent net worth tax applied for all years thereafter and the value remained \$66,000, for each year, \$3,300 of tax would be paid on the \$66,000.

Transition rules could reduce, but not eliminate, the potential for double taxation. For example, the income tax could be phased out over several years, while a net worth tax (or a VAT, or both) was phased in. The reality is that some double taxation would be necessary to transition from the income tax system. That is a concern for both a net worth tax and a VAT.

Adding a large VAT without a phase-in would likely trigger significant purchasing activity before implementation, possibly coupled with inflation, followed by a recession with or without deflation. This is because, as thoroughly explained in the 1997 JCT study, individuals would buy large amounts of durable goods and services before the tax became effective, and they would buy relatively few of them immediately following enactment.⁴² Gradually phasing in a VAT (say, 1 or 2 percent per year) would largely prevent those results.

Tax treaties would need to be amended to address a new system. According to the 2005 tax reform panel, countries around the world modified their tax systems in response to the changes made by the Tax Reform Act of 1986.⁴³ However, the United States is less dominant relative to the rest of the world than it was shortly after the enactment of TRA 1986. If the income tax were to be eliminated, the United States would presumably first discuss the implications of the replacement tax system with all its industrialized treaty partners.

G. Evasion

A higher FICA-SECA rate would create an incentive for some taxpayers to minimize

reported income. However, employers report FICA wages, and most passive income is recorded and reported by financial institutions. The evasion rate for the FICA tax should not change substantially. A well-designed VAT should not experience much evasion. Most net worth is either publicly traded or in the form of real estate. In both cases, the owner is known. However, with a net worth tax, there would be difficulty tracking cash held outside of accounts.

H. Expanded FICA-SECA Tax vs. Net Worth Tax

Because it would be simple, have a low evasion rate, and make everyone pay some tax, a VAT should be part of any replacement system. Both a progressive FICA-SECA tax and a progressive net worth tax with a substantial exemption would not apply to most low- to moderate-income households — significantly reducing the IRS's collections problems for a group of taxpayers that generally has little cash to spare. The question is whether it would be better to couple the VAT with a progressive, expanded FICA-SECA tax or a progressive net worth tax. It's a tough call. However, an expanded progressive FICA-SECA tax would require less change from the current system. Also, an expanded FICA-SECA tax would not require a constitutional amendment.

V. Recommendation and Reasoning

Drawing on the above analysis, I recommend that the following system be implemented, over time, to replace the current federal tax system:

- Repeal the income tax, AMT, ACA taxes, estate and gift taxes, and current tax credits. Expand the FICA-SECA tax by (1) eliminating the cap on Social Security earnings; and (2) taxing the following as self-employment net income: all U.S. passive income; U.S. net income from businesses (even for tax-qualified plans and IRAs); 60 percent of retirement distributions other than Roth distributions; and half of capital gains, including income of all taxable trusts.
- Apply an x percent rate (2x percent on self-employment net income).
- Grant a 25 percent federal poverty-level credit on household income up to the

⁴²JCS-21-97, *supra* note 27.

⁴³President's Advisory Panel, *supra* note 2, at 17.

federal poverty level. Grant refundable credits equal to 25 percent of charitable contributions up to 25 percent of income, 25 percent of home ownership mortgage interest charges up to \$12,000 per year, 25 percent of section 401(k) or IRA contributions up to \$15,000 per person per year (\$20,000 if above age 50), 25 percent of contributions to an HSA, and 25 percent of purchases of high-deductible or similar health insurance.

- Convert all for-profit C corporations to S corporations but permit preferred stock.
- Use a water's-edge system to compute the U.S. portion of passive income and income from business ventures, such that the U.S. percentage of worldwide sales multiplied by tax profit is U.S. taxable income. The U.S. sales percentage would also apply in determining the taxable percentage of capital gain on the sale of an ownership interest.
- Disallow business deductions for wages to the extent the U.S. sales percentage exceeds the U.S. wages percentage (for example, if 60 percent of worldwide sales were in the United States but only 25 percent of worldwide salaries and wages were in the United States, 35 percent of wages and salaries could not be deducted).
- Adopt an x percent VAT, with the exemptions previously described. The x figure produces a balanced budget.⁴⁴

Primarily because of elimination of the EITC and the child care credit, the recommendations above would be less favorable to some lower- and middle-income households than the current tax system. As previously explained, it would be best if Congress adjusted at least non-retirement entitlements in tandem with tax reform. The combination should produce Congress's desired results, while eliminating the ditch.

⁴⁴Using 2013 data and static scoring, the estimate x rate for 2013 necessary to balance the budget would have been 14 percent. The 2x rate would have been 28 percent. To produce the \$2.8 trillion of federal revenue for 2013, the rates would have been 12 percent and 14 percent. For those purposes, it was presumed that the U.S. salaries and wages percentage of companies equaled the U.S. sales percentage.

Unless altered by Congress, the Social Security and Medicare benefits formulae and tax base would be unchanged. However, the trust funds would cease to exist. All government would be funded by the tax system.

Because all for-profit corporations would be treated as S corporations, withholding at the 2x rate would apply to shareholders' U.S. income shares. (The same would apply to LLCs and partnerships.) Companies could agree with shareholders on how they would be reimbursed, including possibly through the redemption of equity if not paid. Passive losses of a company would carry forward, except that current losses could be applied against income of other passive activities, using the current passive loss rules. Affiliated companies would be required to file a consolidated return under unitary principles.

Only earned income of individuals while working in the United States would be subject to the FICA-SECA tax. The tax credits would be available only to U.S. residents. Part-year residents would be entitled to pro-rated credits. Taxable interest paid by U.S.-based governments would be SECA income. Interest paid by companies and dividends on preferred stock would be pro-rated using the U.S.-to-worldwide sales percentage applicable to business earnings and capital gains. The preferred stock dividends would be income and deductible on such basis. (A several-year average might instead apply to capital gains.)

To simplify things regarding the changed FICA-SECA tax outlined above, the prior year's income and expenditure figures could be used in calculating the current year's estimated tax. For withholding tax purposes, employers could use the second preceding year's numbers for credits other than employee benefits provided by the company, subject to potential override if the employee filed a Form W-4 providing new information. Similar to what is now done, necessary information for a year could be required to be reported by the end of January of the next year by reporting entities (IRAs, pension plans, mortgage companies, and health insurers), and individuals and households (which would report only family size and charitable contributions). A later reporting date could exist for self-employment income.

The following income sources under the current system would cease to be taxable: dividends on common stock, state tax refunds, alimony, and Social Security benefits. Virtually all other income of the current system would be partially or fully taxable. The FICA timing and recognition rules would ordinarily apply. For example, sections 409A and 457(f) would cease to apply, and the timing of income recognition for nonqualified deferred compensation would be determined under section 3121(v)(2). For exclusions and employer deductions concerning compensation, only items for which personal credits are allowed would be excludable or deductible. The manufacturer's deduction of section 199 would be eliminated. Outdated rules such as the at-risk rules and the top-heavy rules would be eliminated.

The proposal is reasonably progressive. Everyone would pay the VAT. However, generally only those in the upper half of middle income and above would pay the FICA-SECA tax. Using the x rate, a friction is created that necessitates financial responsibility.

Relative to the current system, the benefits of the recommended system are:

1. simplicity (and related cost savings) and understandability;
2. general relief from multiple taxation;
3. incentive to not send jobs and corporate headquarters overseas;
4. balanced budgets in non-recession years;
5. payment of some tax by every American; and
6. a significant reduction in tax collection problems.

Table 2 shows how the proposed system would impact a four-person household. Assumptions are provided. In all cases, it is assumed that the financial burden of the FICA tax is fully borne by employees. State and local taxes are disregarded.

As previously noted, it would be best if non-retirement entitlements were reformed in conjunction with the tax changes. In any event, on

its own, the proposed system is reasonably progressive.

The proposal would also significantly reduce the size of the tax code and thereby greatly ease the regulatory burden. It would require repeal of the code sections concerning the income tax, the estate and gift taxes, the AMT, and the 3.8 NII tax. However, the code provisions with significance for the FICA-SECA tax would remain, including the applicable income tax provisions. Also remaining would be the S corporation rules, the corporate reorganization rules, the partnership rules, and the passive loss rules. Conversion to the recommended system would require few changes to those code sections. The code's international tax rules would be greatly simplified. And minor matters, such as alimony, could be kept outside the tax system (that is, not deductible and not income).

Deferred compensation and tax-qualified plan rules would not change substantially, except for a small reduction in the 401(k) deferral limits and expansion of the current \$5,500 limit on contributions to IRAs (\$6,500 if age 50+) to \$15,000 (\$20,000 if age 50+). The ability to save for retirement in a favorable manner (that is, tax-deductible and free from creditors) should not depend on the whim of one's employer. Tax qualification rules should and can be greatly simplified. For example, the top-heavy rules are now unnecessary and should be eliminated. Finally, although companies should be encouraged to provide retirement plans, there should be limits for self-employed individuals. Perhaps the best solution would be to require their contributions, other than elective deferrals (which would be subject to the 25 percent credit available to all), to be after-tax contributions, which could later be received tax free upon distribution.

Although individual household returns would generally be necessary, most would be relatively simple. Employed individuals might report only their household size and charitable contributions to the IRS. In most cases, the IRS would have the rest of their pertinent information. The IRS might send a draft return after receiving the household and charitable information, with that return becoming final if not contested within a specified period (for example, 30 days). Self-

Table 2

A. Assuming only FPL credit:					
Total taxable income	\$25,000	\$50,000	\$100,000	\$500,000	\$1,000,000
FICA/SECA gross tax (28%)	\$7,000	\$14,000	\$28,000	\$140,000	\$280,000
Federal Poverty Level Credit (\$24,600 x 0.25)	-\$6,150	-\$6,150	-\$6,150	-\$6,150	-\$6,150
Net FICA/SECA tax	\$850	\$7,850	\$21,850	\$133,850	\$273,850
Assumed consumption percentage	100%	100%	80%	40%	30%
Consumption	\$21,184	\$36,974	\$54,842	\$128,474	\$191,092
VAT on consumption (x 0.14)	\$2,966	\$5,176	\$7,678	\$17,986	\$26,753
Total tax	\$3,816	\$13,026	\$29,528	\$151,836	\$300,603
B. Adding realistic other credits:					
Net FICA/SECA tax (above)	\$850	\$7,850	\$21,850	\$133,850	\$273,850
C. Assumed refundable credit payments:					
Charity	\$250	\$750	\$2,500	\$25,000	\$50,000
Retirement (as limited)	\$1,000	\$7,500	\$20,000	\$40,000	\$40,000
Mortgage interest (as limited)		\$9,600	\$12,000	\$12,000	\$12,000
Healthcare (as limited)		\$3,000	\$7,000	\$7,000	\$7,000
Total credit payments	\$1,250	\$20,850	\$41,500	\$84,000	\$109,000
Multitplied by 0.25 (equals credits)	\$313	\$5,213	\$10,375	\$21,000	\$27,250
Net FICA/SECA tax (after all credits)	\$538	\$2,638	\$11,475	\$112,850	\$246,600
Assumed consumption percentage	100%	100%	80%	40%	30%
Consumption	\$21,458	\$41,546	\$62,123	\$135,842	\$198,263
VAT on consumption (x 0.14)	\$3,004	\$5,816	\$8,697	\$19,018	\$27,757
Total tax	\$3,542	\$8,454	\$20,172	\$131,868	\$274,357
Tax as a percentage of income	14.2%	16.9%	20.2%	26.4%	27.4%

employed taxpayers would still need to file a Schedule C. Households with passive investments would need to address the basis rules for S corporations and LLCs, as well as the passive loss rules.

Obviously, this system would reduce compliance work for accountants. However, tax professionals would still be needed to compute business profits and determine the existence of capital gain. The passive loss, corporate reorganization, and S share basis rules would

remain. (The reorganization provisions of the code would apply to S corporations.) But overall, the system would be simpler and more understandable to the average person. The economy would have less burdensome tax compliance costs.

Instead of using the fluctuating x rate for both the FICA-SECA tax and the VAT, the rate for one of them could be fixed. Because everyone would pay a VAT but not everyone would pay the FICA-SECA tax, it would seem that the VAT should

have the flexible tax rate. Of course, a different variant could be used, such as a 0.75x VAT and a 1.25x FICA-SECA tax.

There is no requirement that an algebraic system be used. For many years, state and local governments have produced balanced budgets (as often required by law) using static systems. Congress could do the same. However, one of the benefits of using an algebraic system is that real spending increases and decreases could be gauged by the change in the tax rate. For example, if inflation for a year was 2 percent, prices could be anticipated to increase by 2 percent, meaning a VAT would bring in roughly 2 percent more revenue, and the FICA-SECA tax would ordinarily bring in roughly 2 percent more revenue. So leaving the rate unchanged would mean letting the tax base grow with inflation. An increase in the rate or rates would generally indicate an increase in spending relative to inflation, and a decrease in the rate (or rates) would generally indicate a decrease in spending relative to inflation.

Using the water's-edge approach recommended above would eliminate the need for foreign corporate tax reduction strategies, such as moving headquarters offshore.⁴⁵ It is unlikely that any company would attempt to reduce its U.S. sales to reduce the tax of its owners.

Our current system lacks substantial certainty and stability, which affects business owners' ability to plan. The proposed system, in which only the tax rate changes from year to year, would provide that needed stability.

One of the tax proposals being analyzed in Congress calls for prohibiting deductions for imports, while allowing deductions for exports.⁴⁶ Another proposal is for a 20 percent tariff to be levied on imports. How could either one of these options not cause greater complexity? Consider a good that starts in the United States, is exported to Mexico, then exported from there to another country, and then returned to the United States. Is it entirely nondeductible (or taxable)? If it is

partially deductible or taxable, imagine the accounting headaches to figure out the deductible or taxable portion. The apparent objective is to discourage sending jobs overseas. My proposed system should accomplish that objective simply.

By requiring a balanced budget in each non-recession year, the proposed system would force Congress to deal with at least some entitlements reform. Voters want the entitlements; they just don't want to pay for them. The jobs of members of Congress and the president need to be *harder*; they need to include making the numbers work. It would also force Congress to live within its means, as is required of households and state and local governments.

It is human nature to procrastinate. And, with entitlements being such a high percentage of federal spending (and growing by the day), neither major political party has shown interest in doing anything except "maxing out" on the credit card. Just as the Bowles-Simpson report was disregarded, the preceding analysis may very well be disregarded. But it and the proposal will be there, waiting, for the day when the wolf comes knocking.

An alternative to the proposed system would be to keep the current FICA-SECA tax and estate and gift taxes and use the x individual income tax system with limited deductions (such as for retirement, charitable giving, home mortgage interest, and healthcare), while converting all C corporations to S corporations and changing foreign taxation to a water's-edge approach as described above. If coupled with other simplifications such as changing section 401(a)(9) to provide for a fixed payout term and eliminating all tax credits, the overall result would be a much simpler system that prevented double taxation of earnings and balanced the budget annually (except for recession years). Such a system would be roughly in line with the current system, in terms of progressivity. The water's-edge limitation on deductions could be part of it. While such a proposal would not eliminate the income tax, it would significantly simplify the tax system and produce balanced budgets in non-recession years. Also, it would be an easier transition from the current system.

⁴⁵ See Allan Sloan, "Positively Un-American Tax Dodges," *Fortune*, July 21, 2014.

⁴⁶ See Tax Reform Task Force, "A Better Way: Our Vision for a Confident America" (June 24, 2016).

VI. Conclusion

Assuming consistent application, simplifying the tax system and tying a common tax rate or rates to spending to balance the budget in non-recession years as outlined above would force everyone to feel the effect of increased spending, which would substantially help solve the United States' financial problems. At a minimum, it would compel politicians and voters to address those problems. Lawmakers and their constituents would need to grapple with difficult spending questions, particularly those concerning entitlements.

The "God bless 'em" crowd likely won't like the recommended replacement systems. But, the big picture needs to be the focus. We don't stop exploration for alternative fuel sources simply because some oil laborers might lose work. The country's debts spiraling out of control would be a catastrophic situation for all. Replacing the current system with a simplified system such as that recommended above would severely limit politicians' ability to create complexity while forcing them to make hard choices. ■

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