

# The American Income Tax Simplification Plan (AITSP)

The complete Internal Revenue Code is more than 25 megabytes, and contains more than 3 million words. If printed, would fill over 7000 pages!

To compound the confusion, the law is not so much what is written, but what the courts have decided in various tax cases brought before it. It is impossible to claim that anyone truly understands the document or its impact on our country.

Today's tax code is so massive, so confusing that it is simple to claim it is unfair for one reason, no one can with absolute certainty calculate what either an individual, company or corporation owes in Federal Income Tax.

There are other reasons that the method current Federal Income tax is calculated and collected needs to be changed. No one argues changes are needed but no one has come up with a comprehensive plan to do so. **The American Income Tax Simplification Plan** attempts to do so while addressing the issues raised by the Flat Tax and the National Sales Tax initiatives.

## A Brief History

During the Civil War Congress enacted the nation's first income tax law. Under that, people earning from \$600 to \$10,000 per year paid a tax of 3%, and those who made more than \$10,000 paid higher tax rates. It was the beginning of our modern income tax system.

In 1913, the 16th Amendment to the Constitution made the income tax a permanent fixture. The withholding tax on wages was introduced in 1943 and was instrumental in increasing tax collections to \$43 billion by 1943.

In 2005, about 132 million tax returns were filed in the U.S., and about 43 million returns will get back every dollar that was withheld from their paycheck. The remaining 90 million returns will end 2005 having paid about \$1 trillion in federal income tax.

In 2003, total federal state and local taxes in the United States were 24.2% of our gross domestic product. 2003 Federal revenue was derived from the following sources in billions of dollars:

Individual	1,006.4
Corporation	205.5

Social Security	749.2
Other	87.0
Total	2,048.1

**The American Income Tax Simplification Plan** will look at a more fair, understandable and controllable method of raising those portions of the Federal revenue stream generated by Individuals and Corporations. In 2003, this amounted to \$1,211,900,000,000.

## The Challenge

I don't think anyone believes that the current method the Federal government collects income taxes works. In fact most hate it but aren't quit sure why. Two alternative proposals have gathered some public support but neither has come close to becoming law. One is based solely on a flat income tax while the other a national sales tax. Both seem to have issues that bother people without them being able to articulate their objections beyond 'something doesn't feel right'. I believe that the one issue lawmakers fail to take into account is simple human nature. The current federal income tax system along with the two more popular alternatives is not only seriously flawed from an economics point of view but also a human nature perspective.

Most people are familiar enough with the current system and all of its flaws that it isn't necessary to delve very deeply into those flaws. The fact is that it consists of 7,000 pages of often contradictory tax code that must be interpreted by the IRS, the courts along with tax preparers. When multiple tax preparers all come up with different answers to a relatively simple return, as has happened in every test conducted, how can the public have faith in its fairness? On the corporate side, I have seen estimates that corporations spend as much making honest attempts to comply with the tax code as they pay in income taxes. Corporations are often forced to make business decisions based not upon good business practices but dictated by tax code. More and more corporations are moving their headquarters offshore to avoid much of the income tax confusion. Many are corporations that end up paying little or no federal income tax but spend huge sums of money ensuring that they are in compliance. I believe most would prefer to be good citizens but find the current situation too complex and costly and they simple raise the white flag and move. International studies have shown our corporate tax system is one of the most oppressive in the industrialized world. We live in a world wide economy and this will continue to force more jobs out of the country.

So what is the answer? I believe that the two current alternatives have some merit but are terrible flawed as well. As I looked at alternatives over the past 5 years, I came to the conclusion that some insight and guidance must be taken from human nature. A public acceptance and a 'that feels right' must accompany any new tax package.

## The Objective:

To develop a tax plan that replaced the Federal Income portion of Federal revenue. This does not alter the collection of various payroll taxes as I believe they conform to the requirements below.

The following are the guidelines I developed in evaluating an alternative taxation program:

1. Efficient – The current system is incredible inefficient costing tax payers and corporations huge sums of money just to ensure compliance. Other overhead expenses include IRS enforcement costs. Plus there is lost tax revenue due to non-compliance and lack of funds in the IRS to adequately enforce tax collection. The impact on our national economy is huge and felt by everyone. Efficiency means a greater percentage of the total cost (tax along with compliance costs) going towards government usage.
2. Behaviorally Neutral – The current tax system along with both notable alternatives fail rather badly in this regard. The resulted changes in behavior of tax payers really falls into two categories, intended by the author of the tax code and unintended behavioral changes. The Federal government has long attempted to 'regulate' behavior both in the private sector and within corporations through the use of tax code. Some attempts have been successful while others have failed. Tax breaks for home owners has encourage home ownership but most have either failed or had serious negative unexpected behavioral changes. The 'luxury tax' assumed that rich people didn't mind getting hit with a large tax on boats. They did and modified their behavior resulting in the large boat business almost going out of business. However, the Federal government certainly has the right to author code with the intent of modifying behavior. I tend to believe that more direct legislation is more appropriate. This is true for both cultural changes and business changes. The Chrysler bailout was a positive example where federal action resulted in mostly guaranteed loans and not tax breaks aimed at an entire industry. Congress passed a specific piece of legislation that aided Chrysler as opposed to some tax breaks that would have affected others in the industry or possible in other

industries. Plus tax code tends to never go away resulting in unexpected consequences down the road.

An even bigger issue is unintended behavior changes. Changing ones behavior to avoid taxes is a simple example. Most people will do the right thing given it is easy and seems reasonable to them. Later I will discuss the huge flaw in the national sales tax proposal that would result in massive, permanent and tragic changes in how we as a society deal with the Federal income tax. On the corporate side, as the tax code has become more difficult and costly to comply with, more corporations have moved off-shore. Tax collection from Corporations has been in a steady state of decline for many years as a percentage of income tax collected forcing that burden to be picked-up by individual tax payers. Any new tax system needs to minimize behavioral changes.

3. Fair - This one is tough and must be viewed from a human nature perspective. Logical dissertations have been presented showing the fairness of a variety of tax plans. Each makes good points but my point is that logic doesn't matter! The fact is that any new tax plan must feel fair to the citizens and what feels fair isn't always the same as logically fair or even factually fair. There must be the perception of fairness as well. Having said that, where there is smoke there is usually fire. I believe that behind the lack of a feeling of fairness, the current system along with the alternatives aren't fair as I will discuss later.

## The Answer

Drum roll please!

While the answer will seem simple, it has gone through a number of revisions. Often when someone sees an answer that makes sense the response is 'duh'. I hope that is the response of most people who read this. It takes the best of many of the current proposals while keeping things simple and most importantly, will be perceived as fair.

The **American Income Tax Simplification Plan** would consist of a three prong approach. While I will cover the specifics in more detail, it will ask that all who benefit from living in or profiting from the economic environment built by this great country will contribute. The method will be simple, straightforward and relatively painless. **The goal is to spread the pain wide and thin!**

Note: For this initial discussion, I am going to use 1995 numbers because they are the most readily available to me. It has been difficult to come up

with some of the numbers as many have not been considered important enough to be widely published.

**Goal:** To raise \$775 billion dollars. That represents the Federal Income tax collected in 1995 along with Estate and Gift taxes. It does not include Excise or Payroll taxes.

### **American Income Tax Simplification Plan:**

- A national sales tax of approximately 5%
- A 3-5 tier Personal Flat Income Tax
- 2 tier Corporate Flat Tax on Gross Revenue

First the Calculations and then a more in-depth explanation:

- 1. Sales/Consumption Tax: 5% \* \$5,980 billion = \$299 Billion**
- 2. 3-5 Tier Personal Flat Income Tax; 10% max: Goal = \$201 Billion**
- 3. Corporate Gross Revenue Income Tax**
  - a. Distributors/Retailers – 1.5% \* \$10,000 Billion = \$150 Billion**
  - b. Manufactures/Service/Professional – 4% \* \$5,000 billion = \$125 Billion**

**Total = \$ 775 Billion**

1. All retail sales would include a 5% federal sales tax. Very simple and easy to implement. Companies are equipped and experienced in collecting State sales tax and computer programs could easily be modified to compute the taxes.
2. We would have a Personal Flat income tax based solely upon income. There would be no deductions except for dependents. Gross income minus a factor per dependent times the rate of your income tier. This would be a version of the flat tax proposal with a lower rate.
3. There would be two categories of businesses with different tax rates. The distinction is really very simple, if a company purchases a product and passes it on to either a reseller or consumer, they are a Distributor/Retailer otherwise they fit into the other category.
  - a. Distributors/Retailers – This would include all businesses which resell or distribute a product where less than 5% of their business involves adding value to a product. It would include all gross sales generated within the United States regardless of the corporate location. It would include all gross sales from a facility in the United States to any location worldwide. The United States has the world's most efficient process for moving products from

the manufacturer to the consumer. This tax rate would minimize any negative impact on their competitive stature and yet require all that benefit to contribute. **This rate would be in line with Wal-Mart who currently pays 1.6% of gross sales in Federal Income Tax.**

- b. Manufactures – This would include any business that manufactures a product, adds value to more than 5% of its business or is a professional service where no product is involved. These companies traditionally deal with higher profit margins and often place greater stress on the business infrastructure.

## **Corporate Rate Justification:**

### **General Electric 2004:**

Goods Sold: Gross	\$ 55 Billion
Services Sold: Gross	\$ 30 Billion
Federal Income Tax	\$ 5.215 Billion unadjusted
	\$ 3.661 Billion with adjustments & credits

This works out to 6.14% of Gross sales unadjusted and 4.3% adjusted. The adjusted number is what was actually owed.

### **Microsoft 2004:**

Gross Sales	\$ 37 Billion
Federal Income Tax	\$ 4 Billion

Percent of Gross Sales paid in Tax: 10.8%

### **General Motors 2004:**

Gross Sales	\$ 194 Billion
Federal Income Tax	\$ 0

I have been a GM fan since I bought my first 1969 Camaro. We currently own three GM cars and wish them all the luck in the world. However, what success GM enjoys is largely because of the great economic engine that is the United States. A large manufacturing company such as GM places an enormous burden on government services and should share in its support. It is neither the government's or others who pick up the slack's fault that GM is unprofitable. This tax should be considered a cost of doing business and shouldn't be dependent upon profitability.

A company doesn't get to choose to pay vendors or employees depending upon profitability and this tax should be considered in the same light. **It is a cost of doing business!** However, the Federal government would be free to grant GM some type of income tax free pass but that would be specific legislation dealing with just that situation.

## Numbers:

As you review the numbers above, please note that the base numbers were difficult for me to gather. They seem straightforward and probably are. However, it seemed that most easily available numbers were far more complex than needed for these calculations. I assume no one expected someone to want to look at the numbers I was after. So I will rely on more knowledgeable economists to derive better numbers but I believe mine are close enough for discussion.

### **A different approach to federal tax income tax rates**

Most importantly, I believe we need to take a fundamentally different approach to the calculation of appropriate tax rates. I will show how this approach fundamentally complies with the three criteria listed above. Given that is the case, **I would propose that we look at the four taxable categories and assign a percentage of total revenue goal for each category. The tax rate would then be set to attain that goal.**

### **For Example:**

Again using the 1995 goal of \$ 775 Billion, these would represent the percentage of total budget to be raised in each taxable category along with the revenue figure.

- 1. Sales/Consumption Tax: 38% ~ \$294.5 Billion**
- 2. 3-5 Tier Personal Flat Income Tax: 25% ~ \$ 193.75 Billion**
- 3. Corporate Gross Revenue Income Tax**
  - c. Distributors/Retailers: 18% ~ \$ 139.5 Billion**
  - d. Manufactures/Service/Professional: 19% ~ \$ 147.25 Billion**

I believe this would result in approximately the following tax rates:

1. Sales/Consumption Tax: 5%
2. 3-5 Tier Personal Flat Income Tax: 3-5 tier rates 0 – 10%
3. Corporate Gross Revenue Income Tax
  - e. Distributors/Retailers: 1.5%
  - d. Manufactures/Service/Professional: 4%

**As an individual, business owner, stock holder or any combination, would you not jump at this tax structure!**

It is simple to understand and most importantly, spreads the burden wide and thin.

Congress could adjust the category rates to maintain the category's goal of total revenue as the economy changes. It obviously would also be possible for them to adjust the goal percentage of each category. **This approach represents a return to a macro management of the Federal Tax systems verses the micro management that has evolved over time. I think this could turn out to be the most vital change presented by The American Income Tax Simplification Plan.**

## **Criteria Compliance:**

I started out with three criteria I used to evaluate Federal Tax alternatives and it is now time to see how **The American Income Tax Simplification Plan** shakes out. Sometimes it is easier to look at alternatives when evaluating compliance so I will plead guilty to using the national sales tax as a way of illustrating the benefits of **The American Income Tax Simplification Plan**.

1. **Fairness:** I wanted to start with this one as I strongly believe that for any tax alternative to move forward, there must be a both a perception and a reality of fairness. We don't want or need a revision of the current system with a fresh coat of paint. We need a system that people can buy into and accept. While it is difficult to define fairness, I do believe the following:
  - a. I believe most people can more readily accept a system where all that benefit also contributes.
  - b. I believe that when more and more of the burden falls on fewer people, a perception of unfairness grows and divides. That is the case today where a dramatically smaller percentage of Federal Tax revenue is coming from companies and greater percentage coming from a smaller and smaller percentage of individual tax payers.

This gets back to the concept of wide but thin which I believe people would embrace. Let's look for a second at some of the ideas of the Sales Tax bunch. They correctly believe money travels in a circular path. However, they incorrectly believe that it doesn't matter where in that path taxes are extracted. They are close but their 15 second sound bite answer is just wrong. They believe that the National Sales Tax would in fact engage those people that benefit from our great economic engine. They don't believe that companies need be taxed because all their profits are funneled through people that would pay the National Sales Tax. That is flat wrong!

In 2004, foreign owned assets totaled \$ 2.7 Trillion in this country. Profits generated from those assets go back to the parent company and their owners and stockholders. Those people, in general, would not help support this economic environment through sales taxes.

An even larger group, which I was unable to quantify but is huge, are stock holders of US corporations. The United States has been a haven for foreign investors in our stock markets since the beginning of those markets. These investors include foreign nationals along with government entities. All of these people derive benefits from our economy and yet would not participate in its support at all. This is not a trivial issue and one not addressed by the sales tax supporters. It severely impacts the perceived fairness of that program and does help illustrate the fairness of **The American Income Tax Simplification Plan**. These benefactors of the American economy would contribute through the taxation of the companies. This would include taxation of foreign owned companies operating in the United States plus taxation of the American owned companies in which they are shareholders. Nothing is perfect but this would help include those who would fall between the cracks in other tax proposals.

The other fairness issue pertaining to the National Sales Tax will be covered in more detail in Behavior Neutral discussion but when one segment of society perceives that it is overburdened, it believes it isn't fair and changes its behavior, normally not for the best!

#### **The American Income Tax Simplification Plan:**

- Spreads the burden wide and thin.
  - There are limited opportunities for the government to unfairly target specific groups and/or businesses.
  - If it looks, acts and feels fair; it just might be!
2. **Efficient:** The importance of this aspect of **The American Income Tax Simplification Plan** can not be underestimated. From the

government's perspective, it might be the most important. The goal is to raise the required funds with the least negative impact on the economy as possible. The current system has a tremendous overhead or compliance cost associated with it. As I have mentioned, I have seen estimates that corporate compliance costs might run as high as 100%. Tax compliance costs Microsoft millions each year. This is money that neither helps the company, employees, the stockholders or the government. While the tax attorneys, accountants and CPA firms might disagree, it is as cost that should go away.

There is also an impact on individuals. Tax returns for the millions that actual pay the bulk of the Federal Income Tax are complicated. Billions are spent on tax preparation that again is a lost cost that benefits no one.

There are other tremendous costs passed on by the current tax code. The inheritance tax is an easy target. Supporters claim it only affects the very wealthy and most, with good tax planning, aren't affected. Most of the very wealth spend huge sums of money on tax planning and are able to avoid the impact of the inheritance tax. Again, this is money that neither benefits the economy nor the government. Small businesses and farms are particularly hard hit. Again supporters claim very few are actual hurt but they ignore the tremendous cost and turmoil created behind the screens and what must be done to survive that tax. These costs are real and non-productive.

We can not discuss Efficiency without including the IRS. Any tax system must have an enforcement arm. The hope is that the system doesn't need much enforcement! This system would retain the IRS unlike the national sales tax alternative. I would like to offer this support for the IRS: It has been a government agency tasked with the impossible. It has been asked to enforce tax laws no one understood and no one felt was particularly fair. There have been abuses by individuals within the IRS but given the agency's task, I am more amazed that it has done as good a job as it has.

Within **The American Income Tax Simplification Plan**, the IRS will play an important enforcement role while engaging equal foes. Given the fact that the individual rates will be low and will still be withheld from paychecks, I see a greatly reduced IRS involvement with individuals. The IRS would be tasked with the enforcement of the more complex corporate/business taxes along with the collection of the sales tax. I believe that this will be the areas where abuses will be more likely. The positive aspect will be that the IRS will be dealing with companies equipped to handle such inquiries and their interaction with individual tax payers will be greatly curtailed.

**The American Income Tax Simplification Plan:**

- Greatly reduce compliance costs thereby growing the economy
  - Greatly reduce tax planning costs for individuals along with preparation fees
  - Reduce compliance issues for companies and corporations in both the areas of sales tax and revenue tax collection.
  - Reduce the role of the IRS to the enforcement of companies and corporate tax compliance.
3. **Behaviorally Neutral:** Without question, not only is this a strength of **The American Income Tax Simplification Plan** but is a shortcoming of the national sales tax plan so serious that it permanently damage our economy and society. It seems that far too often those in our society that seem to be convinced that they know what is best for everyone believe they can control simple human behavior. The fact is that we are adaptable and within certain limits are willing to modify our behavior for the good of our society. However there are limits at which point a greater percentage of people deem the limits unfair/unjust and change their behavior accordingly. This limit does vary among people. There are a small percentage of people that feel that their inability to rob people is an inconvenience they can not tolerate. A large enough percentage of society disagrees that these people end up in jail. However, history is full of examples of where society has made demands of its citizens where a majority did in fact change their behavior, normally in violation of the law. Obviously, Prohibition is the classic example but there have been other less historic example. One closer to home with regards to tax law was the Luxury Tax. The idea was that wealth people would pay an additional 10% sales tax on very expensive items. There was a threshold of \$500,000 for cars and \$100,000 for boats. Proponents claimed that it was a very affordable tax on people who bought such products. They were right but missed the point. These buyers didn't like being singled-out and simply changed their behavior. According to The Wall Street Journal editorial, the Labor Department estimated that in Florida, the nation's leading boat building state, builders laid off 5,000 out of 18,000 laborers by the end of 1990 and these layoffs were not isolated. Retailers, manufacturers, and services aligned to the boating industry were simultaneously affected. The law was revoked.

Between the extremes there are countless examples of additional sales taxes adversely affecting behavior. New York has a state sales tax on cigarettes that is higher than surrounding states. The Cato Institute has chronicled the years of black market and associated criminal activity they have fought for over 50 years. This over just a few cents per pack!

<http://www.cato.org/pubs/pas/pa468.pdf>

The national sales tax proponents claim that workers will bring home more money and this will somehow mentally equip us to pay 20% more for things. My belief is that the revolution will begin slowly as companies push more products through side sources such as eBay sites run by employees. Who will enforce tax collection of 'private' sales? Black market sales will increase as people feel more comfortable with that behavior and that will happen. Is the government going to come after I save a few bucks buying on-line from a private party? Soon people not participating in the black market are going to feel left out. Again, the national sales tax people are going to get rid of the IRS so who is going to enforce anything? We will see the emergence of organized crime at a level not seen since Prohibition. I really can't believe anyone supporting a national sales tax at 20% has really thought this through. It would be a disaster of monumental proportions.

#### **The American Income Tax Simplification Plan:**

- Would provide for the generation of adequate tax collection while having minimal impact on the behavior of the tax payers.
- I believe that a 5% national sales tax will not create the behavioral changes that would accompany a 20% or higher rate.
- I do not believe the Corporate rate will negatively impact their behavior either. In fact, given that the incentive to move off-shore has been removed, many may come back and become even better American citizens.

One last comment on the national sales tax plan. One component is that the Federal government is to collect huge sums of money and rebate some of those funds back to low-income people. Let's face it; the Federal government has never been good about giving back money!