NATIONAL CENTER FOR POLICY ANALYSIS

# Real, Simple (and Transparent) Tax Reform

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*Every candidate running for the presidency in 2016 will trumpet tax reform as part of his or her agenda. The contenders may propose to reduce rates, eliminate deductions, or give credits for this or that. But real reform requires structural changes to the tax system. Otherwise, taxpayers will be left with the same onerous system as today.*


Dallas Headquarters:
14180 Dallas Parkway, Suite 350
Dallas, TX 75254
972.386.6272

www.ncpa.org

Washington Office:
600 Pennsylvania Ave., SE
Suite 310
Washington, DC 20003
202.830.0177


My perspective on tax reform is informed by my 40-year career as a tax attorney. The crux of the U.S. tax problem is that the system is built upon "net income" — income after deductions, exclusions, limitations, credits, rate differentials and so forth — which does not achieve fairness, simplicity or transparency. Instead, it invites lobbyists and interest groups to seek special treatment, and enables Congress to use the tax code to pass out benefits to favored constituencies. Any tax reform proposal that utilizes this same "net income" approach to taxation, no matter how well-intentioned, is destined to fail. Flattening rates and eliminating a few deductions and credits may seem like a good approach, but is at best a temporary fix.

The tax system today brings in approximately $3 trillion in tax revenue annually. The share of revenues from each component of the tax system varies from year to year, but on average [see the figure]:[1]

- The biggest share of revenue, $1.4 trillion (about 45 percent), comes from individual income taxes.
- Another $1 trillion (about 35 percent), comes from payroll taxes that fund Social Security and Medicare.
- In a distant third place is the corporate income tax, which brings in $300 billion, or about 10 percent.
- The remaining 10 percent of tax revenue, another $300 billion, comes from a variety of sources: estate and gift taxes, excise taxes on fuel, alcohol, tobacco, firearms, air transportation and so on.

The last major piece of U.S. tax legislation was the Tax Reform Act of 1986, which made significant changes to the Internal Revenue Code, but didn't come close to making it a simple, comprehensible and readable set of laws. It certainly didn't threaten the livelihood of those who, like myself, make a career out of the intricacies of the tax system. Even so, the ink wasn't dry on the 1986 Act before Congress, with the help of the K Street lobbyists and the special interest groups they represent, set out to fashion it

more to their liking. And the system requires an inordinate amount of paper to facilitate the tax process:

- The Internal Revenue Code, which began as a 27-page piece of legislation in 1913, is now over 5,000 pages long, not including Treasury Regulations, IRS Revenue Rulings, official opinions and judicial decisions — all critical materials in interpreting and applying the tax laws.
- The *Commerce Clearing House (CCH) Standard Federal Tax Reporter*, which compiles these materials for tax professionals, is today a 25-volume set of binders filled with over 70,000 loose-leaf pages.

This complexity comes at a huge cost — billions and billions of hours and dollars in compliance costs for individuals and businesses.

According to a recent study by Citizens for Tax Justice:

- Fifteen Fortune 500 companies — including General Electric — reported billions in earnings last year, yet paid no income taxes.
- GE, with its legendary staff of a thousand tax professionals, reported $33.9 billion in U.S profits to its shareholders between 2008 and 2013; yet not only did it not pay any income taxes, it received $2.9 billion in tax refunds.
- None of these companies did anything illegal or improper; they simply took advantage of the U.S. tax code.

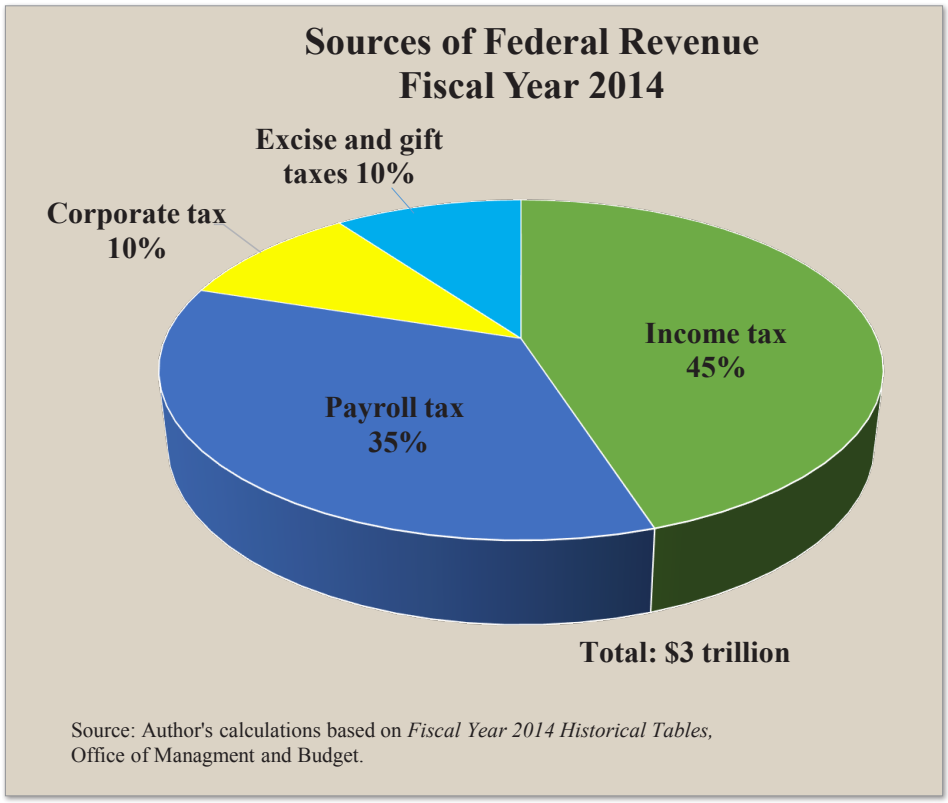
What should be done? My recommendation is to replace the existing system with two very simple, broad-based taxes — one for individuals and another for business.

- For individuals, a 15 percent tax on gross wages — in addition to the already existing payroll tax — deducted from paychecks in the same fashion as the current payroll tax system, but with no wage cap.
- No tax on interest, dividends, capital gains or estates.
- For businesses, a simple 2 percent tax on all gross domestic business receipts.

No individual tax returns need be filed. No complicated corporate tax return to file. No need for the IRS, other than perhaps a skeleton crew. No more lobbyists crowding the halls of Congress.

**How and Why the Plan Would Work.** The plan would produce the same amount of revenue as the current tax system. The current payroll tax system generates approximately $1 trillion annually through a payroll tax of 15.3 percent (7.65 percent on the employer; 7.65 percent on the employee) applied to gross wages, capped at $118,500. The wage cap, according to Social Security Trustees, covers approximately 83 percent of wages. If the wage cap was eliminated and all wages were subject to a flat 15 percent tax on gross wages, about $1.2 trillion in annual tax revenue would be generated.

The current payroll tax is simple and straightforward. The tax applies to virtually all compensation. No deductions, exemptions, exclusions or credits. It doesn't matter if a taxpayer is single or married, has 12 kids or no kids. The payroll tax is not just a flat tax; it is actually regressive, considering its $118,500 cap. Yet, one rarely hears a complaint about it.




Source: Author's calculations based on *Fiscal Year 2014 Historical Tables*, Office of Managment and Budget.

If the flatness of the payroll tax is a problem for politicians, Congress could impose a surtax on gross wages above $118,500 — or whatever other wage level it might choose — and send an annual bill to those affected. Similarly, if Congress wanted to provide a rebate for taxpayers below a certain income level, it could send a check to those individuals at the end of the year. In other words, Congress can still do the things it wants to do. It will just have to do so in a little more direct fashion, rather than embed those preferences into the tax code.

**Corporate and Business Tax.** With respect to corporate taxes and business taxes in general, imposing a simple 2 percent tax on gross business receipts is not a new concept. Several states, most notably Washington, use some variant of it. It is a tax on the total gross domestic receipts of a company, regardless of source. It is different from a sales tax, which applies only to the final sale, at retail, to the end consumer. Gross receipts taxes apply to all transactions, including intermediate business-to-business purchases of supplies, raw materials and equipment. Each stage of production is taxed. Every business, on all of its transactions, pays a simple tax at a low rate. Gross receipts are gross receipts, period. And, because the receipts of every business at every level of production are subject to the tax, the tax base is extremely broad. That allows for the rate of the tax to be set at an extremely low level, yet still raise a significant amount of tax revenue.

A study of Washington State's gross receipts tax (known as the Business & Occupation Tax) indicates that the tax base is about 2.5 times the state's gross domestic product. Washington has a diverse economy of technology, manufacturing, agriculture, tourism and transportation. Extrapolated to the U.S. economy, the tax base for a federal gross receipts tax on domestic revenue would be 2.5 times the U.S. gross domestic product of $17 trillion, or over $40 trillion.

A 2 percent gross receipts tax would generate over $800 billion in tax revenue, twice as much as the corporate income tax currently generates. This amount would cover not only the corporate income tax, but also the estate and gift tax, and all the other hidden regressive taxes that chip away at disposable income: 18.4 cents on every gallon of gas, $2.00 on every bottle of liquor, $1.01 on every pack of cigarettes, 40 cents on every cigar, 10-11 percent on fishing rods and firearms, 7.5 percent on airline tickets, and on and on. The estimated $800 billion generated by a 2 percent gross receipts tax, added to the $1.2 trillion generated by a 15 percent gross earnings tax, coupled with the $1 trillion generated by the current payroll tax that funds Social Security and Medicare, brings total tax revenue to $3 trillion — our current level.

A gross receipts tax will have its critics. Economists don't like the "pyramiding" of tax at multiple levels of production. Because some industries, such as manufacturing, have more levels of production than others, like the service industries, they find it unfair. And industries with lower profit margins than others will also find it unfair. But it is a tax that people can actually understand, and one that large companies can't hide from, no matter how large and clever their staff of tax professionals. A gross receipts tax is simple, easy to comply with and enforce, and far more stable and dependable than a net corporate income tax. Moreover, since it taxes only domestic revenue, it eliminates the nasty competitive problem the United States has faced in recent years because the current system attempts to grasp extra-territorial income

**Conclusion.** The two-pronged tax system outlined above is not the only meaningful approach to meaningful tax reform. What it demonstrates, however, is that a system can be designed that is easy to comply with and easy to enforce. As with any plan, there will be opposition — from lobbyists, the tax industry, special interest groups and members of Congress on both sides of the aisle — those who have found the tax system to be a convenient vehicle for conveying benefits to various and sundry constituencies.

*Jeff Lerner is a tax attorney and research associate with the National Center for Policy Analysis.*

## Notes

1. Fiscal Year 2014 Historical Tables, Budget of the U.S. Government, Office of Management and Budget. Available at https://www.whitehouse.gov/sites/default/files/omb/budget/fy2014/assets/hist.pdf.

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