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The SET Tax

A Tax System for Our Future

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The New York State Society of CPAs

The New York State Society of Certified Public Accountants (NYSSCPA) is pleased to have this opportunity to testify to this distinguished body. The NYSSCPA is the largest and oldest state-based society of CPAs in the world. Its membership of 30,000 ranges from partners in the largest of international accounting firms to the one-person CPA firm down the block. In addition, a little over a third of its membership is employed by businesses (other than accounting firms) ranging from banks, to brokerage firms and insurance companies, retail establishments to wholesalers, to government, colleges and universities.

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

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

Executive Summary

The NYSSCPA proposes the Simple Exact Transparent Tax, or SET Tax, as the solution to the dysfunction of the current **income** tax system for individuals and corporations. The SET Tax would tax all incomes over an acceptable threshold established by our political leaders, reduced by government-approved exclusions at an economically appropriate and socially acceptable single rate. Income would be defined broadly and exclusions clearly, using our current, highly developed rules and tax vocabulary. Conflicting tax systems, brackets, credits and deductions are eliminated.

The SET Tax infuses the tax system with transparency, while leaving intact the ability to collect revenue in order to fund according to the social and political priorities of the day. It reduces the "clutter" of complex tax calculations to a simple formula that most taxpayers will be able to understand, applies a fair and universal tax rate, and allows everyone to know exactly what money the government is taking to support tax driven initiatives. The SET Tax will provide much greater assurance that all taxes are collected so tax cheats will be losers and honest taxpayers will be winners.

The SET Tax addresses all the key issues in today's debate on tax reform and proposes a solution: transparency. The SET Tax is **fair**, **simple**, and **pro-growth**. Perhaps most importantly, it can remove from the Code misdirected complexity while meeting today's current economic need for **revenue neutrality.** By addressing intentional and unintentional tax compliance failures, it can be designed to produce a "compliance bonus" that can provide government with funds for greater spending flexibility in making future policy decisions.

What is the Simple Exact Transparent Tax?

The SET Tax is a greatly simplified income tax, devoid of unnecessary complexity and alternative tax systems. Congress would select a politically acceptable, economically appropriate single rate to tax ***income***, and then use only straightforward exclusions of its choosing to accomplish additional public policy goals, such as: achieving progressivity; encouraging economic behavior such as saving for retirement, manufacturing in the USA, discovering oil, or developing alternate energy sources; and accomplishing social policy goals such as encouraging home ownership, charitable giving, etc.

Calculating a taxpayer's tax rate under the SET Tax is accomplished using a simple, straightforward, and easy to understand formula:

(Income - Congressionally defined exclusions) x Rate = Tax

How the SET Tax Would Work

The SET Tax uses a single tax rate and <u>all</u> gross income as a starting point – the broadest income tax base possible and the easiest to teach and understand. Generically, therefore, it is a flat tax. Unlike the proposal referred to as <u>the</u> flat tax, however, the SET Tax would continue to enable Congress to use the tax laws to accomplish their multifaceted policy initiatives in an easy to apply manner.

"Exclusions" in the SET Tax system could include all of today's deductions, exemptions, exclusions, credits (re-engineered into exclusions) and other reasons to reduce an individual's or a corporation's gross income to determine the taxable income.

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

Achieving a SET Tax

The SET Tax has four components:

Single rate. The SET Tax would be set at a single, relatively high rate – for example 33 1/3% – so everyone can understand the maximum he or she would pay in the absence of exclusions. The actual rate is to be determined by our political leadership after receiving input from economists, revenue estimators, and constituents.

Gross income is ALL income. Income would be measured under existing principles, generally using the cash basis for individuals and small businesses, while most larger businesses (including large corporations and certain partnerships) would be required to use the accrual system to recognize gross income. There would be no omission from realized gross income, only deductions we call exclusions. Interest on tax-exempt bonds, then, would be included in gross income and granted an exclusion, provided Congress continues to believe such interest should not be subject to federal income tax.[ii] On the other hand, cash receipts that are not income, like gifts or borrowings, would not be included in gross income. Similarly, as under current law, various tax-free business creations and reorganizations would not create gross income to owners. Current law definitions will be very helpful in this area, and retained.

Every taxpayer would have at least one exclusion; all exclusions should be as simple as possible. Every taxpayer should have a personal exclusion. This will draw all income earners into the tax system, through an extremely simple filing process. Exclusions beyond the basic exclusion would be consistently and simply crafted, and could be capped or subject to percentage limitations to accommodate progressivity goals.

Not everybody may pay, BUT EVERYBODY FILES! While we agree with building vertical equity into the tax system through transparent approaches to transparency, we do not believe it is wise to remove individuals completely from tax reporting, even if they owe no tax. That approach acclimates individuals to inaction in their interaction with the tax system. It forces an individual to undertake significant changes when he or she moves from being untaxed into being taxed. In the process, it nurtures the underground economy and tax-evasive behavior.

Every citizen should become accustomed to interact with the tax-filing system, either by filing a paper tax form or through telephonic or electronic filing. Also, the income tax system should be so designed that the tax forms and instructions are exceedingly simple for lower-income taxpayers to file without requiring assistance from an accountant. These taxpayers should not be forced by an incomprehensible tax system to seek professional assistance, especially those targeted for relief through earned income tax credits or higher education incentives for the yet-to-be educated.

Simple Exact Transparent Tax Implementation

Our political leadership would retain the flexibility to set the rate and identify the amount and types of income to tax. An example of how the tax might work explains the concept best. The NYSSCPA is not endorsing any of the amounts included in the following examples, nor the one-third rate mentioned above. That determination must be made in the context of the political process.

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

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

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

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

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

Caregiver Exclusion. If the political leadership determined that society benefits if a person forgoes gainful employment to raise a couple's children, with appropriate disclosure, an additional special exclusion (in addition to any other standard exclusion) of say $15,000 could be permitted on the income-earning partner's return.[iv] Everyone would know that this would entail a $5,000 benefit.

Mortgage Interest Exclusion. If our political leaders determined to encourage home ownership, they could permit an exclusion for mortgage interest up to a certain amount, say $75,000 of interest to approximately replace today's $1,100,000 total debt cap. This is an example of an exclusion cap. Homeowners would know that they were receiving a benefit of one-third or their mortgage interest, up to a total benefit of $25,000. The amount of the exclusion could even vary annually to take into consideration moving interest rates.

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

Taxes on Capital Income. Suppose our trading partners taxed income from capital at only 15%. If our political leaders decided that the U.S. should meet that societal "offer" for capital, they could permit a 55%[v] exclusion of any income from capital (interest, dividends, and capital gains). Everyone would know the amount the nation would be investing in capital formation, the amount of capital income times 55% times one-third. (This is an example of a percentage exclusion.)

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

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

Additional Benefits of the SET Tax

The SET Tax eliminates the worst aspects of our current tax Code, adds new benefits, and, most importantly, retains the best aspects of the Code. Innumerable "complexifying", opaque drafting techniques would disappear from the Code. For example, there would no longer be a need for:

- alternative tax systems, like the alternative minimum tax
- phase-outs – the purpose served by phase-outs would be addressed by limiting exclusions,
- credits (except for those especially defined by Congress, like necessary refundable credits),
- multiple filing statuses,
- transition rules, and
- artificial constructs like "adjusted gross income", "modified adjusted gross income".

New benefits created by the SET Tax include:

The Compliance Bonus. The SET Tax system will be a vastly more efficient tax system and will collect more of the tax that is due, setting off a "compliance bonus."

Although our 85% tax compliance rate is the envy of many of our trading partners, a 90% compliance rate would raise significantly more tax and permit Congress to enact lower tax rates to compliant taxpayers, reduce deficits, increase spending for worthy government programs, or any combination of the three.

Measuring "Tax Expenditures." The SET Code greatly reduces the complexity of measuring our tax expenditures. Currently, the measurement of tax expenditures is immensely complicated by the fact that benefited taxpayers can be subject to dozens of different marginal tax rates because of the interaction of the progressive rate structure, limitations, and phase-outs. By relying on a single rate and simplifying the methods used to deliver tax benefits, tax expenditures can be measured annually.

Finally, the SET Tax leverages and builds on the strength of our current tax Code through:

Easy Integration. The SET Tax would integrate easily with the current system, only it would be easier to administer. There are no new concepts to learn and many old tricks and traps are relegated to the dustbin. A very significant SET Tax benefit is that it lends itself to much simpler scoring. Congress can better gauge the cost of tax-policy initiatives and taxpayers easily identify how much they receive in tax benefits.

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

Conclusion

Adoption of the Simple Exact Transparent Tax would focus political debate entirely on what "tax expenditures" the political leadership wants to make, and how much the expenditure should be. Instead of locking Congress into what benefits it wants to encourage – as does the Flat Tax and other fundamental tax reform approaches – the SET Tax provides Congress and the president with a single, transparent delivery vehicle for tax expenditures. It provides the American people with a straightforward tool to measure their incomes and the taxes they pay. Everyone would have a better chance to understand how government works and why it makes the fiscal decisions it does.

The SET Tax is transparent, simple, equitable and fair, certain, conveniently paid, and revenue neutral. It is efficient, promoting economic growth (to the extent our political leaders determine that is advisable), lowering administration costs and the tax gap, and resulting in much easier assessment of fiscal propriety. The SET Tax meets today's economic need for revenue neutrality. In short, it meets all prerequisites of a good tax system, while maintaining for political leadership the flexibility necessary to govern and finance government initiatives.

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[i] Committee on Practical Reform for the Tax System: David A. Lifson, *Chair*; Joseph L. Charles; Alan J. Dlugash; Robert L. Goldstein; Laurence Keiser; Leon M. Metzger; Stephen A. Sacks; Maryann M. Winters

[ii] There are those who think this would require a Constitutional amendment.

[iii] By the way, there would be no need for joint reporting by married couples, no marriage penalty; all that complexity results from progressive rates.

[iv] In the alternative, Congress could permit couples, married or otherwise, to use combined reporting to simplify filing; and a care-giver deduction could be allowed there.

[v] $(33\frac{1}{3} - 15\%) / 33\frac{1}{3} = 55\%$

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