

Political Will Can Shore Up Tax Administration, Enact Reform

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There are two major problems with the state of the U.S. tax system: the law on its face and the law as applied. Much attention has been paid over the years to the first problem, generally without much to show for it in the way of improvement (although the Tax Reform Act of 1986 could be viewed as a change for the better). Too little attention has been paid to the second problem. As a result, the applied law is a tax system unto itself, bearing only passing resemblance to the rules Congress believes it has enacted.

If there is a shared desire to raise more tax revenue, and if amelioration of the tax system is really a goal of policymakers, the first step should be to shore up tax administration. That means restoring that function to its rightful place at the heart of our country's affairs. Specifically, the Obama administration should be seeking to improve morale and performance at the IRS, an agency that politicians of all stripes have found convenient to vilify for more than 30 years. That is tantamount to national suicide. The agency needs more support in every form — funds for operations; training for specialists; technical supervision at the management level; and encouragement from the political class, up to and including President Obama. It would not be a bad idea, in fact, for the president to make an appearance at the IRS to acknowledge clearly and forcefully that its employees are performing a valuable public service and to tell them their efforts are appreciated.

It also would make sense to recruit more skilled and experienced personnel in every corner of the agency, not only in Washington; to ensure that employees receive regular training and encouragement to improve their capabilities; and to give them enough time to perform their duties. Rushing through examinations of large-business taxpayers is senseless, as is thinking of taxpayers as customers and neglecting the basic law enforcement function inherent in tax administration. Doubtless many other steps could be taken to improve tax administration, and it would be worthwhile to survey IRS employees and others with detailed knowledge of the agency for the purpose of collecting and developing more ideas.

The preceding recommendations assume no change in substantive tax law.

The substantive tax law, however, is a major part of the tax administration problem. The rules are too complex to be understood by most people, including those charged with administering them; too concerned with policies peripheral to raising revenue, the true function of the tax system; too redundant in their penalty and other compliance-securing provisions; and too generous to high-income taxpayers and business interests. Beneficial changes in the rules are not hard to either imagine or develop. What is and has been lacking is not ideas, but political will.

It would be an excellent idea to remove millions of taxpayers from the tax rolls by adopting a VAT and limiting application of the individual income tax to incomes above a specified level. That idea has been proposed by Yale Law School Prof. Michael Graetz, and it is a good starting point for a policy of depending less on the income tax as the source of our tax revenue. If we depend less on the income tax, the inherent flaws in that tax will have less importance.

In the area of cross-border taxation, it is time to rethink the inbound rules. The ones in place were developed in 1966 and have changed little in the 43 years since. Does anyone think the United States stands in the same position today as it did in 1966? There should be more effective limits on stripping the U.S. tax base, clear rules — better meshing with the U.S. tax treaty network — on the taxation of foreign persons doing business in

the United States, and more attention paid to the foreign taxpayer generally. Foreign taxpayers are now happily eating the U.S. lunch.

Insofar as outbound taxation is concerned, the rules of the foreign tax credit should be streamlined and a partial exemption system installed. The credit system costs more than total exemption and lends itself to abuse. A direct challenge to deferral is less important, despite the notoriety of that issue. Exemption should be used for income from true business activity in countries with normal and serious tax systems, the countries where most U.S. foreign investment is situated.

Finally, the rules for low- and no-tax jurisdictions (tax havens) should be different from those applicable generally, insofar as transfer pricing, deferral, and the credit and exemption rules are concerned. The United States ties its hands when it relies on rules that equate France with the Cayman Islands, as the rules in place now do. Adoption of a partial exemption system should be accompanied by rules requiring full current taxation of income earned in the tax havens. The United States should discard the belief that there is no harm to U.S. interests in a lower foreign tax paid by affiliates of U.S. multinational companies. That is not true, because low foreign taxes suck investment from the United States. ■