

Strive for a Sound and Respected Tax System

By Annette Nellen

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Our federal income tax can be modified to better reflect good tax policy and reduce the tax gap. Lasting improvement will require a commitment to stop enacting changes that violate principles of good tax policy or that use the tax law to solve problems that would be better addressed another way. A strong commitment to a sound and respected tax system by Congress, Treasury, and the public, along with modernization of rules, can yield a workable system appropriate for 21st-century ways of living and doing business.

Five proposals are offered for consideration by President Obama's task force on tax reform.

1. Require tax proposals to pass a "tax system soundness" analysis. For too long, our federal tax system has been viewed not only as a revenue source, but as a method for solving almost any problem. This has led to an immensely complicated system, the need for high tax rates and an alternative minimum tax, and growing disrespect for the system. Complexity and disrespect also contribute to the tax gap.

Many of today's deductions and credits were not created to reach an appropriate measure of taxable income, but to encourage certain behavior or to provide relief that may not be appropriate or even needed. Those provisions come with costs and problems:

- Complexity, which increases the tax gap and compliance costs.

- Reduced revenue that must, in effect, be made up by other taxpayers.
- Distortions that can adversely affect the economy and people's lives. For example, homeowners may deduct interest on home equity loans, but not on other personal debt. That rule does more to encourage debt on a residence than to appropriately measure taxable income. Incentives that are too narrowly focused can create economic distortions, such as with the ethanol fuel incentives that have increased corn prices.¹
- Unnecessary rules that are often complex and inequitable. Not everything needs to be encouraged via the tax code or the government. For example, federal tax law encourages homeownership. However, the rules go far beyond that goal by allowing mortgage interest deductions on a vacation home and on debt that exceeds the median U.S. home price.
- Violation of design features. For decades, individuals have either claimed the standard deduction or itemized deductions. In recent years, the integrity of that system has been violated by allowing nonitemizers to claim deductions such as real property taxes. If there is concern that the standard deduction is too small to reflect ability to pay, the deduction should be increased rather than adding selected deductions for some nonitemizers.

A system is needed to require any proposal for a new or expanded deduction or credit to satisfy criteria to help ensure that provisions serve a legitimate and appropriate purpose; do not run counter to existing design features; and meet principles of good tax policy, including equity and simplicity.² An approach similar to the tax complexity analysis created by section 4022 of the Internal Revenue Service Restructuring and Reform Act of 1998 — but with more authority — should be required of tax proposals.

¹See Congressional Budget Office, "The Impact of Ethanol Use on Food Prices and Greenhouse-Gas Emissions" (Apr. 2009).

²Various formulations of those principles can be found at Annette Nellen, "Policy Approach to Analyzing Tax Systems" (Apr. 2003).

2. Modernize the tax system by considering trends. Much of our tax system was designed for the industrial era, employees who worked for a single employer, U.S. dominance in world markets, and shorter life spans. An analysis of economic, societal, technological, and environmental trends will help in modernizing our tax system so that it is better aligned with today's ways of living and doing business. For example, rapid technological advancement and greater use of outsourcing and just-in-time practices means that some depreciation lives are too long and that uniform capitalization and other inventory rules may no longer be serving a legitimate purpose.

Changed work patterns and longer lives call for reconsideration of tax rules on retirement and savings plans. An analysis of trends as they relate to existing tax rules should be performed to identify where our tax system needs modernization to support, rather than work against, business and personal welfare and the U.S. economy.

3. Simplify. There are numerous proposals for simplification, such as from the 2001 Joint Committee on Taxation study³ and from the American Institute of Certified Public Accountants and the American Bar Association. Those proposals should be acted on. Also, the number of special provisions should be reduced, replacing them with lower tax rates. That should also reduce the tax gap. The tax system soundness analysis suggested above would help identify existing provisions that should be repealed.

4. Address the tax gap with an appropriate overall plan. Recent efforts to address the tax gap, such as requiring basis reporting by securities dealers, are good steps, but they avoid the larger aspects of the tax gap such as the 20 percent that is attributable to sole proprietors.⁴ There are many proposals from the Government Accountability Office and others on how to reduce the tax gap. Action must be taken through a comprehensive plan that

³See Joint Committee on Taxation, "Study of the Overall State of the Federal Tax System and Recommendations for Simplification," JCS-3-01 (Apr. 2001).

⁴See Government Accountability Office, "Using Data From the Internal Revenue Service's National Research Program to Identify Potential Opportunities to Reduce the Tax Gap," GAO-07-423R (Mar. 15, 2007), estimating a nonfarm sole proprietor gap of \$68 billion and a total gap of \$345 billion.

addresses the key causes of the tax gap rather than through a piecemeal approach that results in the enactment of proposals designed to hit a revenue target.

5. Stop studying and act. Our tax system has been the subject of many studies by government agencies, academics, think tanks, and federal tax reform commissions. Many of those reports describe weaknesses of the federal tax system and offer proposals for improvement. The reports address complexity, the tax gap, depreciation, penalties, global competitiveness, corporate integration, worker classification, and more. The most comprehensive and objective of them should be reviewed and used by the task force. Rather than continually studying the tax system, it is time to improve it. ■