

Reasons Underlying Desires for Federal Tax Reform

Professor Annette Nellen
San José State University

For more information – visit
http://www.cob.sjsu.edu/facstaff/nellen_a/txrefupd.html

At least once every decade there is a lot of discussion about making significant changes to our federal tax system. This article lists and explains some of the reasons why there is a desire to reform the federal tax system.¹

The federal income tax has become too complex

When today's federal income tax came about in 1913, it was not complex. The rate structure was simple at 1% for individuals and corporations, and a graduate surtax on individuals with income over \$20,000. There was a personal deduction and a few itemized deductions. The 1% rate was withheld at the source so most individuals did not have to file a return.ⁱ More deductions and special rules, such as a differential for capital gains, were added and modified over the years to move the system from a fairly simple one to a very complex one. The complexity began within the first decade of the income tax. In 1923, in an article on tax simplification, an author lamented that the system was “unduly complex” and the “maze of administrative and judicial technicalities surrounding the taxpayer has been steadily thickening.”ⁱⁱ Eight decades later, the “maze” has grown even more complex. Despite congressional studies prepared over the past three decades on reducing complexity, it remains.ⁱⁱⁱ

In 2004, the National Taxpayer Advocate stated that “the confounding complexity of the tax code” is the most serious problem facing taxpayers today.^{iv} This complexity, which is also a lament of taxpayers and practitioners, exacerbates other problems with the system, such as the high levels of both intentional and non-intentional non-compliance, the growing costs of administration and compliance, and reduced transparency of the system.

In calling for tax reform, President Bush noted: “The number of pages in the Internal Revenue Code and regulations has more than doubled over the past twenty years. Today's ‘short’ income tax form takes more than 11 hours to prepare - about the same as the ‘long form’ did a decade ago.”^v

One need only look at the instructions for simple income tax forms to gain a sense of the complexity plaguing the system today. The instruction booklet for the 2005 Form 1040EZ is 36 pages and the Service estimates that it should take, on average, 10.1 hours for all of the activities necessary to complete the form. If a Form 1040EZ filer needs information about the earned income tax credit that isn't addressed in the 1040EZ instructions, there is a 58-page publication available on the topic (Pub. 596). Despite all of the published assistance, about 15 to 25% of eligible individuals do not claim the EITC.^{vi}

Complexity can lead taxpayers to overlook or misapply rules, even ones that are beneficial to them. For example, a 2005 private survey found that only 16% of those surveyed knew that a homeowner must live in their residence for two out of five years in order to exclude gain upon sale.^{vii}

¹ This article is adapted from prior work I did for the AICPA report - [Understanding Tax Reform: A Guide to 21st Century Alternatives](#) (2005), an article written for the California Tax Lawyer, Spring 2006 and lots of work done in the mid-1990s when there was a lot of activity on federal tax reform (see [website](#)).

In 2004, taxpayers worked over 3.5 billion hours to complete their income tax forms – about 26 hours on average.^{viii} Increasing complexity has led a majority of taxpayers to hire someone to prepare their federal income tax forms. In 2003, 56% of individuals and over 85% of businesses hired someone to prepare their tax forms. For taxpayers claiming the earned income tax credit (EITC) over 70% used a paid preparer. In addition, 75% of taxpayers owing alternative minimum tax (AMT) hired someone to prepare their tax return.^{ix}

The costs of complexity have been noted by the Panel and others. In an April 13, 2005 Panel statement, it was noted that the cost to the U.S. economy of the complexity is about \$140 billion annually or about \$1,000 per family.^x

The federal income tax has a significant tax gap

The Service estimates that for 2001, the gross tax gap (the difference between taxes owed and taxes paid when due) was between \$312 billion to \$353 billion for all types of taxes. This means that the rate of non-compliance with federal taxes is between 15% and 16.6%. The Service estimates that late voluntary payments and collection activities bring the uncollected amount down to between \$257 and \$298 billion.^{xi} The National Taxpayer Advocate notes that with 130 million individual taxpayers in the U.S., on average, each of these individuals pays about \$2,000 annually to “subsidize” the tax gap. About 67% of the tax gap is the result of sole proprietors failing to file returns or under-reporting their income for which they were not required to receive a form 1099 showing the amount received by customers or clients.^{xii} A significant portion of this tax gap stems from the growing cash economy. The 2005 National Taxpayer Advocate’s report to Congress cites a study showing that in Los Angeles County, between 9 and 29% of workers are paid in cash with no tax withholding. There is also concern that the cash economy growth rate will accelerate with more transactions completed via the Internet.^{xiii}

The National Taxpayer Advocate also notes that the tax gap has grown at “ever-expanding rates” in the past 20 years. The gross tax gap was estimated at \$76 billion in 1981, \$127 billion in 1992 and \$310 in 2001. Thus, the gap increased 67% from 1981 to 1992, but from 1992 to 2001, increased 144%.^{xiv} The National Taxpayer Advocate notes that non-compliance can grow as it diminishes respect for the system and can make “compliant taxpayers feel foolish” for properly reporting their income and paying their taxes on time.^{xv}

Finally, the tax gap may be growing for reasons beyond the cash economy. The 2004 annual report of the IRS Oversight Board noted that public attitudes towards cheating on tax returns have worsened since 1999. In 1999, 11% of Americans indicated that it was okay to cheat at least a little on their tax return, that number was 13% in 2002 and 17% (almost one in five people) in 2003.^{xvi} It is likely that more than increased enforcement efforts or a new tax system is needed to change attitudes about cheating.

U.S. savings levels are low

The current U.S. tax system is viewed as not encouraging savings because it taxes earnings from savings. Household savings rates are lower for the U.S. than for many other countries. OECD data for 2003 for selected countries are provided below. The OECD describes household savings as a key domestic source of investment. The household savings rates are computed as disposable income from wages, unincorporated businesses, investment and the imputed rents paid by owner-occupiers of housing, less cash outlays for consumer goods and services and the imputed rents that owner-occupiers pay to themselves.^{xvii}

<u>Country</u>	<u>Household net saving rates % of disposable household income</u>
Canada	1.4
France	11.1
Germany	10.7
Japan	6.3
United Kingdom	5.5 (gross savings)
United States	1.4

Gross national savings^{xviii} are also lower for the U.S. than for other industrialized countries as indicated by OECD data for 2002.^{xix}

<u>Country</u>	<u>Gross national saving % of nominal GDP</u>
Canada	22.3
France	20.9
Germany	21.1
Japan	25.7
United Kingdom	14.9
United States	14.6

The Panel reports the trend has been for U.S. savings to decrease, noting that the net U.S. savings rate^{xx} has dropped from about 9% of GDP to about 2% of GDP in the past 30 years. The Panel also notes some research which indicates that a tax system “neutral between savings and current spending could increase the national savings rates by 12 to 31 percent over a period of 14 years.”^{xxi}

The federal income tax system violates the principle of neutrality

When a set of tax rules includes provisions that treat similarly situated taxpayers in dissimilar ways, it is perceived as not fair which undermines compliance and respect for the system and can make the system more complex due to the special rules. The current U.S. tax system is frequently used to create incentives to either encourage a particular activity or discourage a particular activity (that is, it is not neutral). Just about any economic, social or environmental “problem” can be alleviated to some degree through a tax provision. For example, an excise tax on certain types of chemicals that cause pollution or a tax credit for purchasing energy-efficient equipment will alleviate some environmental problems, but will cause the tax law to impact decision-making by taxpayers and increase the complexity of the tax law. In stating his intention to study tax reform, President Bush stated: “The current tax code is a maze of special interest loopholes that causes America’s taxpayers to spend more than six billion hours every year on paperwork and other headaches.”^{xxii}

The cost of preferential rules in the tax system is rarely weighed against alternatives for reaching the same goal, either when they are added, or in future years. For example, does the cost to the government of allowing teachers to deduct certain expenses outweigh the costs of providing appropriate funding to schools? If the cost to the federal government is larger, a direct subsidy from the federal government to the schools or state governments would be “cheaper” than having a tax preference for teacher deductions. However, such analysis is rarely performed due to its difficulty and the ease of adding preferences to the tax law. Also, once a tax preference is added to the tax law, there is no systematic approach to evaluating them regularly for effectiveness and value. Such preferences get added to the list of tax expenditures and measured frequently,^{xxiii} but with little to no evaluation of their value.^{xxiv}

Arguably, some preferences have evolved to the point of having lost sight of their underlying purpose. For example, despite interest in pursuing alternative fuels, the long-standing tax benefits for oil exploration and drilling remain. Also, as noted in an AICPA tax reform report, the home mortgage deduction extends beyond its goal of encouraging home ownership. The federal income tax system allows for deduction of mortgage interest on two homes, rather than just one, and on debt up to \$1.1 million, far greater than the average home cost in the U.S. This system also allows an interest deduction for home equity loans which have nothing to do with acquiring a home, but allow homeowners to deduct interest on loans used for personal expenditures – something a non-homeowner is unable to do.^{xxv}

Another example of a preference that arguably has evolved beyond its purpose is the charitable contribution deduction. This deduction yields the same benefit to an individual making a donation to a private university or symphony orchestra as for someone donating to an organization to help those who might be viewed as more in need of philanthropic support (such as people who are poor or ill).

Another example of a problem of ignoring neutrality is the continual addition of preferences that seem to work similarly to existing ones that remain. For example, the desire to help families and individuals pay for higher education has yielded several different provisions all aimed at basically the same goal.

The Panel points out a specific outcome of a system that is non-neutral. The Panel notes that the likely impact of the tax rules on investments yields the following varying effective tax rates on different investments:^{xxvi}

Owner-occupied housing	0%
Non-corporate business	17%
Corporate business	26%
Investment by the business sector	22%
Economy-wide total	14%

In short, while there are reasons justifying non-neutral rules in a tax system, it seems that many people view the current situation as out of control in terms of number of preferences, overlapping preferences, lack of review of the continued value, and failure, in some cases, for preferences to continue to serve the original purpose for which they were created. The current state of affairs leads to widespread calls of unfairness and undue complexity. And, as noted by the Panel: “We have lost sight of the fact that the fundamental purpose of our tax system is to raise revenues to fund government.”^{xxvii}

General perceptions of unfairness

In addition to the neutrality concerns noted above, there are other fairness concerns that stem from how taxable income is defined, ability to pay, and state tax differences that impact federal tax liabilities. The selective nature of deductions, exemptions and credits arguably causes taxpayers with similar levels of economic income to pay different amounts of tax. For example, an individual with significant medical expenses might get a deduction whereas an individual with an equal amount of education expenses will not get a deduction and so will pay more tax even though their income and cash availability amounts are similar.

In addition, the exclusion for health insurance provides a more significant tax benefit to the insured than if they had to buy a policy on their own with after-tax dollars. Thus, even if they have similar income levels, the individual with employer-provided health care has a lower tax obligation.

Finally, the deduction for state income and property taxes provides a larger benefit to high tax states that is, in effect, subsidized by taxpayers in other states.

Defining taxable income can be challenging

As court cases continue to illustrate, defining any tax base can be challenging and the income tax is no exception. Defining “income” has proven challenging since the inception of the current federal system in 1913. Even by 1955, the definition of income was not firm as evidenced by the need for the U.S. Supreme Court to hear the *Glenshaw Glass* case on the taxation of punitive damages.^{xxviii} In addition to understanding the meaning of “income,” identifying which deductions are appropriate to derive taxable income is challenging as is deciding whether all types of income should be taxed similarly.

Some of the features of the Federal income tax that the AICPA identified as ones that are sometimes questioned include:^{xxix}

- Double taxation of corporate income.
- Encouragement of corporate debt over corporate equity through a deduction for interest, but not for dividends.
- Limitations on capital losses.
- Taxation of inflationary gains.
- Preferential treatment of certain types of income, such as fringe benefits, tax-exempt bond interest, and capital gains.
- Lack of basic conformity with accounting principles, such as disregard for the matching principle.
- Depreciable lives provided in the tax law do not always tie to the economic life of assets.
- Most dollar amounts in the tax rules are not indexed for the effects of inflation.
- Ineffective reporting options for some types of income which causes some of that income to go unreported (one of the causes of the tax gap).

Another issue in defining income is one that can also lead to global competitive issues for U.S. companies. The federal income tax system measures income on a worldwide basis rather than the territorial one that many countries use.

Interest in addressing current difficult issues

The federal tax system faces some current issues that may lead policymakers to think that revamping the system is the remedy given the difficulty (and cost) of addressing the matters. These current issues include the following:

1. The growing reach of the alternative minimum tax: Prior to 2000, the AMT affected less than 1% of individual taxpayers. By 2010, it will affect about 20% of million taxpayers.^{xxx}
2. Expensive temporary provisions: The Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) added several taxpayer favorable provisions (such as repealing the estate tax), all of which expire after 2010. Generally, taxpayers enjoy tax cuts and don’t want to see them end and their tax liabilities increase. But, the cost of extending these cuts is quite high. One estimate is that it would cost about \$2.8 trillion from 2007 through 2017 to make the tax cuts enacted since 2001 permanent.^{xxxi} The high cost of making the tax cuts permanent may lead to interest in revamping the tax system instead.
3. Tax shelters: Continuing concern over the proliferation of tax shelters may also lead some to think that a revamped system is the answer to eliminating the shelters.

4. Rising health care costs and approximately 47 million individuals without health care insurance. Today, the largest tax expenditure at the federal level is the exclusion for employer-provided health care - \$134 billion in 2007. Both health care and tax reforms will most likely need to consider this tax provision because modification to it can help resolve issues in both of these areas.^{xxxii}

-
- ⁱ Robert M. Willan, *Income Taxes Concise History and Primer*, 5 - 7 (1993)
- ⁱⁱ “Suggestions for Simplification of Federal Income Taxation, *The National Income Tax Magazine*, August 1923, Vol. I, No. 7.
- ⁱⁱⁱ For example, see Joint Committee on Taxation, *Issues in Simplification of the Income Tax Laws*, JCS-57-77 (Sept. 1977), called for by the Tax Reform Act of 1976 (P.L. 94-455). Also, Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification*, JCS-3-01 (2001), a 3-volume report identifying simplifications throughout the entire Internal Revenue Code.
- ^{iv} National Taxpayer Advocate, *2004 Annual Report to Congress*; available at <http://www.irs.gov/pub/irs-utl/ntafy2004annualreport.pdf>.
- ^v White House press release of 9/2/04 stating President Bush’s plan to form a panel to study tax reform; available at <http://www.whitehouse.gov/news/releases/2004/09/20040902-7.html>.
- ^{vi} The President’s Advisory Panel on Federal Tax Reform, *Simple, Fair, & Pro-Growth – Proposals to Fix America’s Tax System, (Final Report)* 68 (2005); available at <http://taxreformpanel.gov/final-report/>.
- ^{vii} Commerce Clearing House, “CCH Complete Tax Survey Suggests Taxpayers Confused by Tax Code Complexity,” 3/16/05; available at <http://www.cch.com/press/news/2005/20050316t.asp>.
- ^{viii} *Final Report, supra*, 2.
- ^{ix} *2004 Annual Report to Congress, supra*, 4 – 5.
- ^x The President’s Advisory Panel on Federal Tax Reform, “America Needs a Better Tax System,” available at <http://taxreformpanel.gov/04132005.pdf>.
- ^{xi} IRS, *Understanding the Tax Gap*, FS-2005-14 (March 2005); available at <http://www.irs.gov/newsroom/article/0,,id=137247,00.html>.
- ^{xii} *2004 Annual Report to Congress, supra*, 6, 66, 211.
- ^{xiii} National Taxpayer Advocate, *2005 Annual Report to Congress*, Vol. 1, 58; available at http://www.irs.gov/pub/irs-utl/section_1.pdf. Other parts of the report can be found at <http://www.irs.gov/advocate/article/0,,id=152735,00.html>.
- ^{xiv} *2004 Annual Report to Congress, supra*, 229.
- ^{xv} *2005 Annual Report to Congress, supra*, 56.
- ^{xvi} IRS Oversight Board, *FY2005/Special Report* (March 2004), 19 - 20; available at <http://www.treas.gov/irsob/documents/fy2005-budget-report.pdf>.
- ^{xvii} OECD, *Economic Situation, Analysis and Projections* (Dec. 2004), Annex Table 23; available at <http://ninetta.sourceoecd.org/vl=937741/cl=41/nw=1/rpsv/factbook/02-02-03.htm>.
- ^{xviii} The Congressional Budget Office defines “national saving” as “total saving by all sectors of the economy: personal saving, business saving (corporate after-tax profits not paid as dividends), and government saving (the budget surplus). National saving represents all income not consumed, publicly or privately, during a given period.” CBO website at <http://www.cbo.gov/showdoc.cfm?index=6060&sequence=13> and <http://www.oecd.org/dataoecd/5/48/2483858.xls>.
- ^{xix} OECD, *Economic Situation, Analysis and Projections* (Dec. 2004), Annex Table 24; available at <http://www.oecd.org/dataoecd/5/48/2483858.xls>.
- ^{xx} The “net U.S. savings rate” is defined as household savings plus retained earnings plus or minus the government surplus or deficit. *Final Report, supra*, 91.
- ^{xxi} *Final Report, supra*, 91.
- ^{xxii} White House press release of Sept. 2, 2004; available at <http://www.whitehouse.gov/news/releases/2004/09/20040902-7.html>
- ^{xxiii} Tax expenditures are reported annually by the Joint Committee on Taxation. See, for example, *Estimates of Federal Tax Expenditures for Fiscal Years 2006 – 2010*, JCS-2-06 (2006); available at <http://www.house.gov/jct/s-2-06.pdf>.

^{xxiv} The Panel's Final Report notes that for FY 2006-2010, the largest tax expenditures are health deductions, incentives for home ownership and retirement saving provisions (page 27).

^{xxv} American Institute of Certified Public Accountants (AICPA), *Understanding Tax Reform: A Guide to 21st Century Alternatives*, 7 (2005); available at

<http://tax.aicpa.org/Resources/Tax+Advocacy+for+Members/Tax+Legislation+and+Policy/Understanding+Tax+Reform+A+Guide+to+21st+Century+Alternatives.htm>. Note: The author was one of the co-authors of this report.

^{xxvi} *Final Report*, *supra*, 71.

^{xxvii} Panel press release of April 13, 2005; available at http://taxreformpanel.gov/press/press-posting_04132005.shtml.

^{xxviii} *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).

^{xxix} *AICPA Report*, *supra*, 8.

^{xxx} Congressional Budget Office, *The Alternative Minimum Tax*, 1 (2004); available at <http://www.cbo.gov/ftpdocs/53xx/doc5386/04-15-AMT.pdf>.

^{xxxi} Joel Friedman and Aviva Aron-Dine, *Extending Expiring Tax Cuts and AMT Relief Would Cost \$3.3 Trillion Through 2016*, 1 (Center for Budget and Policy Priorities, 2006); available at <http://www.cbpp.org/2-6-06tax.htm>.

^{xxxii} For more information on health care and tax reform see Nellen, Pot of Gold in the Employer-Provided Healthcare Exclusion, *AICPA Tax Insider*, 6/12/08;

http://www.cpa2biz.com/Content/media/PRODUCER_CONTENT/Newsletters/Articles_2008/Tax/potofgold.jsp.