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Introduction To Simplified USA Tax

The Simplified USA Tax by Congressman Philip English (H.R. 134) is a landmark achievement that shows how genuine tax reform can become a reality without resorting to radical experimentation. The tax code can be simplified without repealing the deductions for home mortgage interest and charitable contributions; the double tax on saving and investment can be removed without enacting a "consumption" tax; tax equity for working men and women can be achieved by allowing them a credit for the payroll tax they pay; the archaic tax barriers to U.S. competitiveness in world markets can be removed in a way that protects and enhances American jobs; a simple deduction for the cost of post-secondary education can, for the first time in history, help put investments in human capital on a par with investments in physical capital; marginal tax rates can be lowered; progressivity can be preserved; and transitional dislocations can be avoided.

Simplified USA embodies a new approach that has the effect of including in the U.S. tax base for the first time in history all amounts derived by foreign companies from selling goods and services in the U.S. market. It seems to me that the result is an enormous tax cut for the U.S. economy -- perhaps $100 billion per year or more -- paid for by foreign companies that presently derive income from U.S. markets on a nearly tax-free basis.

The biggest beneficiaries of this tax cut would seem to me to be the wage earners of America who receive a full credit for the payroll tax they pay now.

How Simplified USA Works -- Structural Framework

Like current law, Simplified USA consists of a business tax and a personal tax with multiple personal rates. The illustrative tax rates below trace back to H.R. 4700 in the 105th Congress and were carried over without change into H.R. 134 when Simplified USA was reintroduced in the 106th Congress.

(1) A Business Cash Flow Tax is paid by corporations and other businesses. The rate is 12% of gross profit. Profit is computed using cash accounting; capital equipment is expensed because the income it produces is fully taxed when received; no deduction is allowed for interest or dividends paid for the use of capital, or for wages paid for labor, but a full credit is allowed for the 7.65% OASDHI payroll tax which is the equivalent of a deduction for about 65% of wages up to $72,000 per year for each employee. Export income and all foreign-source income is excluded from tax. A 12% import tax is collected when foreign-based companies sell into the U.S. market.

(2) A Progressive-Rate Personal Tax is paid by individuals when they receive interest, dividends, wages, salaries, and gains. The two bottom rates are 15% and 25% and the top rate is 30% on taxable income computed after deducting a Family Allowance of $8,000, personal exemptions of $2,700 per family member, home mortgage interest, charitable contributions and post-secondary education expenses of up to $4,000 per family member. Individuals are allowed a full tax credit for the employee's share of the 7.65% OASDHI payroll tax withheld from their wages and, if the amount of that credit exceeds their USA income tax for the year, the excess is refunded. All individuals are also allowed an unlimited USA Roth IRA for personal saving -- except that, unlike the current Roth IRA, saving is not limited to retirement and can be withdrawn for any purpose. Because tax is paid on the money going into this special savings and investment account, there is no additional tax on the inside build-up in the account or on withdrawals from the account. For the first time in history, the double tax on all personal savings will be removed and everyone will be allowed to save for whatever purpose they desire.

Simplified USA is a plain-language, stripped-down version of the current income tax (individual and corporate) that is concentrated on the main goals of tax reform -- which are (1) to be evenhanded as between labor income and capital income; (2) to be neutral in a person's choice to consume income or save; (3) to remove the archaic barriers to international competitiveness; and (4) to be neutral as between equity and debt financing and evenhanded among all forms of business organization.

The basic amendments necessary to achieve these results are neither unfamiliar nor shocking. First-year expensing of plant and equipment is already allowed for small businesses and probably would have been made universal long ago except for revenue limitations under the current code.

The idea of removing the double tax from personal saving -- and thereby taxing saved income no more heavily than consumed income -- has been around a long time. Since the enactment of the Roth IRA in 1997, the simple yield-exemption approach to removing the double tax is now familiar and standard fare. With the Roth IRA already very much part of the tax landscape, it only remains for Simplified USA to make it universal by eliminating the dollar caps, the income limitations and the restriction to retirement savings.

For decades, Treasury reports and bipartisan Congressional studies on corporate/shareholder tax integration have recommended uniform treatment of all forms of financing and all forms of business.

There is nothing new about the idea of excluding foreign-source income from taxation or about the related idea of not taxing exports. The Foreign Sales Corporation (FSC) provision in the current code is a flawed attempt to go halfway, but FSC has run afoul of the WTO and it remains for Simplified USA to do the job correctly in a way that is consistent with U.S. tax traditions and WTO requirements.

The Road to Simplification

Once the basic amendments necessary to achieve neutrality and international competitiveness are made, some of the most complex portions of the code become moot. Substantial simplification automatically occurs. Simplified USA also undertakes to eliminate an array of miscellaneous deductions, credits, exceptions and exceptions to exceptions that are unnecessary when the basic rules are correct to start with. But Simplified USA does not make a fetish out of repealing long-standing and familiar deductions under the misguided belief that they are the source of complexity in the code.

The existing and long-standing exclusions from income for parsonage allowances, combat pay, municipal bond interest or employer-paid health insurance are not the reason that Form 1040 is monstrously long and incomprehensible. Simplified USA retains these and several other exclusions and deductions that are easily understood and of nearly universal application without any special eligibility requirements and that do not require any side calculations. What, for example, is complicated about the deduction for home mortgage interest? All the homeowner does is take one number off the annual statement from the mortgage lender and put that one number on one line of the tax return.

Simplified USA will reduce the size and complexity of the tax code by about 75 percent and the personal tax return (long Form 1040) will be only a few pages -- about like it was in 1960 before four decades of complexity ruined it.

Neutrality Between Saving and Spending

Simplified USA taxes income (whether saved or consumed) only once. It does that by taxing income when received (first tax) and then excluding the earnings on after-tax savings from a second tax.

The current code's bias against income that is saved is easily illustrated by a simple example: Mr. Jones earns $100, pays a $40 income tax, and has $60 after-tax income left over. If he uses the after-tax $60 to buy a car to drive to work (in lieu of paying bus fare), he will not have to pay tax on the value of the transportation services the car provides him; nor should he. After all, he has already paid tax on the $60 once. On the other hand, if instead of buying the car, Mr. Jones saves the after-tax $60, he will have to pay bus fare (having no car) and he will have to pay tax on the interest earned by the $60 of savings. This is not a correct result. It biases Mr. Jones's choice against saving.

Simplified USA produces the correct result: once Mr. Jones has paid his tax, he is not taxed again, either on the interest earned by his after-tax savings or on the value of the transportation services provided by the car.

International Competitiveness

Simplified USA is carefully crafted to allow American companies to compete and win in world markets without in any way providing a tax incentive for American companies to move their plants and jobs offshore. In fact, it makes the United States of America a very attractive place to be for the purpose of conducting a worldwide business.

Simplified USA does this by the combination of three things. First, it replaces the current archaic and inconsistent worldwide tax rule with a territorial rule consistent with modern practice in other countries. Thus, when necessary, U.S. companies will be able to invest and compete directly in foreign markets without having to pay U.S. tax on the profits they make in some other country's economy and bring home for investment in America. Second, export income will be excluded from U.S. tax. Thus, a U.S. company can stay home, manufacture in the U.S. and sell into a foreign market without paying U.S. tax. Third, an import tax will be imposed at the same rate as the regular USA business tax rate -- 12%. Thus, while a company may operate abroad when necessary to gain foreign-market sales that cannot be reached by exports from the U.S., if it goes abroad for the purpose of selling back into the U.S. market, it will have to pay a U.S. tax at the border without the benefit of any deductions.

International competitiveness will flourish under Simplified USA, but there will be no runaway plants.

The Way Border Tax Adjustments Work -- A Major Shift in the Tax Burden

The border tax adjustments in USA have been borrowed from the European VAT (which is a form of sales tax) and appended to the business portion of the USA Tax in a WTO-permissible way -- but when appended to a business cash flow tax like the USA business tax, the border tax adjustments operate quite differently from they way customarily are thought of in the VAT context.

Because the USA business tax is a tax on net cash flow instead of a tax on goods, USA excludes from tax the revenues derived by a business from exports. This full exclusion of export revenues is similar to the partial exclusion provided by the Foreign Sales Corporation (FSC) rule in the current corporate income tax which the USA business tax resembles in many ways.

Except for exports, USA includes in the tax base all GDP -- which, in turn, is equal to the sum of all returns to labor (wages and salaries) and all unreinvested returns to capital (interest and dividends).

By means of an import adjustment, USA also includes in the tax base an additional amount which represents the amount of goods and services that are produced by foreign-sited labor and capital but sold into the United States market. The 12 percent import tax might appear to make imported products more expensive, and, in some cases, it will, but both neoclassical economic theory and common sense say that in many more instances involving a very large portion of the total dollar value of imports, the foreign companies who sell these imports into the U.S. market will have to absorb all or a major part of the 12% import tax. They will do this by adjusting their pre-tax price downward so that the after-tax price to the U.S. purchaser is the same or nearly the same amount that purchasers had previously been paying. When foreign companies do lower the pre-tax prices, they are, in effect, paying the U.S. tax and when a company pays a tax (whether it be U.S. tax or home country tax), the burden of that tax will ultimately be borne by its employees (in the form of lower wagers or fewer jobs) and its shareholders and debtholders (in the form of lower returns to capital).

As of the end of 1999, imports were $1.3 trillion involving an almost uncountable number of U.S. buyers and foreign sellers of an almost uncountable variety of imported goods and services. Out of all this, no one knows how many of the foreign companies will be "price takers" who will absorb all or part of the import tax or how many will be "price setters" who will not absorb any of the import tax. Therefore, no one knows the precise dollar value of the import tax that will be passed back to foreign labor and capital, but we do know that much of it will be. The U.S. market is, after all, the largest market in the world and the pressure on foreign companies to absorb at least a part of the tax will be large. Only those who sell a unique product for which there is no substitutable alternative will be totally immune from that pressure, but there are not so many of those situations and, even when they do exist, what may be a unique product today may not be tomorrow.

The point is not to be precise about the exact amount of import tax that will be borne by foreign labor and capital. Rather, the point is to know that the dollar amount is large and that even if 60 percent of the $160 billion import tax revenue increase is borne by foreign labor and capital, that mans that the U.S. economy has received roughly a $100 billion per year tax cut.

Payroll Tax Credit -- An Offset to Implicit and Explicit Taxes on Wages

Not only is the payroll tax credit an historic breakthrough in fairness, it is essential to the evenhanded treatment of labor and capital that is the hallmark of Simplified USA and the foundation on which genuine tax reform must be built.

A. Implicit Withholding Tax Offset by Payroll Tax Credit

Like the current corporate income tax, the USA business tax is an implicit withholding tax on dividends. (Unlike the current corporate income tax which favors debt over equity, the USA business tax also serves as an implicit withholding tax on interest as well.) This implicit withholding on interest and dividends arises because the business pays tax on its as gross profit without any deductions for interest paid or dividends paid.

Like the current employer-paid OASDHI payroll tax, the USA business tax also serves as an implicit withholding tax on wages -- because the business pays tax on its gross profit without deducting wages.

But for the credit that Simplified USA allows for the 7.65% employer-paid payroll tax (which reduces the implicit withholding), the implicit withholding on wages up to $72,000 per employee per year would be 19.65% (12% + 7.65%); whereas the implicit withholding on wages in excess of $72,000 and on interest and dividends would be only 12% (the USA business tax rate).

With the payroll tax credit, the implicit withholding tax is uniform as follows:

Wages up to $72,000	Wages above $72,00	Interest and Dividends
12%	12%	12%

B. Explicit Tax Offset by Payroll Tax Credit

When wages, interest and dividends are received by individuals, the remainder of the tax on that income is collected from the individual, and, in the case of wages, all or part of that tax may be withheld at the source by the employer as under current law.

In the case of wages up to $72,000, however, current law imposes an additional 7.65% employee-paid OASDHI tax that is explicitly withheld at the source by the employer.

Simplified USA allows the employee a credit for the 7.65% OASDHI tax explicitly withheld from wages. With this credit, wages, interest and dividends are all taxed equally, the only variation being the rate bracket of the particular individual -- 15%, 25% or 30%.

Resisting Analogies -- Simplified USA Is Sui Generis

The Simplified USA Tax combines some elements that may also be found, variously, to some extent, and in different forms, in taxes said to be based on cash flow, net income, consumed income or business value added, but because Simplified USA is a hybrid, none of those analogies is altogether accurate or especially illuminating.

Simplified USA is best understood as the current income tax amended to allow (1) first-year expensing of capital equipment, (2) an unlimited Roth IRA for everyone that applies to all saving (not just retirement saving) and (3) a credit for OASDHI payroll taxes. Internationally, it adopts a "Super FSC" for outbound transfers (exports) and a "Super §482" adjustment on inbound transfers (imports).

If one insists on putting Simplified USA into some preexisting generic category, the USA Tax on individuals is an "income tax" and the USA Tax on businesses is a "business cash flow tax" (a concept which is well-known and long-standing in the tax literature).