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A Federal Tax System for the 1980s

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Too often the tax professional is viewed as being engaged "merely" in trying to obtain special tax benefits for his clients—finding loopholes, seeking some modicum of support for far-out tax positions, acting as a taxpayer advocate in tax controversies. Any such description displays a shallow understanding of both the professional's role and how the U.S. tax system works.

The tax system is complex and ever changing, because legislators and administrators alike have found it the most responsive and efficient way of fine-tuning the American economy, of meeting the volatile needs and desires of the American taxpayer/voter. Therefore, before discussing the future effectiveness of our tax system, I'd like to discuss briefly the social significance of the existing system and the CPA's role in that system.

How vital is the role that the tax practitioner plays in the system? Let us use the example of a subsidy program that the government sets up to stimulate the purchase of energy conserving devices. Setting up such a subsidy program would be a time-consuming and administratively expensive task. First, enabling legislation would have to be passed. Then an appropriation would be required. Either an existing agency would have to staff-up to meet the demands of this new program or a new agency would need to be brought into existence. Regulations would have to be written and application forms and procedures adopted. The first requests for the subsidy money might take quite some time to process. Perhaps two years after the legislation was proposed, an actual program might be in operation—by which time the energy problem would have passed beyond the point where that program would be of any help.

Contrast this with using the tax system to provide this subsidy either through a deduction or a credit. The minute a program was proposed, tax people would start monitoring on behalf of their clients. The enactment of the proposal would result in almost instantaneous communication to affected clients about how they could take advantage of it. Clients in manufacturing or selling—of solar panels, let's say—would quickly advertise the new subsidy. Marketing programs would be operational based upon the tax practitioners' interpretations of the new statute—and the first installation actually generated would be almost concurrent with legislative enactment.

This is hardly the whole story of the social role of the tax consultant. But it is one part that is often overlooked. We, not the IRS nor the Treasury, are the element that makes viable the tax system's role as a fine-tuner of the economy. (The administration of the tax system by the IRS is key to its continued existence, of course. If voluntary compliance in self-assessment drops below some critical level, the whole involved structure starts to disintegrate—a point to which we shall return briefly at the end of this article.)

The fine-tuning role is significant, of course. It involves big dollars. The tax expenditures budget is well over $250 billion currently and rising fast. Further, these tax subsidies are not themselves subject to tax, nor do they generally reduce other deductions. Thus, compared to subsidies that are taxable income or that reduce the basis for depreciation, a dollar of tax benefit is probably worth two. So we CPAs play a vital role in running a $500 billion tax subsidy program. And $500 billion is vastly bigger than any other subsidy program that the federal government administers.

Given this context, and given the repeated need that tax practitioners have to examine the basics of our federal tax system and explain it to successive generations of entrepreneurs and business executives, I believe CPAs in tax practice are uniquely qualified to speak out to the public and to Congress on the fundamentals of how our federal tax system operates. Herewith, then, are some concerns that have been slowly germinating in my mind.

What's Wrong With the Income Tax?

The present federal income tax can be viewed as a ratchet mechanism. It is relatively easy to increase tax benefits. In fact, it is politically difficult to avoid increases. For example, once alimony was reclassified so that it could be taken as a deduction in addition to the taxpayer taking the standard deduction, then charitable organizations started clamoring for reclassification of charitable contributions so that they, too, could be taken as a deduction in addition to the standard deduction.

But the ability to use tax benefits to manage the economy is limited, because it is difficult, almost impossible, to curtail tax benefits substantially once they affect large numbers of taxpayers. Deductions for mortgage interest and real estate taxes act as tremendous subsidies to the housing market. They have been in the tax law for decades—perhaps long before they even were viewed as subsidies. No one consciously determined that this aspect of the federal tax system should be structured to stimulate the conversion of apartment buildings to cooperatives or condominiums in 1981—and yet the current system contributed substantially to that result, as demonstrated by the shortage of rental apartments. The system is simply not able to do anything major about distortions of its purpose. Any proposal now to completely eliminate deductibility of mortgage interest and real estate taxes probably never would leave the House Ways and Means Committee.

Attempts to limit and curtail benefits are, in fact, a major cause of the tax law's present complexity. The 1969 and 1976 tax reform acts, plus intervening technical amendments, illustrate the type of tax reform that our congressional tax leaders feel is politically palatable. These acts do not withdraw tax benefits so much as impose limits to their use. The limits are drafted with exquisite care, in order not to hurt large numbers of taxpayers so much that they will raise a ruckus. The 1981 act added more of the same, and the 1982 act continues the tradition.

Deductibility of interest paid, therefore, has not been directly challenged. Instead, the 1969 Tax Reform Act initially made excess investment interest expense a tax preference. Since few people were affected—and even fewer understood it—interest as a tax preference slid in quite easily. The same act automatically provided for a shift of investment interest out of the tax preference category at a later date. Limits were then put on the tax benefit derived from investment interest if it exceeded investment income, including long-term capital gains, by $25,000. The limit was one-half the remainder. In 1976 the net investment interest that triggered tax deduction limitations shrank to $10,000—and long-term capital gains were eliminated from the definition of investment income. Thus, most of the benefit of the interest expense deduction was withdrawn bit by bit from a handful of taxpayers. (Ironically, the impact of the new limits on deductibility of interest expense has affected mainly the entrepreneurial individual whose diasppearance from the economic scene has led to great lamentation.)

Some observers/legislators who have been intimately involved in the congressional tax-writing process in recent years conclude from such behavior that the federal income tax is "burned out." It has lost its drive, its creative potential, its flexibility — its effectiveness in today's economy. They even fear that it is becoming impossible to administer the tax law.

But even if the diagnosis is correct today, I think it extremely unwise to let these conditions persist. If the nation is to continue to control inflation and improve its ability both to satisfy the needs of its citizens and to compete effectively in the world economy, we need to do something to restore our tax system to its former state of usefulness as a fiscal tool.

Basic Tax Reform

William Simon, Charls M. Walker, and the staff of the U.S. Treasury Department wrestled with the same problem six years ago—albeit at a time when the inflation situation seemed less unmanagable. The result, in January 1977, was a 230-page opus, *Blueprints for Basic Tax Reform* (Government Printing Office). Simon and the others cited the three basic principles of equity, efficiency, and simplicity as the cornerstone on which to rejuvenate the income tax system. *Blueprints* concluded that either of two models was feasible, depending on the degree to which taxation should foster investment and inhibit consumption.

One model was essentially the present federal income tax system, with a number of specific modifications, including:

- Integration of corporation and individual income taxes, coupled with elimination of the corporate income tax.
- Full taxation of capital gains after allowing a step-up in basis for inflation (and full deduction of capital losses).
- Taxation of municipal bond interest.

The other model emphasized taxation of consumption and was based on cash flow. "A consumption tax differs from an income tax in excluding savings from the tax base. In practical terms, this means that net savings, as well as gifts made, are subtracted from gross receipts to compute the tax base. Withdrawals from savings are included in gross receipts to compute the tax base." (*Blueprints*, P. 9).

While implementation of either model would require a radical alteration in our present income tax structure, either could be a natural outgrowth and a total replacement of what already exists. The objection to either approach might be that it has no constituency.

But taxation of oneself seldom does attract enthusiastic support—at least until compared to some alternative that is even less attractive. We now face that alternative. The U.S. may have to choose radical tax change or else risk disastrous and uncontrolled inflation. The consumption model of *Blueprints* would fight inflation by encouraging investment rather than consumption, and would do so without the direct inflationary jolt that would result, for instance, from the imposition of, or increase in, a value-added tax.

A Touche Ross Proposal

If a basic tax reform, a la *Blueprints*, is regarded as too revolutionary, perhaps an evolutionary approach would be more palatable—and thus more politically possible. The 1969 Tax Reform Act spawned what is now called the "add-on"minimum tax on tax preferences; while the Revenue Act of 1978 spawned the "alternative"minimum tax. Both were attempts to tinker with the income tax structure by offsetting the more extreme results produced by other tax provisions.

An alternative consumption tax against inflation (ACT against inflation) would take a similar approach, but would tend to encourage investment and discourage consumption. The description that follows is intended as an illustration only, since the basic concept is quite flexible.

A separate schedule for the ACT tax return , to be filed with Form 1040 showing gross income over $20,000, would start with adjusted gross income. To this would be added:

- The long-term capital gain deduction.
- The tax basis of assets sold.
- Tax-free municipal bond income.
- Gifts and bequests received.

From the resulting total, which would be ACT gross receipts, there would be subtracted:

- Gifts made.
- Investment made.

A 25 percent tax would be imposed on the resulting ACT net receipts. Negative ACT net receipts, unless caused by gifts made, would entitle one to a 25 percent refund (or reduction in the amount of income tax that otherwise would be due).

The effect of such an ACT would be to impose a 25 percent tax on consumption, if the amount exceeded the regular income tax, or provide a 25 percent subsidy for any form of investment as a credit against the regular income tax.

The U.S. income tax has evolved over a 73-year history. It is now an accepted part of our economy and is woven into the framework of our institutions. The suggestion of radical change always creates rather justified protests that established relationships will be disturbed and existing values destroyed. We thus feel trapped within our own history and within the framework of our own institutions. But we can break this mold if we wish.

The alternatives we face in tax reform call for either a radical revamping and purifying of the present federal income tax system, a la William Simon's *Blueprints*, or else more of the paper clip and cellophane tape tax tinkering that has characterized tax legislation since 1964. The former does not seem likely. Given the latter, I suggest that the Alternative Consumption Tax (ACT) might well be the approach to take. That, in addition to the more liberal capital cost recovery and marginal rate reductions of the 1981 tax legislation, plus more effective administration, might give us the momentum to make it through the eighties in better style than the prognosticators of stagflation would believe possible.

A Final Thought

More effective administration? Of course. No tax bureaucracy can succeed in administering the U.S. tax structure unless it is given the funds and the congressional support to get the job done. Much of the present public distrust of the federal income tax stems, I am convinced, from congressional unwillingness to provide the IRS with the people, the money, and the legislation to adequately administer existing law. The IRS should be able to get funds if it can demonstrate that there is a net "profit" to the Treasury on each added dollar appropriated. While we have to be sensitive to the dangers of IRS overreaching, there may be even greater dangers in turning IRS into a paper tiger, or a long-shot losing number in "the nation's tax lottery." For if the tax system does not function effectively, then the long-run substitute for what we have had will be the capricious, pernicious, destructive tax that is called inflation.