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United States Senate
WASHINGTON, DC 20510-3101

PRESIDENT'S ADVISORY BOARD FEDERAL TAX REFORM
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Senator John Breaux
Vice-Chair, President's Advisory Panel on Federal Tax Reform
1440 New York Avenue, NW, Suite 2100
Washington, D.C. 20220

Dear Senator Breaux,

As you begin your work on recommendations for simplifying the tax code, I wanted you to have a copy of my "USA" Tax proposal. Like you, I believe that the current tax code is overly-complex, overly-burdensome, and overly-costly to the American taxpayer.

I want to reiterate, once again, my support and commitment to the Commission's undertaking. The President could not have chosen a better person.

Thank you, and I hope all is well.

Sincerely,

Pete V. Domenici

Pete V. Domenici
United States Senator

Enclosure

HOAGLAND

The USA Tax System

An Overview of the Unlimited Savings Allowance Income Tax System

ALLIANCE USA

Prefatory Note

Paul H. O'Neill, Chief Executive Officer, ALCOA
Robert A. Lutz, Chief Operating Officer, Chrysler Corporation

The United States faces massive and growing public cynicism about the equity and efficiency of the tax code. None of us will ever relish paying taxes. But in a democracy we have a right to demand that those taxes be levied in a clear, consistent, and coherent way. On this issue turns our ability to govern ourselves and make the hard economic choices that confront us.

This report is the first of several publications introducing a new, comprehensive tax reform proposal called the Unlimited Savings Allowance Tax (USA Tax System). The USA Tax System began as a proposal by two United States Senators, Pete Domenici (R–NM) and Sam Nunn (D–GA) to abolish the present corporate and individual income taxes in favor of a new, integrated system that is progressive and efficient and does not penalize the core components of national economic growth and individual prosperity—personal saving and business investment.

We endorse the USA Tax concept. We are committed to initiating a public debate on its merits. To that end, we founded and co-chair an organization called Alliance USA. The Alliance will endeavor to build a consensus for reform along the lines of the USA Tax System. Alliance USA will also provide a forum for the full and open examination of the economic impact of specific details of the tax.

This paper is designed to introduce readers to the USA Tax System and to address questions commonly raised by people when they first encounter the proposal.

The case for fundamental tax reform seems to us compelling. In our view, the current tax code is a national disgrace, utterly unsuited as a tool for building a better future for ourselves and our children.

★ At a time when national saving has sunk to a dangerously low level, the current code exacerbates the problem with its strong bias against saving and investment.

★ At a time when the nation can ill afford to waste resources, the current code's mind-numbing complexities impose extortionate compliance costs on business and many individuals.

★ At a time when all businesses and their employees must compete in a tough world marketplace, the current code denies them a fair opportunity to succeed.

★ At a time when special interests must give way to the overriding national interest in securing America's future, the current code remains an incoherent jumble of special interest provisions understood by no one other than the particular constituencies they favor.

The USA Tax System corrects these deficiencies in the tax code in a straightforward and understandable way. Apart from its intrinsic merit, its great strength is that it is practical and has been developed in a spirit of true bipartisan cooperation. We therefore believe the USA Tax System can be enacted.

The USA Tax System described here is a prototype designed to illustrate the new system's key features.

★ ***The USA Tax System does not discriminate against saving and investment.*** The USA Tax System would eliminate the multiple taxation of saving and investment under the current code.

★ ***The USA Tax System is simple and efficient.*** Of the roughly 700 sections in the income tax law of the Internal Revenue Code of 1986, over 75 percent would be eliminated. The remaining sections would be modified and reduced. From the perspective of a business or individual taxpayer, complying with the USA Tax System would be much easier and cheaper than the current code.

★ ***The USA Tax System reflects international competitive realities.*** The USA business tax excludes from taxation export sales and income from foreign sources and imposes an import tax equal to the tax paid by domestic producers.

★ ***The USA Tax System is easy to administer.*** The USA Tax would require no new collection bureaucracy.

★ ***The USA Tax System can accommodate a progressive rate structure.*** Conventional notions of tax equity demand a progressive rate structure at the individual level. The USA individual tax can be easily designed to accommodate that goal.

It is time for the United States to consider and adopt an efficient, intelligent tax system. Such an achievement would not end the debate about taxes in this country. It would instead refocus that debate where it should be: on how much we tax ourselves, on how the government spends our money, and on how we plan for our collective future in a free society.

We invite comments and questions about the USA Tax proposal and Alliance USA. We are committed to an open, inclusive process that will eventually involve all Americans. We all have a stake in the outcome.

February 1995

Overview

The USA Tax System is a single tax in two parts: a tax on business and a tax on individuals. It is designed to *replace* the current business and personal income taxes. Although the payroll tax would remain in place under the new system, the USA tax would also provide businesses and individuals a tax credit for large portions of the payroll taxes that they pay.

The business tier of the USA Tax System has two essential characteristics.

★ it is a *low, flat* tax on *all* businesses including corporations, partnerships, sole proprietorships, and other forms of organization

★ it allows an unlimited deduction for capital investment

The personal tier of the USA Tax System also has two essential characteristics.

★ it is progressive, a goal achieved through a combination of graduated rates, large exemptions and a deductible family living allowance

★ it permits an unlimited deduction for personal saving

The deduction for capital investment parallels the deduction for personal saving. The former allows a business to recover capital before being taxed. The latter allows individuals to defer tax on that portion of income that is saved and, ultimately, converted into capital.

The effect of both is to eliminate the embarrassments of the current tax code, in which capital investment and saving—the keys to long-term growth—are subject to multiple taxation. Both deductions possess powerful and important implications. These implications will be touched upon throughout this paper and examined in greater depth in other Alliance USA publications.

For now, the important point to grasp is the integrated nature of the USA business and personal tax.

In our economy, income is created at the business level when goods or services are produced and sold. That income then flows to people: employees, investors, and owners. The USA system taxes every dollar in that flow *once and only once*. To do so, it establishes two collection points—the business level where the income is created and the personal level, where the income is received.

This can be illustrated in terms of a toll road. Some toll roads demand payment on the entry ramp. Some toll roads have their collections booths on the exit ramp. And still other toll roads extract partial payment when cars enter and the remainder when the cars exit. Whatever the collection method employed, no car escapes paying a toll and all cars pay the same amount.

The toll booths of the USA system are located at the business level and the personal level. One could imagine a USA Tax System with only one toll booth: the *entire* tax could be paid at the business level or, alternatively, the *entire* tax could be paid at the personal level. Whatever method is chosen, with an integrated tax system, the result would be the same.

The prototype described in this paper assumes a two-tier system where the two tiers function as one. The linchpin is the deduction for personal saving which greatly simplifies the business tax and profoundly changes the role and treatment of retained earnings. Because retained earnings are saving, and saving is encouraged under the USA Tax System, it is no longer necessary to have the complex rules of the current code that are designed to prevent people from sheltering income from the personal income tax by accumulating earnings in a corporation.

With the USA Tax System, no one will need to invest in nonproductive or superfluous business arrangements designed to avoid the personal income tax because every American will have recourse to an unlimited saving deduction. Just by keeping the money in the bank, individuals can defer taxation on that income. The saving deduction would render obsolete the tax shelter industry that has metastasized under the current code, in turn releasing for more productive pursuits the many intelligent people now employed by that industry.

The saving deduction will give all Americans, including those of modest means, more control over how much of their income is taxed each year—a financial competence now enjoyed only by those able to hire tax accountants, expensive lawyers, and other advisers to search out loopholes. More profoundly, the saving deduction, and the economic growth it portends, will allow all Americans to earn higher incomes in the future.

This, then, is the framework of the USA tax. It is a fully integrated two-tier tax levied at the business and personal levels with unlimited deductions for capital investment and personal saving. Within that framework hundreds of decisions must be made regarding the tax treatment of specific business and personal transactions. One purpose of Alliance USA is to invite interested Americans to take part in the crucial decision-making that lies ahead.

The USA Business Tax

The remainder of this paper looks in a general way at how the business and individual tiers of the USA Tax System might operate. It also includes a general discussion of the key provisions for making a smooth transition from the current code to the new tax system.

As currently modeled, the USA business tax would apply to all corporations, partnerships, limited liability companies, and unincorporated proprietorships including self-employed individuals.

Under the USA business tax, a business's gross tax base consists of the amount it receives during the taxable year from the sale in the United States of goods and services. From that gross tax base, a business may deduct the amount it has paid during the taxable year to other businesses for goods and services for use in its business activity in the United States. Such purchases might include, for example, plant, equipment, inventory, rent, utilities, fuel, and legal and accounting fees.

The remainder after the allowable deductions are subtracted from the gross tax base is subject to a low, flat tax. At present, Alliance USA estimates the flat tax to be 10%, although it is possible that it could be as low as 8% or 9%. A tax credit is then allowed for the 7.65% employer payroll tax (commonly called FICA or Social Security Tax) that a business must under the current code pay on wages paid to employees.

A number of significant observations can be added to this general description of the USA business tax.

★ ***Financial transactions are outside of the business tax.*** Interest and dividends received, for example, are not included in the gross tax base and interest and dividends paid are not deducted.

★ ***The business tax assumes cash flow accounting.*** The complexities and high compliance costs associated with accrual accounting under the current code disappear under the USA business tax. The compliance savings that result from this change are extremely important.

★ ***The business tax is territorial.*** A business will not include in the gross tax base the proceeds from sales made by subsidiaries outside the United States. It will also not deduct the purchase of goods or services outside the United States. For their part, foreign businesses with a commercial presence in this country will include in their tax base amounts received for goods sold or services provided in the United States and will subtract amounts paid for goods acquired and services provided in the United States.

★ ***The business tax is border adjustable.*** Proceeds from export sales are excluded from the calculation of the gross tax base. Correspondingly, goods imported into the United States are subject to a tax with a flat rate equivalent to the business tax rate.

★ ***Employee compensation is not deductible.*** In contrast to the current code, under the USA Tax System the cost of salaries, wages, and indirect compensation is not deductible.

The model's treatment of employee compensation merits elaboration. If compensation were deductible under the USA business tax, the first toll booth in the two-tier USA Tax System would produce less revenue. Compensation could be made deductible at the business level but only if tax rates on wages and salaries were correspondingly raised at the individual tier.

Collecting part of the tax on compensation at the business level with the remainder collected at the personal level permits the USA business tax to be border adjustable under prevailing international trade agreements. It also retains the system's coherence and simplicity.

The combination of the payroll tax credit with the low, flat business tax rate and the repeal of current code rules that capitalize some labor costs means that the inclusion of compensation in the gross tax base will for most businesses result in a comparatively small amount of tax. And, of course, the current code does not offer the advantages of either border adjustability or, more fundamentally, the opportunity to expense the capital investments necessary to unlock the productive and creative capacity of employees. That human productivity and creativity translates into better and higher paying jobs.

The USA Individual Tax

The individual tax is the second toll booth through which the annual flow of cash created by business and received by people must pass.

Structurally, the USA individual tax would function in a manner similar to that of the current income tax, but in a simpler way. The basic calculation of taxable income is: gross income minus a few allowable deductions. The difference is taxable income.

Tax rates are applied to the taxable income to determine the amount of tax due. The amount of tax due is then reduced by certain tax credits such as the 7.65% credit for the individual side of the payroll tax and an earned income credit. People would then file their returns much as they do now. There would be withholding as under present law.

This prototype of the USA individual tax defines gross income to include wages, salaries, interest, pensions, annuities, the proceeds of life insurance contracts, dividends, equivalent distributions from a partnership or other unincorporated business, and most amounts received from the sale of assets.

Unlike the business tax, the USA individual tax is *not* territorial; income from worldwide sources is included in the gross income calculation. This prototype *excludes* from gross income gifts, bequests, the proceeds of loans, and certain income transfers or substitutes received from governments. The more significant of these exclusions are discussed below.

The distinguishing feature of the USA individual tax is the Unlimited Savings Allowance. This allowance is a deduction available to all that permits the deferral of tax on that portion of annual income that is saved. For example, if a worker receives a salary of $100X and purchases a share of stock for $50X, the salary is included in gross income and the purchase of the savings asset is deducted from gross income. The tax on the $50X saving asset will remain deferred until the asset is sold and the proceeds are spent. At that time, the proceeds will be included in gross income.

The Unlimited Savings Allowance only applies when an individual has, at the end of the taxable year, more saving than what she or he had at the beginning of the year. Mere portfolio shuffling *without a net addition to saving* does not result in a deduction.

A definition of what constitutes a saving asset is necessary to administer the saving allowance deduction. This prototype, as under current IRA treatment, defines a saving asset as a *financial* asset such as stock, bonds, bank and money market deposits, brokerage accounts, the payment of life insurance premiums or annuity contracts, and individual contributions to retirement trusts or savings plans sponsored by a company or an association. As under current law, real properties and tangible properties are not financial assets and are not saving assets.

The individual tax with its saving allowance easily accommodates a progressive rate structure. Additionally, Alliance USA recommends the maintenance of personal and dependence exemptions. The Alliance also supports an additional Family Living Allowance deduction as a means of establishing a substantial nontaxable level of income.

Any estimate of rates for the USA individual tax depends upon the number of deductions added to the tax above and beyond the saving allowance, personal and dependency exemptions, and Family Living Allowance. This prototype, which assumes a few additional such deductions specified below, contemplates a long-run tax structure with a top rate similar to current law (a more precise simulation of rates is forthcoming). Such a structure, in combination with the flat rate collected at the business level, would yield revenues roughly equal to the current code. Obviously, in any given year individuals with similar incomes might pay very different tax bills depending upon their propensity to save.

Other Deductions

This prototype of the USA individual tax assumes certain deductions in addition to the saving allowance, individual and dependency exemption, and Family Living Allowance deductions. The inclusion of these or other deductions is a decision that balances the desire to encourage certain forms of economic activity with the need to keep overall rates as low as possible. For that reason, the prototype's additional deductions are merely illustrative.

- ★ ***Homeowner Deduction***. The individual tax allows deductions for the amount of mortgage interest on a person's personal residence and second home as under present law. Interest on home equity loans is not deductible. Overall, this deduction would continue the benefit in the current tax code in favor of home ownership.

- ★ ***Charitable Contributions Deduction*** The individual tax permits a deduction for charitable contributions in much the same way as under present law.

★ *Education Deduction* Not in present law, this deduction would allow each person a deduction up to some stated amount for tuition paid to an accredited post-secondary school, equivalent trade or vocational school, or remedial education programs. Each person who is allowed a dependency exemption is also allowed each year an education deduction up to some stated amount for the post-secondary education, training or remedial instruction of the dependent.

The Alliance suggests this deduction as a parallel to the expensing of new capital investment at the business level. Education is an investment in human skill and knowledge that will generate taxable income in the future many times greater than the initial investment. From this perspective, the initial investment should not be taxed.

Tax Credits

The USA individual tax allows three tax credits to be applied against taxable income. Along with the 7.65% payroll tax credit, there is a credit for estimated and withholding tax paid tax and, for low-income individuals, an earned income credit similar to the credit under present law. All other existing credits are disallowed.

Exclusions from Gross Income

Under the USA individual tax, certain amounts are excluded from gross income and are therefore not taxed. Some of the more important excluded categories are listed below.

★ *Some Military Pay and Veterans' Benefits* This prototype retains existing exclusions for military combat pay, combat-related payments, benefits for veterans and families, certain military allowances, and moving allowances for active military personnel.

★ *Healthcare reimbursement and payments* As under current law, reimbursements and direct payments from Medicare and Medicaid are excluded from gross income as are reimbursements and direct payments for medical expenses under any personal, employer-provided, or group policy.

★ *Income transfers and substitutes* This prototype like current law excludes from gross income the components of the social safety net such as: food stamps received, Supplemental Security Income (SSI) payments, Low Income Home Energy Assistance Program payments, rent supplements and other subsidized housing payments, payments under the Aid to Families with Dependent Children (AFDC) program and other federal and state welfare payments.

★ *Fifteen percent of Social Security Payments* This prototype retains current law treatment which excludes fifteen percent of each Social Security payment from gross income. This reflects that approximately fifteen percent of each Social Security payment represents a return on previous payments of the employee payroll tax out of after-tax income.

★ *Gifts and Bequests* Gifts and bequests are generally excluded from gross income. Because the USA system defers taxation on saving and investment, this prototype of the USA Individual Tax does not permit a step-up in basis on assets transferred at death.

★ *Tax-Exempt Bond Interest* Interest received on state and local bonds purchased either before or after the effective date of the USA Individual Tax is excluded from gross income.

The exemption applies to bonds purchased after the effective date even though the principal amount invested in those bonds would be deductible under the USA Individual Tax. This exemption thereby maintains the current law preference for state and local bonds relative to commercial bonds.

- ★ *Loans* Borrowings are not included in gross income. Correspondingly, the repayment and interest is not deducted (with the exception of interest on the mortgage of personal residences).

Readers may wonder if saving assets purchased with borrowings are eligible for the saving deduction. In this prototype, they are not. Borrowing to save does not increase the pool of national saving. It merely shifts one person's saving into the portfolio of someone else.

In the calculation of the saving deduction, the prototype disregards a moderate amount of consumer debt and mortgage debt on a personal residence. All other non-mortgage indebtedness incurred during the taxable year, however, *is* "netted out" in the calculation of the saving deduction.

Transition to the USA Business Tax

Central Transition Issues of the USA Tax

All tax reform proposals inevitably raise questions of transition. The USA Tax is not an exception.

UNRECOVERED BASIS When adopted, the USA Business Tax will permit businesses to deduct the cost of plant, equipment, and real property in the year those assets are purchased and paid for.

On the day the Business Tax comes into effect, however, most businesses will not have fully recovered or amortized the cost of assets acquired before the effective date. Businesses should be permitted to retain their basis in these "old" assets and to recover that basis in a way appropriate to the new tax system. Doing so requires transition rules.

Simply allowing companies to retain basis in pre-effective date assets without any special procedures would cause drastic revenue shortfalls in the first year of the USA Business Tax. This is so because a company would be encouraged to "game" the system. It could sell its pre-effective date assets to other businesses and then acquire similar property to replace what it sold. If the company sold its old assets at a price equivalent to its basis in those assets, it would recognize no gross income on the sale. Meanwhile, the purchase of replacement property would be expensed under the USA Business Tax.

This churning of used property means that much of the unamortized basis of all pre-effective date business assets in America could be expensed in the first year of the new Business Tax. Obviously, that would be unacceptable; the USA Business Tax would raise very little revenue in its first year.

To avoid tax-motivated churning, this prototype of the USA Business Tax includes special rules applying to pre-effective date assets. Under these rules, businesses will place all depreciable property in service before the effective date into one of two categories.

- ★ **Category I**—Property with a remaining recovery life of fifteen years or less.
- ★ **Category II**—Property with a remaining recovery life of more than fifteen years.

Businesses would be entitled to amortize their balances in both categories. Assets in the Category I would be amortized over ten years and assets in Category II would be amortized over thirty years. As a general rule, no adjustments will be made to these accounts if property is sold, retired, destroyed, or converted to personal use. Instead, the general rules of the Business Tax will apply to such property.

Thus, if after the effective date a business sells a machine acquired two years before the effective date of the Business Tax, the selling price would be reported as gross income. There would be no adjustment in the Category I account. This transition rule will make the Business Tax simpler, prevent tax-motivated churning of used property, and permit businesses to recover their basis in pre-effective date assets.

Two Other Business Transition Issues

The recovery of basis in old assets is the central transition issue for the USA Business Tax and the one of most importance for a general understanding of the Tax. The prototype also contemplates transition rules in two other areas.

In the first area, the prototype specifies rules to help companies manage certain accounting changes necessitated by the adoption of the Business Tax. In the second, transition rules may also be necessary in the first few years following the Business Tax's implementation for companies that have zero or negative income for financial accounting purposes.

Issues for Which There Will Be No Transition Rules

The USA Business Tax prototype does not take into account or provide transition rules for a number of existing business deductions and credits. Upon the effective date of the USA Business Tax, these provisions under the current model would simply disappear:

- ★ *Net operating loss and capital loss carryover deductions*
- ★ *General business credits carryovers*
- ★ *Foreign tax credit carryovers*
- ★ *Credit for prior year minimum tax*

If it is decided to provide transition relief in these areas, a higher business tax rate would be required.

Transition to the USA Individual Tax

BASIS IN SAVING ASSETS

When adopted, the USA Individual Tax will permit taxpayers to deduct the cost of saving assets in the year those assets are purchased and paid for.

On the day the Individual Tax comes into effect, however, many Americans will possess saving assets with a basis upon which they have already paid tax. If those assets were to be sold following the effective date of the Individual Tax and the proceeds included in gross income, the previously-taxed basis could be subject to taxation yet again. Transition rules are necessary to prevent this unacceptable result.

Although the total value of previously-taxed basis is huge—many trillion dollars by some estimates—most taxpayers individually possess very modest amounts of that total. Designing appropriate transition rules for them is therefore a simple matter.

In this prototype, taxpayers who have total tax basis in pre-effective date saving assets of less than $50,000 may elect to amortize and deduct that basis ratably over a stated period, perhaps three to five years. After that period their old saving assets would no longer have a previously-taxed basis and would be on equal terms with saving assets acquired after the effective date. The transition period would be over.

To prevent a large revenue shortfall in the first years of the USA Individual Tax, Americans with large amounts of previously-taxed savings will not have recourse to this simple amortization scheme. For them, the prototype proposes a special set of transition rules. These rules have two objectives. They prevent the taxation of previously-taxed saving *and* they avoid allowing a deduction for merely shifting old saving into new saving.

Under these rules, once a taxpayer has calculated his net saving, he subtracts his tax basis in saving assets he sold or withdrew during the year. The remainder consists of deductible net saving and is in turn subtracted from gross income to determine taxable income.

The basis of saving assets that are netted out are accounted for in a general basis account. In years in which the taxpayer has no net saving, but instead has net withdrawals from saving which would be includable in gross income, he may apply his general basis account against those withdrawals. That lowers his gross income which, in turn, lowers his tax bill.

This description may seem complicated, but it yields a very simple result. By reducing net saving by the tax basis of saving assets sold or withdrawn, a deduction is denied for merely shifting old saving into new saving. By establishing a general basis account and applying it in years when the taxpayer has net withdrawals from saving—a situation typical, for example, of retirees—previously-taxed saving assets are brought into the USA system *without being taxed again*. Both objectives for transition are thereby met in a conceptually sound way.

Final Points

This report has attempted to demonstrate that the USA Tax is a workable and highly preferable alternative to the present tax system and that its implementation can be readily accomplished.

We can "get there from here." If we make the trip we will earn revolutionary gains in terms of simplicity, ease of compliance, fairness, international competitiveness, and, most important, economic growth. And, on a higher level, we will be endowing our citizens with greater freedom—and responsibility—to shape their own financial future.

To realize this reform, we need leadership. That leadership must come from outside of Washington. It must reflect a broad-based and informed desire to secure this country's future.

Replacing the current tax code with a whole new system will not be easy. It doubtless will seem daunting to some and threatening to more than a few. So it is with any worthwhile change. Our collective responsibility to move forward nonetheless remains the same.

ALLIANCE USA

is a not-for-profit, temporary organization incorporated as a 501(c)(4) entity.

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