

# **The Withdrawals Tax**

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## **Introduction**

We first introduced Withdrawals Tax (WTX) in 1996<sup>1</sup>. In this paper we intend to develop a more practical model with realistic implementation capabilities. We concentrated our research on similar transactional-based systems, some proposed at one time or another and one actually in use today<sup>2</sup>. We quickly discovered that systems based on the same general principle evoked sharp criticism from the academic community. Opponents usually cite cascading, vertical integration, bartering, offshore evasion schemes, currency hoarding and a general fear of turmoil in the capital markets as major concerns. Over the years since such systems have been proposed, these criticisms have effectively prevented any mainstream application of this type of tax. However, in our opinion, we have found many of the critical challenges to be overstated and see technological advances in electronic commerce and banking changing the arena in which we can now evaluate this model.

We did not ignore the most compelling concerns but we had to settle on one unyielding fact; that no one can reach tax nirvana. This tempered our evaluation of the WTX allowing exploration of points of view beyond the strict biases of economics. Our approach was to logically quantify the discernable benefits in the system, weigh them against the concerns and see if we could realistically live with this type of tax system. While we concluded that there is enough value in the WTX to warrant further perfecting a workable model for mainstream application, we acquiesce that the WTX may cause some uncomfortable transitional changes. Nevertheless, we concluded that a certain amount of restructuring to our business practices in order to adapt functionally to the WTX system may be worth the effort.

The reader should not lose sight of basic premise of the WTX model which is: 1) To synergistically combine the elements of the three major tax systems that the WTX will replace, and 2) To completely automate the collection process and eliminate any draconian compliance and reporting system. The reader must also avoid the natural tendency of most people to contrast the WTX assuming the basic principles of the existing tax systems. Since the income, sales and estate tax systems are so strongly embedded in our psyche, most of us cannot imagine life without them and this makes it difficult to accept the principles of the WTX.

## **System overview**

The WTX generally applies the withdrawals of individuals and businesses alike with minor modifications. Conceptually, it was modeled as a federally administered tax umbrella predicated on purging three major tax systems from both the federal and state levels of government: the income tax, the sales/excise tax and the estate, gift and inheritance tax. The WTX was prototyped

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<sup>1</sup> Cashless taxation in the 21<sup>st</sup> Century, Colabella & Coppinger 1995

<sup>2</sup> The Debit tax is a state administered tax in Queensland, Australia, Leonard Crisp, the Tobin tax 1996, National Retail Sales Tax NRST, Bill Archer et al

as a revenue-neutral system which means that the system is capable of generating the same revenue as the systems it will phased out.

The WTX would incorporate and coordinate the autonomous collection of both federal and state revenues. The tax revenue, accumulated in a clearing account, is electronically allocated to the various federal and state treasury accounts by strict legislated formula allowing each participating governmental unit to autonomously direct and control their respective pool of revenue<sup>3</sup>.

The WTX uses a low single rate of tax over a very broad tax base. The rate is a composite federal and state tax rate. For analysis purposes, we use a rate of five percent, which consists of a three percent federal portion and a two percent state portion. The actual implementation rate may be different. In many of the comparable systems we researched, the rate was less than one percent.

The WTX would be assessed electronically by a standardized computer process and taken directly from a taxpayer's bank account. Mechanically, a debit of five percent is made on the gross withdrawal amount or the equivalent transfer of value flowing from a taxpayer's account and transferred to the applicable governmental account. The source for all accounting of the tax would be through the banks and the taxpayers' accounts.

Withdrawals would not be able to be made unless there are enough funds available to pay the related tax. Therefore, a \$100 withdrawal would result in an overall \$105 deduction from a taxpayer's account with \$5 being directly transferred to the government's account. If there were only \$100 in the account, the taxpayer would be able to withdraw only \$95.24.

The WTX would not apply to every bank debit. Disbursements made from funds acquired from direct financing activities and credit card use are not taxed at the point of disbursement but rather taxed upon withdrawal from the account to retire the debt. It is important to point out that refinancing the debt would be made out of debt proceeds and not subjected to the WTX. Only the actual retirement of debt is subject to the tax.

By necessity, the WTX will also have to apply to certain non-bank transactions such as asset transfers made by gift and in certain corporate reorganizations and liquidations that occur outside the banking system. This application of the tax will require a simple reporting system be maintained but the collection mechanism would remain processed through the banking system. The anticipated reporting system for such transfers is largely in place under current income tax reporting requirements<sup>4</sup>.

## **The Model**

### **Principles of WTX taxation**

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<sup>3</sup> The States would set their own rate for official residents. Corporations doing business in multiple venues, would report on an annually adjusted apportionment factor basis in order for states to share revenue.

<sup>4</sup> Form 1099B is used in all real estate transfers. This system could be expanded to other applicable title transfers.

One of the foundational elements of the WTX model is the fact that taxpayers use their economic equity either for some gainful purpose, consume it or just give it away. The WTX focuses the taxation process squarely on the taxpayer's active and passive accumulation and use equity<sup>5</sup>. After all, that equity is the economic basket from which all taxes will actually be paid.

By extracting a tax on the uses of accumulated equity, we effectively tax the accumulated income component of that equity. Therefore, the WTX can be viewed as a back-loaded income tax that is also progressively regulated in the process. Equity used for consumption or transfer of wealth, whichever the purpose is for the withdrawal is coincidentally taxed.

The WTX effectively taxes the traditional tax bases as a composite and we believe that there is more synergy in the WTX system than using stand-alone tax systems. As non-integrated systems, income, sales and estate taxes are natural adversaries to each other. This means that, in their coexistent operation, evasion of one always ricochets to one or both of the other systems thus defeating one another. Therefore, the combination of the systems into a composite captures revenue lost by the cascading of evasion tactics.

The most compelling aspect of the WTX model, is the unilateral automation of the entire process of federal as well as state tax collection<sup>6</sup>. By using the banking system to collect and account for the tax, virtually all tax reporting and compliance is coincidentally eliminated along with the built in biases of tax deductions and credits. The impact of that is huge in terms of government cost and the elimination of jobs associated with the system. The expected reduction in compliance costs would be massive<sup>7</sup> in both the public and private sector and this will translate into enormous budgetary relief for the government and likely tax relief for the taxpayer. In turn, this will inevitably enhance capital production in the private sector and allow the government to achieve a better redistribution of wealth.

Finally, as the WTX forges an unbreakable union of the banking system, the taxpayer will find it very difficult to avoid or evade the tax if it is instituted as we modeled it. In addition, the simplicity of an automated tax eliminates the human capital that is exhausted by taxpayers in the pervasive litigious confrontations between them and the government under our current system. This latter benefit effectively shrinks the ominous specter of "big government" and enables government to focus on the more desirable processes of prosperity and democracy.

### **Detailed operation**

The focus of the tax is *generic* withdrawals by check, debit advice or exiting wires to bank accounts from the taxpayer's financial institution regardless of most intended purposes. The tax base would be simply a percentage on all debits to accounts with **any** financial intermediary. For this purpose, a financial intermediary is any institution that offers traditional banking services. These institutions would include savings and loan associations, commercial banks, securities firms and insurance companies. Any other institution that essentially provides banking type services would also be included. Essentially they will operate taxpayer accounts that are specifically structured to administer the tax.

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<sup>5</sup> Generally accepted accounting principles (GAAP) is the only means of measurement that is relevant.

<sup>6</sup> Automation results in the near elimination of tax evasion controversies and the related tribunals at all government levels

<sup>7</sup> The cost of compliance in 1995 averaged 20 – 50 percent of the revenue raised by the tax system and 1.9- 4 .1 percent of GDP - Arthur Hall testimony , House Ways & Means Committee , March 20, 1996

## **The WTX bank account**

The WTX bank account will operate like combined checking and mortgage escrow accounts. In other words it will have two sub-accounts, an operating account and the escrow account. All funds deposited in the account will go into the operating account, such as paychecks, business receipts and rents etc. unless they are earmarked for non-taxable distribution and placed in the non-taxable sub account. Such deposits would include funds credited to an account from the proceeds of loans where disbursement is not a taxable event. Other deposits that may be similarly earmarked like welfare payments or some other amounts that the government may wish to exclude from the tax. Currency, once withdrawn from the account cannot be replaced in the account without taxing it again unless certain control mechanisms are in place. (See *Perishable Currency Model* - appendix B)

## **The WTX securities account**

The securities account is a taxpayer's investment account. This would encompass all funds in securities, money market funds, commodities and the like that are under the management of a particular institution. The income making activity of the account namely the security purchases and sales would not be taxed. Instead, the account would be treated like an IRA account, taxing all withdrawals regardless of their nature. This account would have no escrow component. Redeposit of cash would have the same problem as above. (see appendix B)

## **The WTX insurance account**

This account is essentially an insurance policy. Theoretically, all insurance premium payments would be taxed as they are withdrawn from the taxpayer's bank account. Accordingly, claims paid out of the insurance account should only be subjected to tax but excess of premiums paid. This would be applicable to all insurance contracts. Therefore, an insurance account will be comprised of an escrow fund . "Accumulated premiums paid" would act as a contra-account to the operating portion which taxable disbursements are to be made from as claims are paid.

## **The tax base**

The required tax base for the WTX is simply the tax rate divided by into total of budgeted government expenditures. If the rate were three percent for the federal government's share, the base of taxable withdrawals must equal \$43 trillion. Based on Federal Reserve statistics, the total of all cash flow, including deposits as well as withdrawals flowing through the banking system is \$422 trillion annually. This excludes securities firms and insurance companies. Therefore, if the total cash flow were allocated at least half to withdrawals, then The WTX would generate \$6.3 trillion. This caused us to think our proposed rate was excessive. Nevertheless, at a five percent rate, we can safely assume the system will cover all governmental revenue needs. This leaves us a great deal of leeway in the items we choose to include or exclude from the base.

The tax base is modeled from three groups, individuals, business entities and general title transferors. The items included and excluded were based on at time on the practical and political needs of government and the taxpayer in order to facilitate the implementation of the system and not always grounded in strict economic principle.

## Individuals, trusts and estates

The tax base derived for individuals would be inherently different than a commercial enterprise. Individuals would pay tax as they withdrew or transferred cash or a cash equivalent from their accounts for any purpose<sup>8</sup>.

Individual transactions subject to the WTX include the following:

- Check withdrawals
- ATM or Cash withdrawals of any kind from checking or savings accounts
- Inter-bank transfers or wires of money directed by an individual for *any* purpose<sup>9</sup>
- Title transfers by gift at fair market value<sup>10</sup>
- Transfer of an estate at death at fair market value
- Distributions from trusts in cash
- Distributions of property from trusts and estates at fair market value
- Check cashing

Individual's transactions not subject to tax would be:

- Credit card purchases
- Cash advances
- Use of credit lines
- Disbursement of mortgage proceeds
- Transfers to similarly titled accounts (rollovers)
- Transfers to trusts
- Transfers of cash and property to controlled entities

## Commercial enterprises

The tax base derived for business entities is more problematic but it is intentionally designed to be simple to avoid any exceptions to certain businesses and cause inequities.

The following would be subject to tax at the source:

- All business operating expenditures made in cash or by cash equivalent
- All transfers of cash or cash equivalents that are not rollovers
- Payments of all dividends
- Retirement of debt paid in cash or cash equivalents
- Boot paid

The following corporate transactions not subject to tax:

- Transfers of cash or property to a wholly owned subsidiary
- Rollovers of cash to similarly titled accounts

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<sup>8</sup> Sole proprietorship or partnerships are governed under rules for commercial enterprises.

<sup>9</sup> Except transfers that are specifically exempted

<sup>10</sup> If fair market value is less than cost, then cost is the applicable base

- Disbursement of bond proceeds
- Disbursements from credit line
- Letters of credit

The nature and complexity of business transactions creates allocation problems, but none of these problems are less workable in the WTX system than are those of the income and sales tax systems. It is possible for businesses to avoid the tax by shifting the burden<sup>11</sup> and measures are expected to counter unforeseen situations.

### Title transfers and non-cash transfers

Since transfers of title for any purpose can be effected without liquidation, this aspect of wealth transfer can escape the tax. Accordingly, we propose to generally tax current title transfers at fair market value. To do this we would merely subject the transaction to tax upon legal recordation of title. The tax would be drawn from the account by debit advice.

We may want to limit the tax on only those large items such as real estate, vessels and vehicles. However, property rights that are hidden in disguised powers of appointment, exercise of options and reversionary interests may present a problem. For this reason we would not want to dismantle the theoretical principles of estate and gift taxation as it stands. We propose that the structure remains but the tax would be the WTX rate. We do not foresee any exemptions or lifetime credits in the application of the WTX to estates and gifts.

### Controlled entities and estates and trusts

The question of taxing title transfers is compounded by our approach to taxing corporate reorganizations and liquidations under the WTX. The problem stems from a taxpayer's transfer of non-cash assets to a corporation, partnership or trust, essentially, the non-cash capitalization of a business. Since cash withdrawals made for investment and gift like transfers are taxed under the WTX, we cannot ignore these types of transfers.

Under the WTX, we propose to exempt capitalization of a controlled entity as under current income tax rules<sup>12</sup>. This justifies fully taxing liquidation and dividends at their source. This would effectively subsidize entrepreneurial pursuits, as well as encourage the use of trusts for more practical purposes. By taxing liquidations and distributions we get the same effect and broaden the "asset transfer" tax base while not compromising the focus of the WTX.

### Corporate reorganizations

Generally, under current income tax law, reorganizations and similarly based swaps of value where there is a continuity of interest, are tax free until boot (essentially a cash equivalent)

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<sup>11</sup> See Assignments this paper

<sup>12</sup> Code section 351 IRC 1986

is effectively extracted from the deal<sup>13</sup>. In such cases, the taxation method would be the same except the rate would be at five percent of the boot.

Stock for stock transfers would be tax free because such transactions are merely restructuring of equity ownership. Owners that sell the stock, will eventually be taxed upon the investment of the cash or when cash is drawn from their securities account.

A stock for assets transfer is essentially a purchase of assets where stock is used instead of cash to acquire assets. It is tax free under current income tax law if substantially all of the assets of a target corporation are acquired. All other such acquisitions of assets using stock are taxable events under income tax law. We may wish to subject the latter transactions to the WTX if in substance the transfer is a cash equivalent transaction. However, taxing complete corporate acquisitions would have some consequences. While we do not feel that taxing a stock-for-assets reorganization would be detrimental to the corporate acquisition process, we believe the foregone revenue is minor. We would allay any conclusion on this to another paper.

### Corporate liquidations and dissolution

Under current income tax law, the liquidation of a corporation results in a taxable event unless there is a liquidation of a subsidiary into a parent corporation<sup>14</sup>. Liquidation occurs upon the transfer of corporate assets, including cash, to the shareholder in complete satisfaction of his interest. In substance, the transfer of assets is in lieu of cash. Under the WTX this would also be a taxable event to the corporation. The tax payment itself would not be subject to the WTX. Inasmuch as such title transfers would be subject to the tax, it seems logical to tax the transfers of assets to shareholders as a cash equivalent. Entity dissolution would be identical.

### Commodities and arbitrage accounts.

The problematic aspect of title transfers, are the small valuable commodities such as diamonds, gold, artwork and foreign currencies where a legal title process is not used. This may give rise to barter and substitute currencies. However, we do not believe that substantial tracking in these commodities or any other commodity will be significant enough to compromise the effectiveness of the tax or its overall fairness. Commodity exchange and arbitrage accounts however, would be considered a financial intermediary<sup>15</sup>. Trading would ultimately be taxed on liquidation from the account but transfers to the account would not be subject to tax.

## **Other Features**

### **Allocation of collected revenue and funding social security**

Revenues collected under the WTX will be allocated by formula. The allocation of revenue to specific governmental units or programs is a function of the number of governmental

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<sup>13</sup> Code section 1031 ( c ); reg. 1.103 ( c )-1

<sup>14</sup> Code sections 331 ( a ) & 336 ( a )

<sup>15</sup> Commodity accounts for this purpose are equivalent to net Code Section 1256 transactions

units and programs that legislators include in the system. The following is a rather broad allocation of tax revenue:

- Budgeted federal government expenditures
- Budgeted state and local government expenditures
- Projected Social Security and Medicare Payments

The parting of the income tax will dismantle the social security reporting mechanism or at least it should. The WTX should generate enough revenue for social insurance contributions. A WTX tax rate could be established that might generate all of the needed revenue. Social security benefits could be divorced from earnings in much the same way that Medicare is already. The amount contributed to a fund could be fixed, thus guaranteeing benefits for all citizens. Alternatively, if the stream of revenue collected within this system is sufficient, the trust fund could be aborted in favor of annual budgeting of social insurance payments.

The fund, as it stands, may be utilized to offset the national debt or serve as a reserve fund for expansionist programs. The potential in such a radical change in policy is enormous. In a global economy, the country that is able to invest in technological advances will achieve and maintain its position of power in the fraternity of industrial nations. The country that stifles such growth with counterproductive taxation systems will be left behind. The following is an allocation of government receipts not including State tax receipts:

1994 Federal Government Receipts:

Personal income tax	39.54%
Corporate income tax	11.95%
Social Insurance	40.57%
Other	07.94%

**Equity as the utilitarian tax base**

We believe that taxation is firmly a function of the classic accounting equation,  $Assets = Liabilities + Equity$ . A tax, in whatever form, is substantively an extraction of equity, regardless of how that equity is acquired and whether the entity is a business or an individual or estate or trust. The rate of equity accumulation, how it is effectively measured and how and when a tax is taken from that equity are key variables in our model.

Under the income tax, an individual or a business entity is taxed at the point where economic gains are realized and the taxpayer theoretically has received enough cash to pay the tax. Essentially the tax wedge is driven on the realization of the cash portion of the accumulated income component of taxpayer equity. Income tax rates are then progressively applied to the larger equity accumulations, thus penalizing successful investors and lessening the pool of capital for new investments and the potential income therefrom. This effectively restricts growth in the equity tax base that successful entities can achieve by the amount of the foregone income. This is killing the goose that laid the most golden eggs.

There is no stark revelation in the aforementioned observation. However, if a tax could be applied evenly and as a constant at the point of investment, the tax would always be recovered in

the investment return and have the same effect as any cost of capital. If this were the case, the constant tax rate would eventually become indifferent to all investors and reach a state of equilibrium.

We hypothesize that if the rate at which equity is accumulated and is higher than the tax rate, the tax base will continually grow. The idea is to place the constant tax wedge into a broad base that will theoretically always grow at a rate higher than the tax. This would make it unique from the income tax because income tax rates are generally higher than most pretax returns on equity. Currently, the tax base only grows in periods of economic boom under the WTX continuous growth can be assured.

The difference in the growth pattern of equity when tax is eliminated or substantially deferred is demonstrated conceptually by the “pension” or IRA account where the tax is back loaded<sup>16</sup>. Utility will be reached if the WTX model can achieve IRA type growth in the general tax base while extracting a thinner blanket of needed tax revenue from an infinitely expanding base. Conceptually, by evenly applying a level rate of tax only to withdrawals, we allow the equity tax base to flourish at a faster rate and across all socioeconomic classes. The tax is largely absorbed by the marginal growth in the base because it is built into the investor’s future return on equity as discussed below.

### **The Investment efficiency of taxing only withdrawals**

First, some economists would argue that it would be more efficient to tax all bank transactions, thus all cash flows (deposits as well as withdrawals). Their rationale is to make investors indifferent to the tax on both sides of a business negotiation. However, we do not believe that an equilibrium state can be achieved if this were the case. Logically, when it comes down to who will shoulder the tax burden in a given economic transaction, there has to be a loser. We believe that by not taxing bank credits largely removes that motivational element which causes parties in business transactions to volley the tax burden. This will occur even if the purchaser feels the tax was discounted from the purchase price. By always placing the buyer in a taxpaying situation, via inclusion of the tax within the purchase, this problem is solved.

Secondly, when a return on assets is realized under the WTX the entire return is added to equity. The tax is effectively equalized in the investment function and current income and the coincident real return on investment is not affected by taxation. This is because the expended tax is returned to the investor on realization of the investment return. Logically, this continually increases the taxpayer’s pool of investable assets and naturally feeds economic growth, as well as the WTX base.

By taxing almost all non-debt generated cash outflows, a uniform standard cost to capital use is created. If it is consistently applied without exception or prejudice to all such transactions, equilibrium will be reached for equalizing the tax effect in all similar transactions. Once that equilibrium is reached, the dynamics of capital production will not be affected by the tax, until the rates are changed over the short run.

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<sup>16</sup> A \$2000 annual contribution for ten years to a tax deferred account will generate approximately \$29,500 as opposed to \$25,800 when it is taxed at 39.9% representing foregone growth of 18%

It is important to note that the power to regulate the tax rate itself provides a sledgehammer effect fiscal tool for the government<sup>17</sup>. This new cost of capital directly controllable by the government would be a more powerful tool than federal reserve policy. This may be troubling when tax policy interacts at cross-purposes with federal reserve policy. However, we think they can easily coexist or counterbalance one another. It may also be advisable to have tax rates and interest rates move in coinciding directions. This is the subject for another paper.

### **Taxpayer acceptance and visibility in the banking system**

Taxpayer acceptance of the tax collection mechanism is essential for the overall success of the system. Taxpayers want a simple and more visible tax collection system that avoids the draconian collection practices. Taxpayers will always favorably respond to that. Our banking system provides us with the keys to achieving this goal. The worldwide network of financial intermediaries has become one of the most reliable and essential elements in transacting business in our socioeconomic system. Technologies now used in banking, such as on line banking and ATMs, are now widely accepted by the general public; even in third world nations. Electronic banking is now an ever-growing part of the current income tax collection process. The domestic banking system of any country, by necessity, will become more indispensable as both the global economic community and computer technology develops. Its role in tax collection is unavoidable.

The banking environment provides the WTX with higher visibility than any other tax system we observed. This is so because the tax is fixed into almost every banking transaction and reported on the bank statement. It also provides us with reliable analytical devices that are not politically manipulative to examine the true bearers of the tax burden. Nevertheless, we predict that the introduction of the WTX system will initially meet with anxiety and trepidation. However, after a short period of adjustment, when the realization of the freedom from tax reporting sets in, a high level of acceptance rate is predicted. We have not surveyed this aspect of the model because a prototype and a methodology for empirical analysis have not yet been fully developed. This will be the subject of a poll and follow up paper.

Finally, the banking system provides us with two more elements of utility. These are certainty and accountability. Certainty in that the tax is literally unavoidable because it is always capable of being paid when a withdrawal is made. Accountability, in providing an audit trail for the taxes paid. These elements add to the credibility of the system insofar as taxpayers are being assured that there are no other taxpayers avoiding taxation. This cannot be achieved with such preciseness in any other system.

### **Revenue generation**

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<sup>17</sup> We do not recommend that governments reset the WTX tax rate without either a two-thirds majority vote or a referendum.

We have assumed the tax base can be approximated into a workable model using banking and economic statistics but we can only speculate on the tax rate of five percent to provide revenue neutral transition. We cannot be certain of the exact rate of tax without a more detailed analysis of some inaccessible databases. However, as markets adjust to the new taxation system during a well-planned out transition phase, the rate can be adjusted up or down at any time to meet the revenue needs of the government.

### **The currency issue**

The first reaction people have to the WTX is that it won't work because people will just hoard money or use a substitute currency to avoid flowing any cash through a financial intermediary. Clearly, a large-scale underground currency exchange would compromise the system as it does with present systems. We have developed a solution to this problem (see appendix A). We would rather focus your attention on the future where all cash transfers outside electronically controlled parameters are no longer viable and the use of substitute currencies was simply outlawed, perhaps globally. While this may be a naïve notion we need to assume it into the model for now. In the not so distant future, we can at least presume that almost all cash will be spent using debit cards, credit cards and other electronic transfer devices perhaps not yet discovered. People will be able to buy refillable cash credit cards at ATMs. In short currency, as we know it, will eventually fade away to be replaced by another anonymous electronic exchange medium<sup>18</sup>. Our study presumes the inevitable elimination of cash/currency from our economic system or at least a significantly changed method of utilization in the next century.

### **Debt financing**

There are two reasons for exempting borrowed proceeds from the WTX. First, limiting tax collection to certain financial intermediaries is just a simpler and more efficient control structure. Most people and businesses have only a few accounts and localizing tax collection among the accounts provides higher visibility and a reliable audit trail. To do otherwise would subject a wider number of institutions like credit card companies and private mortgage lenders to assume the tasks of collection. This would be naturally problematic. The second reason for not taxing debt proceeds is to protect the capital markets and keep leverage strategies and consumer credit attractive by delaying but not avoiding taxation.

By subjecting all debt retirements to the WTX, we are taxing 100% of the consumption of debt proceeds over the term of the loan. This appears to be at odds with our theoretical premise of taxing equity. This does not move us of from the equity premise under our present system; consumption of debt proceeds is subjected to sales and excise taxes, therefore, the WTX, is in fact, taxing that consumption, only collecting it differently.

In addition, the taxpayer has the choice to use debt or equity for a disbursement. If he uses debt, his cost of capital is spread over the term of the debt. In order for one to retire all of his debt, a *defacto* liquidation process must be effected. It is assumed that his equity is going first to retire debt. We don't see this as unfair since refinancing debt and maintaining debt indefinitely escapes tax in the short term.

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<sup>18</sup> See perishable currency – this paper

Under our current system, debt financing is subsidized by an interest deduction and the tax benefit is traditionally part of the basic strategy of finance. If the advantageous interest deduction was lost, the deferred tax on the initial financing under the WTX will keep debt financing attractive, albeit from a different perspective. In fact, debt will be a more attractive means of financing under the WTX. The tax deferral will result in a more rapid expansion of the equity tax base by accelerating investment return due to a lower cost of capital.

### **Taxing consumption**

In our current system of taxation we pay sales and excise taxes largely with after tax revenue. The point of collection on consumption tax is at the vendor level. This is what makes sales taxes inefficient<sup>19</sup>. The WTX taxes consumption at the bank level eliminating the need for vendor collector reporting and remittance<sup>20</sup>.

Under the WTX, the tax base is expanded to all sales regardless of who is the end user. The effect of this could distort prices at all levels and markets where the cascading of this tax is a concern. It could initially burden manufacturing where assembled products are acquired by outsourcing and force vertical integration. Nevertheless, as the tax takes hold over a period of transition, efficiencies will by necessity develop for manufacturers to compete in domestic markets. This is part of the business restructuring we noted.

### **Foreign markets and VAT taxes**

There is concern that foreign countries, that use a different tax system, may be able to gain an advantage in pricing their goods because their manufactured products will exclude the tax and any cascading that we tolerate. Border adjustments to imported goods may be necessary to counteract this but we cannot speculate on rates at this time. However, we point out the goods exported from VAT nations must contain an element of taxation as well and the related compliance cost. Countries that use a VAT tax require a substantial reporting and tracking mechanism, the cost of which must rest in the price of their goods. Because the WTX has no compliance cost, this element is effectively excluded from the pure domestic goods produced under the WTX. Even if countries that wish to counteract the negative effect of VAT taxes and exempt exported goods from the VAT tax to counter border adjustments the element of compliance cost cannot be removed.

Hypothetically, the ability to exempt exports from the effect of the WTX exists. The methodology of this tactic would have to be a function of the need for competitive pricing in certain overseas markets and the condition of the trade surplus or deficit. A possible methodology would be to allow manufacturers that are adversely affected to be directly subsidized by applying for a credit much the same way a VAT tax is calculated along the production process. We are not in favor of this because the compliance cost of application and the bureaucracy that will grow around the process will become unwieldy and counterproductive to the goals we wish to achieve. We note the availability of such measures to counteract foreign gimmickry but only to show the versatility of the WTX to meet such a challenge.

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<sup>19</sup> Under reporting of sales for income tax must coincide for sales tax purposes as well. Appreciated asset accumulations escape Federal income tax. Code section 1014 (a )

<sup>20</sup> The vendor collection system is replete with evasion tactics and there is a significant cost to compliance. The NRST advocates compensating vendors for the collection. Processing collection through banks is much less costly

## **Cascading**

Cascading refers to the repeated taxation of the same items as they are sold and resold at successive stages of production causing the ultimate price of the completed product to include all the taxes paid in the stages of production and the related costs of sales and administration. Sales, excise and property taxes cascade and we haven't sent the world into turmoil yet. In reality, all taxes paid by business cascade into the price of goods. However, this problem is more controllable with the WTX. First we are eliminating all sales and excise taxes at rates that are generally higher than the WTX<sup>21</sup>. Secondly, it is materials and overhead as production costs that contain the cascade multiples. However, direct labor is excluded from cascading because it is paid only once during the production process and includes only one WTX hit. Assuming the sales tax rate was 8% and a portion of the components of production carried excise taxes at 14% and 18%, the elements of the current tax that cascade on these rates, more negatively impacts production than if we had a flat cascading tax of 5%. It is difficult to accurately calculate the negative impact of the cascading effect of current taxes but it will be more measurable if the tax rate were constant, as with the WTX. We agree that this is concern but one that can be managed with tax credits or other subsidies.

## **Vertical Integration**

Essentially, each industry will adjust its production processes to minimize cascading and vertically integrate. Generally, this is less efficient and deals a disadvantage to small businesses that cannot make the change. We tend to disagree on that point. Some businesses will vertically integrate because they have the resources and some will fall by the wayside because they cannot, but there are costly disadvantages that beset the larger companies seeking that advantage. The key equalized in the process may be higher union labor costs due to company-wide unionization in vertically integrated companies. While vertical integration is a concern, it is not restrictive to the WTX.

## **Progressive application**

The WTX is indirectly progressive, because higher taxes are paid by the more affluent consumers. However, the tax may be made directly progressive. For disadvantaged individuals, the WTX could accommodate a welfare element. For example, annually, all individuals would be given a credit to be used until accumulated withdrawals exceeded a particular amount. This will allow such individuals to avoid the tax on the disbursement of funds at least to a point, say \$30,000. All individuals will be entitled to the initial credit, however, high spenders will give back the credit at some level of spending, say between \$50,000 – 80,000 by using a higher temporary rate of tax. This feature could be easily added to provide the progressive structure lawmakers wished to achieve.

## **Implications on the banking system**

In order to collect the tax, the banking community must fully cooperate. The massive accounting system in use by the banking community is essential and may have to be standardized

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<sup>21</sup> Sales tax in many states are as high as 8.25 percent, gasoline , cigarette, liquor and parking taxes are all in excess of 10%

or a clearing-house system may have to be set up<sup>22</sup>. This would, by necessity, be tied into the Federal Reserve System. The banking system will be a source of enormous savings to the government as well as the taxpayer in collection expense<sup>23</sup>. However, the greater issue is how to report, control and audit the tax debits made to the taxpayer's account. This forces the banking system to control the process but with a fair amount of governmental control and intervention. This may be problematic in that we must decide who runs the computers, the bank or the government? In addition, how does the bank pay its taxes?

We considered that because banks enter into the system so prominently that they remain the only entities subject to income tax. The rationale behind this is twofold. First to treat lending institutions differently will allow for interest rate regulation to be maintained. Secondly, the tax audit function would be confined to one type of institution. However, on the other hand, using the same WTX principles we can treat bank deposits as debt. Loans and mortgages made from that base would then not be subject to the WTX. Taxing the disbursement of interest and all other bank disbursements would be the same as any other entity under the WTX. We are not making a determination on this point, just presenting the alternatives. In depth studies of bank statistics must be undertaken.

## **Impact on the business community**

### Benefits

The present system mandates that business firms by self-assessment on profits and withholding from employees incur substantial tax collection expense. Such cost would be radically removed from many firms and imposed on a few concentrated financial institutions where it would be more identifiable and appropriate reimbursement feasible. To minimize a firm's own tax, it must reduce expenditures to accomplish its profit objective. Efficiency would be encouraged. An income tax penalizes the efficient, and rewards peripheral spending that becomes deductible in that system.

Compliance issues as to the measurement of income, the tax year of occurrence and deductibility of expense would no longer be relevant to business decisions. The accounting profession would continue its role in financial measurements to monitor management performance. The reorientation of business may permanently resolve issues of deferred income taxes, employee benefit costs and other items. Cost calculations by managerial accountants would remain a viable function.

### Disadvantages

Capital and financial investing would be taxed. The increased recovered untaxed future profits may offset the higher initial outlay. Financial institutions and capital intensive firms may experience tax increases. Corporate profit taxes are already included in customer prices and so

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<sup>22</sup> See flowchart appendix B

<sup>23</sup> See political implications

would a disbursement tax. The resulting realignment of prices would establish more equitable price messages for consumers to make decisions.

Start up costs for new ventures would be hampered by the up front taxation. Existing firms might be unwilling to undertake risky ventures because failures will not reduce their tax. Financial institutions may come under greater control of the government as their participation enhances. Potentially the government could become owners of all banking enterprises.

#### Distribution of corporate earnings

Dividend payments by corporations might be curtailed, but since such payments are tied to stock prices, we believe the WTX will have little impact on dividends. Corporations gain no advantage to deferring dividends except maybe interest on their bank balances because they could not benefit by alternate spending. However, dividends distributed in the form of stock may increase.

#### Using corporate annual reports to determine cash disbursements

Current income tax payments are sometimes reported separately on the cash flow statements. Using the income statement and the change in deferred taxes is an alternative; we can compare the current tax provision to what a corporation would likely pay under the tax model. (See schedule below).

Revenue less positive or add negative cash flow from operations plus gross payouts from investing and financing activities was used to estimate total disbursements. The income tax provision identified on the income statement was computed as a percentage of the implied disbursements. Intra-period tax allocations to extraordinary items and the applicable tax were not identified by any of the companies.

#### Cash flows and the WTX

	<b><u>IBM</u></b>	<b><u>GTE</u></b>	<b><u>Baker Hughes</u></b>	<b><u>Chase</u></b>
Revenue	75,947	21,339	3,028	27,421
Less: Cash from operations	10,275	5,899	195	(983)
Subtotal	65,672	15,440	2,833	28,404
Cash from investing	8,507	4,614	215	117,426
Cash from financing	11,622	4,099	196	4,922

Subtotal	85,801	24,153	3,245	150,752
Income taxes paid	2,229	1,325	247	1,650
Net disbursements	83,572	22,828	2,998	149,102
Provision for taxes	3,158	1,614	133	1,350
Percent of net disbursements	3.78%	7.07%	4.20%	0.91%

Four companies do not tell much, but it does indicate that Chase Bank does have a unusually lower income tax rate than the others. If the tax on withdrawals were greater than .91percent then the withdrawals tax would be much higher for the financial institution. However, if the withdrawal tax rate of less than 3.5 percent will be a benefit to the industry based company. This dynamic must be further explored because banks show trading transactions net and there is no way to determine loan or deposit related disbursements. A more detailed study we believe will show financial institutions may actually be more seriously impacted by the tax.

## **Political & Governmental Implications**

### Advantages

The cost of monitoring collections would be sharply reduced. The current Internal Revenue Service focus on employee/subcontracting issues, tip reporting and the underground economy become meaningless under our model. How income is earned fades away and it is spending that establishes the liability. The processing of income documents like W-2's and 1099's will no longer be needed. The social security recording of earnings could cease.

With such a system, it is possible to reduce governmental interest costs by immediately paying down short-term governmental debt with each days tax receipts. The interest savings on such a cash management device cannot be estimated at this time but we believe it can be substantial. Ultimately it must be figured into the model.

In Arlington, Virginia, automated taxpaying services have been in use for over twenty years. The banking assisted collection program was borne out of necessity due to manpower considerations and a pledge to simplify the process. Citizen enthusiasm for the program caused the county treasurer to rethink similarly proposed collection schemes.

### Disadvantages

There would be significant reduction in government employment of persons unskilled for work in the private sector. Usable skills in the private sector would be changing as well. Unemployables with educational credentials could temporarily expand. Criminal activities would alter from theft of money to sophisticated computer crimes. Computer security problems would definitely intensify. The police function of government would become more concerned with information age issues.

### State and local tax issues

If all disbursements were taxed, then payments of state income and local real property taxes would be subject to the proposed tax. Many state income tax programs depend upon the existence of the federal system. Without a federal income tax program, state costs of enforcement would become prohibitive. Participation in the federal initiatives may be imperative. This raises issues of allocation. Varying disbursement tax rates by each state would be impractical. The locus of a transaction across state boundaries processed by a remote computer would create impossible situations.

## **Tactics for evasion**

### Offshore transactions

There is a myriad of offshore tax evasion schemes. The WTX will be no exception. However, conceptually, we approach the issue first from the viewpoint of a domestic corporation doing business globally. Assumedly, funds expatriated for any reason will be subject to the WTX. Funds repatriated are not at issue because they are eventually taxed. However, this deviates from our approach to non-taxable transfers to controlled groups and does involve an additional tax.

Goods shipped to the USA from foreign countries could be bartered on a grandiose scale and that would cause significant loss of revenue. Accordingly, notwithstanding border adjustments, proof of cash payment verifying payment of the WTX would have to be presented upon unloading imported goods. If such proof of payment cannot be verified, a tax will be assessed at that time to the receiving corporation of the other business entity.

Assume now the company was a foreign company doing business in USA. The same rules would apply. Therefore, all foreign recipients receiving goods on American soil will pay the tax on imports of their inventories. Expatriation of any funds to a foreign parent would likewise be subject to the WTX.

### Barter

Pure barter transactions of individuals would be very difficult to detect and enforce but it is not expected to materially affect the utility of the tax. The income effect of these barter transactions is no doubt escaping the scrutiny of the tax collector today and this offsets the tax evaded by non-reported cash based income as well. Essentially, formal bartering in businesses would be outlawed but some audit control mechanisms could be formulated to enforce the law. However, barter on a small scale under the WTX should not compromise the system.

### Assignment

Assignment of disbursements to a third party would allow for a person to avoid the WTX. Business practices of buying and then reselling goods at the non-consumer level would probably change. Instead of a wholesaler buying goods from a manufacturer and reselling to a retailer, a new arrangement would probably arise. The retailer would pay the manufacturer direct and pay a brokerage fee to the wholesaler. This would reduce the volume disbursements as compared to current business practices. Health insurance entities making direct payments to providers are already establishing these procedures.

## **Implementation**

If the WTX was to be implemented, it would have to be accomplished in stages. The first stage would be to subject people to the collection mechanism. This means collecting the tax based on withdrawals from a taxpayer's account. Conceivably, our withholding system can be replaced by the WTX collection system. Conceivably, a taxpayer could file his income tax return using the tax paid through the WTX collection system as a credit.

At a second stage of implementation, the taxpayer could be given the choice, of either to file a tax return under the old income tax law or allow the government to keep what was assessed on withdrawals. This implementation scheme can only be instituted for the income tax component and may or may not initially include the States. This transition period should last 5-10 years.

The next stage of implementation would be to include the estate and gift tax component. This can be accomplished by requiring taxpayers to accumulate their respective estates and file an estate tax return on a specified transition date. The dollar amount of the estate tax due under the old rules would be due, but the tax would be collected upon actual death of the taxpayer. At the time of death, the WTX would be collected on the excess of the actual estate at death less the estate filed on the transition date. If the taxpayer was exempted from estate tax because of the exclusion he would be taxed on the WTX over the amount of the applicable exclusion at the time he filed a transitional estate return.

Finally, full implementation would follow, tempered by experience along the way. The best time to do this is during a period of projected surplus. Alas, the inclusion of social insurance would have to be decided upon during the transition. The system has to be seriously overhauled with the deliberation of a change in the tax system. If the WTX is adopted as modeled social insurance would be transfigured into constant old age benefit, thus eliminating the need to account for participant benefits. The logical progression is that the current system be privatized while a new WTX system picks up after. This may be moot if privatization of social insurance achieves the goals of rescuing the current system.

## **Conclusion**

In 1897, Edgeworth adopted a utilitarian welfare perspective in which he concluded that incomes should be neutralized with progressive tax rates. In modern times, tax systems have taken that fundamental premise to extremes. Any system of taxation that does not have a progressive rate structure as a basic tenant is labeled as unfair and not worthy of the maximum utility classification. However, others have challenged this perspective. Vickrey, in the 1940s dealt with the progressive tax schedule and reformulated an inherent problem. He noted that incentive problems take hold in such systems that cause individuals to exert themselves or chose their work effort in conjunction with their tax schedule. He emphasized that the, potential productivity of individuals, is not generally known to the government and this creates a dilemma in formulating a utilitarian tax system.

In the 1960s, Mirrlees developed a general "revelation principle" as a solution to incentive problems. He noted that allocation mechanisms are at work to induce individuals to reveal private information in a way that does not conflict with their self-interest. He surmised that this makes it easier to design optimal solutions to problematic systems like the income tax. In these works two things appear certain: a) income tax systems present inherent dilemmas in social structure, productivity and coincident growth and b) progressivism in tax rates is not essential to a fair tax system, but relevant at times.

The income tax system in the United States and in other industrialized nations is an extremely effective control mechanism for government to manage the economy, as well as control the general population in various ways. Sabrin has suggested alarmingly that the income tax system is a form of creeping "Statism"<sup>24</sup>. The magnitude of this concept could not have been comprehended in the 18<sup>th</sup> Century when Edgeworth formulated his progressive tax structure. Statism may in fact be more of a threat to social well being than equalized tax rates.

We have been taxing income in one form or another from the Civil War period. Then it was largely viewed as a necessary evil to raise revenue to support the war effort, but almost all unilaterally detested it and tried to evade it during its tenure. Later, industrialization made taxing incomes to be the most practical means of raising revenue in an industrialized economy, but today, over 100 years later, society and the world has changed. The income tax has now become privacy invasive, cumbersome to collect and perhaps obsolete for a global marketplace. In fact, we believe that taxation of incomes has more downside risks for the future of global society than any other socioeconomic or political force that we have ever known.

It would appear that Mirrlees observations regarding incentive problems are more relevant today because disclosure in electronic transactions has become prone to abuses by government as well as business. The amount and type of information that one must disclose in routine transactions involving credit purchases and debit card transactions leaves an audit trail that can be used for cross purposes.

The WTX, with its faults, is a better system of taxation. Better because it maintains the motivation for a society's efforts in the proper direction; the creation of wealth and prosperity. Under the WTX, we will no longer penalize productivity, profitability and entrepreneurship. The focus of taxation will be on a modest and reasonable extraction of wealth to operate the government.

The concept of taxation of disbursements opens up a myriad of serious tangential matters, some of which will be dealt with and others require more intense research. Inevitably, the fundamental processes of democracy itself must be dealt with if we are to effect a tax system change. The WTX will undoubtedly transform capitalism much the same way that mercantilism was transformed into modern day capitalism by the industrial revolution with the focal point being the government's role in the economic process. The resources the government needs will now become a high profile factor perhaps causing us to rethink government's power to tax. In the final analysis, we think it will perfect the democracy experiment by simplifying public finance processes. If the means to extract the tax becomes much less expensive, the amount of resources the government collects and the purpose for which it collects it becomes more clear.

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<sup>24</sup> Statism is the belief that the state should control and regulate virtually all economic activity.

Government's utilization of the tax system to control the economy and its need to do so becomes a more open debate and this can only lead to a better life for all of us.

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### **Perishable Currency**

Undoubtedly, the hoarding of cash would appear to compromise the WTX system. Actually, currency transactions are less than three percent of total transaction<sup>25</sup>. Nevertheless, a change in the tax system that taxed currency turnover would naturally result in avoidance techniques. Currency hoarding and substitute currencies are therefore an issue.

The currency system can be redesigned to accommodate the WTX and counter the negative effects of hoarding and underground commerce. Conceptually, it would operate in much the same manner as currency does now, except that currency would have to be recycled within a specified time period. Failure to do so would make currency non-negotiable but not necessarily, non-redeemable.

It would operate in the following manner:

- All currency would be redesigned to include a magnetic strip and an area where a printable date may be inserted.
- As currency was withdrawn, it would be electronically encoded with its source account, which is the taxpayer's account number, and an expiration date. The date of expiration would be the date by which that bearer note would have to be recycled to avoid lapsing into non-redeemable status.
- To recycle the currency, it could either be run through an ATM or through a bank teller's window. At that juncture, the WTX would be withdrawn and updated currency, net of the tax, would be issued.
- Taxpayers that redeposit the same bearer notes that were issued from their account could recycle them with no coincident WTX.
- Notes that expire could be presented to the bank for redemption but only within a specified time period for doing so and for limited amounts each time. The purpose of this is to allow people the use cash and a certain amount of tax-free turnover. Taxpayers, that inadvertently allow currency generated by their account to lapse, are given the second chance to redeem the notes without incurring WTX. This feature would make larger redemptions visible thus unveiling money laundering and underground activity. With taxpayers having the ability to recycle cash at five percent, illegal payments would likely be processed through an ATM long

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<sup>25</sup> Federal Reserve bank statistics

before the currency became non-negotiable. Overall, this would effectively tax the underground economy, which is largely escaping taxation now.

- Major retailers would have the ability to recycle their customer's cash through their account as a convenience or supply ATM for customers to do this at their establishments.
- Cash used to make change would be affected with non-recycled currency in much the same manner as it is now. However, closer inspection of negotiable currency may make the system somewhat cumbersome. Retailers would have the computer capability to verify negotiable currency quickly. We believe that it would be a welcomed device because it removes the problem of counterfeit currency.
- Coinage would remain the same and not be subject to the WTX.
- Finally, the use of foreign currencies would have to be made illegal, unless a complementary international system was developed.

The institution of perishable currency would be to make the WTX more viable but retail commerce in the future is likely to exclude currency transactions. The system of perishable currency can effectively tax the underground economy by default. The revenue captured rather anonymously would serve to both keep the tax rates low and flush out illegal activity. The fact that income is no longer taxable unless it is run through a bank is a powerful incentive to avoid the system. We do not believe that this will be a long-term issue. However, perishable currency is one possible solution to currency hoarding.

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