

# Tax Simplification Proposals

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## Recommendations

Support the following principles.

- Tax simplification should not shift the tax burden from one income group to another
- All income should be taxed
- There should be no deductions other than a substantial standard deduction.

Eliminate those distinctions in the tax code which increase complexity but which have a de minimis effect on federal tax revenues. For example,

- The rules for withholding upon receipt of a pension rollover should not depend on whether the rollover is from a qualified plan or from an IRA.
- The rules governing salary reduction pension plans should not depend on whether the employee works for a profit [§401(k)] or charitable corporation [§403(b)].
- The rules governing the exchange of livestock of different sex [§1031(e)] should be the same as the rules governing the exchange of 100,000 acres of vineyard for a 100,000 square foot office building.
- Taxation of withdrawals from life insurance contracts should not depend on whether the withdrawal is a lump sum or is in the form of an annuity.
- A \$400 Child Credit should not be entangled by the AMT rules.
- Anecdotal evidence suggests that AMT has been a failure to the extent that one purpose was to increase taxes on those exercising incentive stock options. Compliance costs have gone up, tax payments have been accelerated and investment decisions have been distorted but the increase in tax collections has been modest. Change the rules to allow state income taxes as a deduction for AMT purposes, or at least that portion of the state tax which is attributed to the exercise of incentive stock options. This change would not affect the acceleration of tax.
- [This list could include thousands of examples.]

Eliminate rules which encourage dishonest behavior, or improve compliance. For example,

- A single parent living with relatives is usually not eligible for the earned income credit because the credit belongs to the taxpayer with the higher AGI. This rule says, in effect, "Lie about your living arrangements and we will pay you \$3,000." Repeal §32(c)(1)(C).
- Compliance will be low when a taxpayer must make a special effort to determine taxable income and when the risk of discovery is low because the income is not reported. Require that interest paid on private activity bonds be reported to the taxpayer and to the IRS.

## Discussion

The present federal income tax system redistributes wealth. Proposals to simplify the system generally shift the tax burden from one income group to another. The resulting political uproar obscures the debate and dooms the proposal. So, the first principle is that tax simplification should not substantially alter the tax burden borne by each income grouping.

“Flat tax” proposals usually violate this principle by shifting the tax burden from higher to lower income groups. A flat tax system need not shift income. A flat tax of 30% on gross income, including non wage income with no income cap, would cause the high income individual to pay about the same amount of income, FICA, Medicare tax as presently. The employer would pay part of this tax on the first portion of wage income, as presently.

Another principle is that all income should be subject to tax and that individuals should be allowed no deductions beyond a substantial standard deduction. Municipal interest and welfare payments should be taxed, the home mortgage deduction should be eliminated and capital gains should be taxed as ordinary income. If one deviates from this principle, it will be impossible to say “No” to the political pressures that have produced the current complex tax code.

It will take time to debate and gather support for these principles. In the meantime, there is much that can be done to simplify the Code without a substantial effect on revenues. [The effect on individual taxpayers may be substantial.] There are thousands of these de minimis clauses in the Code and a few examples were given above.

We need to change those parts of the present Code which encourage dishonest behavior.

- I have no sympathy for the high income individual who is willing to lie on their tax return to save a few thousand dollars in taxes. We need, therefore, to improve compliance in the areas of household help and private activity bond interest.
- A few thousand dollars is a huge sum to a single parent who might qualify for the earned income credit and it is not appropriate for the Code to tempt them to lie about their living arrangements with a prize of this magnitude. We need, therefore, to repeal the AGI rule in §32(c)(1)(C) that disqualifies most single parents who are living with relatives from receiving EIC.

HR 2488, which Mr. Clinton will be vetoing this week, would have changed the EIC rules to eliminate the AGI rule and would have simplified the Code and Regulations in the retirement area. This legislation would also have introduced further complexities, however.

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