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TAX: FUNDAMENTALS IN ADVANCE OF REFORM

HEARING

BEFORE THE

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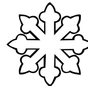
UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

APRIL 15, 2008



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TAX: FUNDAMENTALS IN ADVANCE OF REFORM

TUESDAY, APRIL 15, 2008

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Bingaman, Kerry, Wyden, Salazar, Hatch, Snowe, and Bunning.

Also present: Democratic staff: Bill Dauster, Deputy Staff Director and General Counsel; Cathy Koch, Senior Advisor, Tax and Economics; Tiffany Smith, Tax Counsel; and Tom Louthan, Detailee. Republican staff: Mark Prater, Deputy Chief of Staff and Chief Tax Counsel; and Ellen McCarthy, Tax Counsel.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The hearing will come to order.

Albert Einstein said, “The hardest thing in the world to understand is the income tax.” Regrettably, the tax code has not gotten any easier. Even so, every year the government requires pretty much everyone in the country to take a test. We have to take a test on that hardest thing in the world. The government requires us all to complete that test by April 15.

So this April 15 we thought that it was high time we started talking again about how to make taxes easier. Another reason to start thinking about tax reform is the year 2010. Significant sections of the tax code expire at the end of 2010. The law that has been in place since 2001 will no longer be the law. It will revert back to the law before 2001. Pretty much nobody wants the law to swing back to pre-2001 law in its entirety, so that is another reason to start talking again about tax reform.

Tax reform sounds simple because it is two little words, but those two little words can represent a huge task for Congress. It is a task that requires a lot of cooperation and a lot of working together.

Today we will start to address that daunting task. We will start by discussing our current system. We will discuss what has led to the current complexity. Justice Felix Frankfurter wrote, “A tax can be a means for raising revenue or a device for regulating conduct, or both.” Congress clearly has chosen both. Congress has often cho-

sen to use the tax code to implement social and economic policy, and doing so has led to complexity.

We will discuss how Congress has used the tax code for social policy. The tax code has multiple provisions to encourage people to do one thing or another. For example, you get a charitable deduction for donations because Congress wants to encourage donations. The tax code also has a tax deduction for mortgage interest and real property taxes because Congress wants to encourage home ownership.

We will discuss how our Congress has used the tax code for economic policy. A recent example of this is the economic stimulus package that Congress passed in February. In that case, Congress used the tax code to give a boost to a sagging economy.

The last time the Congress reformed the tax code from top to bottom was 1986. That year we enacted a comprehensive reform bill that was meant to set us on a stable course. Since then, however, Congress has passed tax bill after tax bill, and that has caused confusion and complexity for taxpayers and the IRS alike.

As a result, some folks state that tax reform is like mowing the lawn: you have to do it pretty regularly because it keeps growing back. Pretty clearly, it is time to get out the lawn mower.

So let us try to make it so it does not take an Einstein to fill out a tax form. Let us see what it would take to get tax law back to being mostly a means for raising revenue rather than mostly a device for regulating conduct. Let us start the process of making tax law a little easier, because wouldn't it be nice some April 15th not to be subjected to the hardest thing in the world?

I might say, because I have to leave pretty quickly as a conferee on the farm bill and meeting with Chairman Rangel to find a way to raise revenue to pay for the tax title, I will not be able to be here for most of the hearing. But I want to say to everyone here just how important I think this endeavor is.

I am committed to do all we possibly can in this committee this year to set the stage for significant tax reform in 2009. We are going to begin with, it is kind of like a graduate course in the tax code. It is kind of like spring training before we get into the regular season, which will be next year.

That is, I believe that virtually no one in the Congress has a sufficient grasp of the code to know whether a proposed amendment or bill is really a good or a bad idea with any kind of framework, because I do not think there is much of a framework. There is a kind of a framework in a tax bill, but not a lot. So an early part of these hearings will be kind of like that, a kind of graduate school in tax law, a kind of refresher course, a kind of spring training so we have a better idea of what we are doing.

Then after that, I would like to reform the code in various ways, with social policy, economic policy, and whatnot, with some emphasis looking at the 1986 provisions—did they work, did they not work, was that a good idea or not, and the degree to which moving off of 1986 has or has not caused a problem.

I do not begin this endeavor with any preconceived notions, any bias, any belief as to what kind of code we should have. I just think that the code is so creaky, it is so top-heavy, that fairly soon it is going to fall of its own weight. That is a bad analogy, just like

asset bubbles. We all know the bubble is going to burst sometime but we do not know when. I am not saying that this is an asset bubble, but some kind of complexity bubble that at one point is going to burst, and you do not know when. But I think it is important to start earlier rather than later.

As I also said, whoever is elected President is going to have to make major recommendations to the Congress and the country, because the expiration of the 2001 tax law, the expiration of the 2003 tax law, Federal and State taxes being zeroed in 2010, it is sort of a train wreck that is going to meet in 2010. The AMT, the 1,000-pound gorilla, is going to be a 10,000-pound gorilla by 2010. So, whoever is President is going to have to make a huge, significant recommendation to Congress in his or her budget submission in January or February of '09 that contemplates changes in the code. So, we have to address it for that reason as well.

I am not above looking at consumption taxes, flat taxes, all kinds of different regimes. I think we should also be aggressively looking at American competitiveness, and how is our tax code helping or hurting American companies versus the competition. But, as I said at the outset, this is a serious endeavor. This is not just a bunch of hearings on tax reform because everybody thinks the tax code is complex. Rather, this is an effort to do something very significant so that this committee can make a significant recommendation in 2009 and make a major contribution in 2009, which I think the people who elect us really want.*

I would like, now, to introduce the panel.

Senator SALAZAR. Mr. Chairman?

The CHAIRMAN. Yes?

Senator SALAZAR. May I just say a quick comment?

The CHAIRMAN. Yes.

Senator SALAZAR. One is, I know that you have to leave this hearing to go and continue the work on the farm bill. I just want to say thank you for all the great work that you have been doing in trying to get the farm bill pushed across the finish line. I think with your efforts this morning, we frankly will be in a position where we are getting closer and closer and closer, and I just wanted to say thank you for doing that. Thank you also for this hearing this morning.

The CHAIRMAN. You are very welcome. Thank you, Senator.

I would now like to introduce the panel. The first witness is Daniel Shaviro, professor at New York University's law school. I might say parenthetically, when I was a lawyer at the Securities and Exchange Commission, I thought I would get an advanced degree in tax and I looked at New York to get a Master's degree in tax. I started that for a while, but I thought, no, it is a little too much. I cannot do it all. So, I have a soft spot for New York University.

The second witness is Michael Graetz, professor at Yale University's law school. Welcome back, Professor Graetz. Then we have Jason Furman, who is director of The Hamilton Project at the Brookings Institution. Thanks. Welcome back again, Jason. And

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*For more information, *see also,* "Overview of the Federal Tax System as in Effect for 2008," Joint Committee on Taxation staff report, April 14, 2008 (JCX–32–08), *http://www.jct.gov/publications.html?func=startdown&id=1308.*

Dr. Robert Carroll, vice president for economic policy, The Tax Foundation.

Thank you all for coming. As you all know, we ask you to summarize your testimony in 5 minutes, and your statements will automatically be included in the record.

Professor Shaviro, you are first.

STATEMENT OF DR. DANIEL N. SHAVIRO, WAYNE PERRY PROFESSOR OF TAXATION, NEW YORK UNIVERSITY SCHOOL OF LAW, NEW YORK, NY

Professor SHAVIRO. Well, thanks. Good morning, Mr. Chairman, members of the committee. Thanks for the opportunity to testify on alternatives for comprehensive U.S. Federal income tax reform.

Now, I was asked to offer a bit of background on two questions: one is, why we have an income tax, and the other is to say something about the rate differentials for dividends and capital gains. So I will start with both of those issues, and then I will go on to other main features of my testimony.

In terms of why we have an income tax, it is kind of a historical question. If you go back to when the decision was made, it was considered to be a fair and more progressive system, and it was something you would collect from individuals, not just from businesses, which meant you could have graduated, or differentiated, rates.

Now, in fact, there are answers for consumption tax proponents to all those things today. Essentially an income tax is considered a better annual measure and a consumption tax a better long-term measure. Also, it is now known you really can collect the consumption tax from individuals. So, I think that is an option that merits consideration, but I realize it is not really at the—I got the sense, for example, from what happened at the Tax Reform Panel a couple of years ago, that policymakers are not really convinced of this point, so I think we are probably in an income tax world.

One thing I will say is, very often being halfway between the two poles is worse than being in either system. You have some assets being treated like income tax, others like consumption tax. You create distortions, and that is not very good for efficiency. The other big problem is having kind of consumption tax treatment on the income side, but income tax treatment of deducting interest on the borrowing side. That can be pretty bad. So it can be a real mess to be between the two systems rather than in one or the other, and that is an important design feature to keep in mind.

About the expiring 15-percent rate for dividends, just very quickly, I want to say that there is a pretty widespread academic consensus that double taxation of equity-financed corporate investment does not really make a lot of sense, but there is a lot less consensus about whether a shareholder-level low rate is the right way to address it.

A few things to keep in mind. One is, you kind of want to be confident you are collecting tax effectively at the corporate level. The second point is that the debt-equity distinction, which is preserved when you have a low rate for dividends rather than attempting corporate integration by some other means, makes very little sense. Financial engineers can kind of get whatever financial features they want and call the instrument whatever they want. Increas-

ingly in today's world, the choice between debt and equity for the sophisticated players is really just a way of deciding whether you want to pay tax at the company's marginal rate or your own. It does not really make sense to create that type of election in our system.

A further thing is, I think both sides of the aisle have at times expressed interest in lowering corporate rates due to international tax competition for tax base for both investment and for what people report as income. If that is done, then you need to think about the owner level rather than the entity level as the place to address distributional concerns.

So I think it is important to distinguish the question of corporate integration, for which there is widespread support, from the particular way of doing it through a low rate for dividends.

On capital gains, although it is an ancient debate, I am not going to end it here today. There are a lot of arguments for it that I personally feel—and I can elaborate—do not make a lot of sense, but it is certainly clear that the revenue tends to disappear from raising the rate a lot faster for capital gains than for ordinary income. That is an important design feature one has to keep in mind.

So even 10, 15 years ago when the Democrats and the Republicans were battling about what capital gains rate would raise the most revenue, they really were not that far apart. It was kind of below some rates we would consider for individual income.

Turning to the main themes of my testimony, they are basically threefold. The first thing is that tax reform is all about base broadening, about a broader base and lower rates. Issues of distribution and issues of how much money we want to raise are really distinct because tax reform base broadening makes sense no matter what you think of those things.

This is why, in 1986, the Democrats and Republicans were able to agree about a tax reform that was designed to be revenue- and distribution-neutral, because they figured, even if we disagree about any of these other issues, it is just obvious that you get big benefits, big social and economic efficiency benefits and perceived fairness benefits from having a broader base and lower rates to do the same thing.

Now, there are some very popular items on the individual side that this involves addressing, but they do not have to be repealed in order to address them. There are kinder, gentler ways, if you will, of getting those done, and I discuss that in my testimony.

The final two points I want to make, as I see my 5 minutes is vanishing fast——

The CHAIRMAN. You could take one or two more.

Professor SHAVIRO. All right. Thank you.

One point is that the way we tax business enterprises is messed up in a lot of ways, and there are a lot of big problems that need to be addressed. One thing I would point to is the big book-tax gap: that companies tend to report high financial accounting income to the SEC and low taxable income to the IRS. It does not mean they are cheating, it means they are using the rules to their advantage. But when that is going on, it tells you that, kind of, something is wrong on the financial reporting side and/or on the taxable income side.

By the taxable income side, I mean taking advantage of tax planning opportunities that no one really intended and that may not be very desirable. I have suggested a partial adjustment between the two, which was done in 1986 in the Alternative Minimum Tax as a way of addressing that. But I think whether that proposal were done or not, it is something that needs to be looked at.

The second point I want to make is about corporate integration. The system is kind of not in equipoise right now. I think the debt-equity distinction is just fun and games for financial planners to decide how they want to strip out income and where they want to pay the tax, at what rate. That is not really good policy and certainly needs to be addressed.

Also, the U.S. rules for outbound investment by U.S. multinationals are pretty messed up. People are well aware that the two classic approaches are exemption and full worldwide taxation. We have kind of managed to be in the middle, with a set of rules that is really probably worse than either, and that raises very little revenue relative to its complexity. So, I think the international area is well worth addressing.

Finally, on April 15th, having gone through my own Turbo Tax nightmare—nightmare would be overstating it, but it was not enormously fun—I think this is a good day to keep in mind how easy it would be to ease the burdens on lower- and middle-class taxpayers because there is so much needless complexity and anxiety associated with the system. There are a lot of ideas out there.

My colleague, Michael Graetz, has one idea to take people off the rolls. Joe Bankman of Stanford Law School experimented with something in California called Ready Return, which would make things easier. There are also a lot of other proposals out there. There just actually are a lot of ways to make life easier for low- and middle-class taxpayers in a revenue-neutral way that will really make them better off, and no one worse off. I think that is something the Congress really ought to look at. Thanks.

The CHAIRMAN. Thank you, Professor. I note with some interest that a tax professor at a prestigious law school uses Turbo Tax to figure out his tax returns.

[The prepared statement of Professor Shaviro appears in the appendix.]

The CHAIRMAN. Next is Michael Graetz, professor at Yale University law school.

Professor Graetz?

STATEMENT OF DR. MICHAEL GRAETZ, JUSTUS S. HOTCHKISS PROFESSOR OF LAW, YALE LAW SCHOOL, NEW HAVEN, CT

Professor GRAETZ. Thank you, Mr. Chairman. If we are in the confession mode, I should confess that I filed my extension request yesterday with the help of my accountant. I could tell you more about that, but I do not want to use my 5 minutes for that.

Thank you for inviting me to talk about this difficult subject. I want to remark that I began working off and on with this committee almost 40 years ago, and this committee has a tremendous history of bipartisanship. I think it is very important that tax reform proceed on a bipartisan basis. I want to compliment you and the members for beginning this process today.

As you said, Mr. Chairman, our tax system is badly broken. No one quarrels with that. You mentioned the train wreck coming in 2010 and the complexity of the system. I want to mention three other reasons that I believe it is broken. The first is that, although the U.S. is a low-tax country compared to the rest of the world, we are not a low income tax country. Our income tax is comparable to those around the world. The difference is that we fail to tax consumption.

All of the low-tax countries of the world—Ireland, Hong Kong, Eastern Europe—all of them manage to achieve low income taxes by taxing consumption, and all of them do it in the same way, which is through what they call a value added tax, or what Canada calls a goods and services tax. So, I think we need to think about taking better advantage of our low-tax status.

The CHAIRMAN. Mr. Graetz, I regret I have to leave. I have asked Senator Bingaman to chair this hearing.

Professor GRAETZ. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Professor GRAETZ. Second, there is an issue of the adequacy of revenues. I do not believe that is a short-term problem. But for the long term, we need a system that will raise revenues in a way that is conducive to economic growth and promotes American workers and businesses to be competitive in our international environment.

Third, I want to mention what I describe as the "chicken soup" problem, which is that the Congress, Presidents, political candidates, and presidential candidates as well, all use the tax system the way my mother used chicken soup, which is as a cure-all for whatever ails society or the economy at the given moment. One could cite the higher education provisions of the code, one could cite the health insurance provisions of the code, proposals for dealing with long-term care, and the recent legislation on housing.

The one thing that is clear is that these provisions are a lot like putting a Band-Aid on cancer: they really do not work. We need to find a way to get the Congress and get the country out of the business of relying on income tax provisions this way.

After a lot of study, I have concluded that the only way to do that is to get most people out of the income tax and to return the income tax to the system that we had before the second World War, when the income tax was a small tax on relatively high-income taxpayers and the masses were not burdened by it, but instead paid consumption taxes—at that time in the form of tariffs. But now we have much better forms of consumption taxes around the world.

I do want to endorse Professor Shaviro's point about distributional and revenue neutrality. Those were important constraints in 1986, and I think it would be useful for this committee to look at proposals on that basis.

Which brings me to tax reform alternatives. There are a number of alternatives. I talk about them in my statement. I apologize to the committee that my statement was so long; to paraphrase Justice Holmes, if I had had more time it would have been shorter. [Laughter.]

But I do discuss the alternatives in my statement, and I discuss them in a recent book that I think I have sent to most members

of the committee and to many of the staff, but, if anybody wants a copy, I am happy to send more.

The basic point is that there are really two directions that have been proposed for tax reform. One is income tax reform. Senator Wyden and Congressman Emanuel on the House side have an important proposal. The President's Commission actually had an important proposal. There are very good things in both of those proposals, and there are also very controversial things in both of those proposals.

I have to say that I have become convinced over the years, having watched the 1986 Act unravel, that, while Senator Wyden is correct when he describes his bill as a good cleansing of the Internal Revenue Code, it will get rapidly dirty once again, and probably quicker than the last time. So, I am not optimistic about reforming the system and creating return-free income taxes or the like.

Let me say something about the consumption tax alternatives which I describe in my statement. I think some of them are simply political documents; I regard the flat tax and the fair tax much that way. In any event, they both would redistribute the tax burden from very high-income taxpayers down the income scale and, given the inequality of wealth and income in the United States, this seems an odd time for us to do that. The retail sales tax at a 30-percent level, which is the fair tax proposal, is unheard of anywhere in the world, and I believe it cannot be collected.

Most of these proposals, including the President's Panel's Growth and Investment Tax, as they called it, which was a hybrid between—I will say this and it is a technical term—a subtraction-method value added tax and a tax on capital income, are untested in the world. More importantly these consumption tax alternatives do not fit well with international arrangements.

The President's Panel admitted that, not only would its proposal have to go through Congress and be signed by a President, but we would have to renegotiate the general agreement on trade and tariffs and all 86 of our bilateral income tax treaties. In my view this is not realistic. We need to have a system that fits well with international arrangements.

Now, I see my time is basically up. Let me say just two more things. First is, I think the corporate tax has become very different today in the global economy than it was in the past. There is a lot of economic evidence that it is being paid largely by workers, not by owners of capital, because workers cannot move the way that capital does in the modern economy.

I think that we are disadvantaging ourselves in many ways, which I am happy to talk about, by having high nominal corporate rates. Not only do we make the U.S. a less-good place for corporate investments by both domestic and foreign suppliers of capital, but we also create a great incentive for shifting deductions to the U.S. and income elsewhere, even if you do not move any plant or equipment. So, we are bearing the burden of low rates around the world that we do not have ourselves.

Finally, as many of you know, and as I hope I will get a chance to testify as the committee really considers serious alternatives, I have advanced a plan myself, in this book and elsewhere, for enacting a value added tax, and for using it to create a $100,000 exemp-

tion from the income tax, to remove 150 million people from the income tax altogether, to have a low-rate income tax above $100,000 at a 20- to 25-percent rate, and to have a corporate rate of 15 to 20 percent, and I have suggested payroll tax offsets and debit cards—I called them Smart Cards, but I have learned since they are debit cards—as a way of delivering things like the Earned Income Tax Credit which are now delivered through the income tax.

So with that I will stop, but I do want to conclude just by saying that, if my proposal were enacted today, April 15th, for 150 million Americans, would be just another spring day.

Senator BINGAMAN. Thank you very much.

[The prepared statement of Professor Graetz appears in the appendix.]

Senator BINGAMAN. Dr. Furman, go right ahead.

STATEMENT OF DR. JASON FURMAN, DIRECTOR, THE HAMILTON PROJECT, BROOKINGS INSTITUTION, WASHINGTON, DC

Dr. FURMAN. Sure. Thank you for inviting me to testify at this hearing. In my remarks, I want to focus on one fundamental reform issue which I think illuminates a lot of issues in tax reform, and that is the concept of tax neutrality.

The basic concept is simple. Generally the tax system should strive to be neutral so that people are making decisions on the merits and not for tax reasons. In some cases this neutrality is impossible and policymakers have to accept a certain level of distortion to behavior as inevitable. In other cases neutrality may be undesirable if policymakers intend to promote specific goals like contributions to charity, health insurance, or discouraging specific activities like smoking or the emission of carbon.

Tax neutrality is the motivation for the canonical tax reform, broadening the base and lowering the rates. Both halves of that tax reform make the code more neutral about the choice between different activities and the choice between working and not working.

The tax base is narrowed substantially due to tax expenditures. In the last budget, the Treasury listed a total of $987 billion of tax expenditures. If, for example, half of these were eliminated, it would be enough to permit a 32-percent reduction in all individual and corporate income tax rates. A few specific proposals have been made that embody these basic principles, including Senator Ron Wyden and Congressman Rahm Emanuel's Fair Flat Tax Act.

In some cases, however, the code is deliberately non-neutral in order to encourage desired activities like home ownership, a college education, or health insurance. In many of these cases these are worthwhile goals, but to accept tax expenditures is not to defend how they are presently structured. For years, tax analysts of widely differing philosophies have written about the benefit of shifting tax expenditures from deductions to uniform refundable credits.

A deduction of $1 is worth 35 cents to someone in the 35-percent marginal tax bracket, and only 15 cents to someone in the 15-percent bracket. A uniform credit, by contrast, provides the same tax subsidy regardless of one's tax bracket, and a refundable credit provides that subsidy even if the credit exceeds one's tax liability.

For years people have thought of credits in terms of fairness, but I think the more fundamental issue is economic efficiency. For example, we spend about $200 billion annually on tax expenditures for health care that are larger than they need to be to encourage high-income people to purchase health insurance, but not nearly large enough for low-income households, leaving tens of millions uninsured, all while providing an inefficient subsidy to spend more on more generous health insurance.

Converting the exclusion to a progressive tax credit can provide more of an incentive to purchase insurance, especially for households with lower incomes, but also make the tax code more neutral vis-à-vis purchasing more generous health insurance plans. Reforming this tax expenditure could be a useful part of broader health reform, as the Healthy Americans Act introduced by Senators Ron Wyden and Bob Bennett does.

I now want to turn to how the concept of neutrality can apply to thinking about the taxation of capital income, and in particular, corporate income. Lately, significant attention has been focused on the fact that the United States now has the second-highest corporate tax rate in the world. Less attention has been focused on the fact that the United States also has the fourth-lowest corporate revenue collections of any OECD country measured as a share of the economy.

The reason for this, according to a report by the Treasury, is the "narrowness of the U.S. corporate tax base," including accelerated depreciation allowances, special tax breaks, and the general manner of taxing debt that Professor Shaviro discussed.

This narrow tax base manifests itself in substantial and very inefficient non-neutralities in the way capital is taxed. The overall tax rate on capital income is 14 percent, but debt-financed corporate investment is taxed at a negative 6-percent rate. That is, debt-financed corporate investment is not taxed, it is subsidized.

In contrast, equity-financed corporate investment is taxed at the corporate and individual rates, and faces a combined rate of 36 percent. There are also large differences in the tax treatment in different forms of housing, corporate and non-corporate businesses, different assets, and whether or not investors are located in the United States or overseas.

Moving towards more neutral taxation of business income need not require increasing the deficit or reducing the overall progressivity of the tax system. There are a number of models policymakers could consider, the most comprehensive being the Business Enterprise Income Tax developed by Ed Kleinbard.

In conclusion, a number of considerations are important in tax reform. The large increase in income inequality provides a rationale for making the tax code more progressive. The tax code could be substantially simpler. And—the topic of my testimony today—the tax code could be more efficient if it were more neutral vis-à-vis different economic activities, and if deviations from neutrality were better designed, for example, by converting deductions to credits and making the taxation of business income more uniform.

Thank you.

Senator BINGAMAN. Thank you very much.

[The prepared statement of Dr. Furman appears in the appendix.]

Senator BINGAMAN. Dr. Carroll?

STATEMENT OF DR. ROBERT CARROLL, VICE PRESIDENT FOR ECONOMIC POLICY, THE TAX FOUNDATION, WASHINGTON, DC

Dr. CARROLL. Thank you very much for the opportunity to speak to the committee on the important issue of tax reform. The economic sluggishness we read about each day in the newspapers and see on the TV has prompted many suggestions of short-term economic fixes, but tax reform remains one of the most important long-term economic challenges.

Without a doubt, the tax system is complex, as the other panelists and Senator Baucus indicated. There are a vast array of provisions, a vast array of exclusions, credits, and deductions that result in enormous complexity for taxpayers filling out their tax returns during the spring filing season.

The Alternative Minimum Tax adds to complexity, and that parallel Alternative Minimum Tax is, in some sense, a poster child for full reform. That is an issue that is only going to get more difficult as time goes on.

The compliance burden of the income tax is roughly about $140 billion annually. That is one of the ways of thinking about the cost of the complexity. But to put it in real terms, often the statistic is that 60 percent of Americans use paid preparers when filling out their returns, and another roughly 25 percent use tax preparation software. Another way to phrase that is to point out that only 1 in 8 Americans still fills out their own tax returns in an unassisted way. So, clearly we have a tax system that is, without a doubt, very complex and needs reform.

I want to focus on a couple of issues in my remarks in summarizing some of the points in the testimony. One, I want to focus on kind of a fundamental choice that proposals to reform the tax system usually face and take on, a fundamental choice of whether the tax system should be based on one that attempts to tax income or attempts to tax consumption.

In a sense, the key difference between consumption-based taxes and income-based taxes is that consumption-based taxes do not tax the returns of savings or investment. In some sense, when someone refers to a consumption-based tax it is, in effect, code. It is a way of speaking in code and pointing to the notion of a tax system that taxes savings and investment more lightly or not at all.

To be clear, our current system is neither an income tax nor a consumption tax. It is an income tax in name only. It is very much a hybrid tax, as some of the other panelists have alluded to. It deviates from income tax principles in important ways, primarily by offering tax-free savings accounts in the forms of IRAs, 401(k)s, and defined benefit plans, and also allowing accelerated depreciation, primarily for equipment. In fact, about 35 percent of household financial assets receive consumption tax treatment according to some estimates, so the current income is very much somewhere in between a pure, comprehensive income tax and a pure, comprehensive consumption tax.

In some sense, one of the benefits of not taxing the return to savings, the key benefit, is it encourages more savings and more investment, which results in more capital formation, increases labor productivity, and results in larger living standards in the long run. In some sense, Congress has kind of made a fairly clear choice not to create a pure income tax system and to provide some rather substantial benefits to lower the tax on the return to savings and investment through the various savings and accelerated depreciation provisions that I mentioned.

A lot of the debate on tax reform focuses on where we ought to be between an income tax and consumption tax, whether we ought to move further towards a consumption tax base or move back towards an income tax base.

A very important element in the discussion is the distribution of the tax burden. It is an empirical fact that a great deal of the capital stock is held by higher-income individuals, and moving to a consumption tax which would relieve the tax on the return to those investments would have significant distributional effects.

Some of the criticisms that Professor Graetz mentioned with regard to the fair tax and the flat tax proposals that have been considered in the past have been on distributional grounds. Consumption-based taxes are often viewed as regressive.

But I think the key point is, and this is embodied in some of the work of the President's Tax Panel several years ago, and also to some extent in the "Competitiveness Report" released by Treasury in December, consumption-based taxes can be progressive. You can have a consumption-based tax with a progressive rate schedule.

Then, more important than that, perhaps, as Dr. Furman mentioned, is that the current tax base is extraordinarily narrow relative to either a comprehensive income base or a comprehensive consumption base. The current tax base is only about 50 percent, 55 percent of a comprehensive income tax base and about 70 percent of a comprehensive consumption tax base. So what that means is that the various special tax provisions, the health exclusion, the housing tax subsidies, the charitable deduction, and the various other provisions, result in a much more narrow tax base.

If one were to move towards a consumption tax base, one could, in fact, address the distributional concerns by limiting those provisions for higher-income taxpayers to address distributional concerns through the definition of the tax base and the limitation of those provisions rather than through higher tax rates or a higher-than-necessary tax on the return to savings and investment.

I wanted to just spend a few seconds on one additional point to really amplify one of the points that Professor Graetz mentioned. Another key element to consider with respect to the U.S. tax system is how it does fit in globally. One thing that I think the committee does need to focus on is the extent to which the U.S. business tax system may be becoming out of line globally, and how this may in the future affect our ability to attract investment and jobs. The Treasury, of course, released a report in December on this subject as a follow-up to Secretary Paulson's July conference.

One metric that analysts often use in comparisons of the U.S. to other countries is the U.S. statutory corporate tax rate. The U.S. now has the second-highest corporate statutory tax rate among

OECD nations, and importantly the world continues to change. We had a very low statutory corporate tax rate relative to the OECD in the late 1980s and the early 1990s.

A series of tax rate reductions among those nations—Ireland, Eastern Europe, and now Germany and France, and some of the larger economies—has resulted in a world where the U.S. is, in fact, perhaps falling behind. What is particularly important is, as the world continues to change, the U.S. is standing still, and that is something that I think deserves some attention.

Thank you.

[The prepared statement of Dr. Carroll appears in the appendix.]

Senator BINGAMAN. Thank you all very much. Thanks for your excellent testimony.

Let me start with a few questions. Dr. Graetz, your suggestion that we could shift to a system where 150 million Americans would not have to pay taxes, as I understand it, would not be subject to the income tax: what has been the push-back against that suggestion? Where do you see the arguments? Are there credible arguments that have been made to oppose your proposal, or is it just too big a change? What are the problems?

Professor GRAETZ. It is a difficult position you put me in, Senator, to announce the objections to my proposal without announcing the advantages.

Senator BINGAMAN. Well, give us a few advantages.

Professor GRAETZ. But I will take the question. I think the advantages of it are that it would be an enormous simplification, that it would put the U.S. in a much better position for economic growth, and it really takes advantage of our low tax status.

The push-back is that, politically, in the United States there has been a great deal of resistance to a value added tax. This was true in Canada for a long time, it was true in Japan for a long time. But today there are 141 countries in the world that have value added taxes. We are the only member of the OECD that does not have a value added tax.

Larry Summers, when he was Secretary of the Treasury, quipped that "Democrats hate a value added tax because they believe it's regressive, and Republicans hate a value added tax because they believe it's a money machine, and when they each understand the other's position they'll both come around."

Now, whether that is true or not, I do not know. But there is some resistance that I have actually tried to take into account in this proposal. For example, if you use a value added tax to buy down the income tax, essentially to return us to the pre-World War II tax system that we had, then that limits its ability to become a money machine. I also spend a chapter in my book detailing how to avoid regressivity of a value added tax.

The final objection, Senator, that I would mention is that, in the 1970s when Richard Nixon was thinking about a value added tax, the Governors of the States said, we tax sales and consumption. That is our tax base, not the Federal tax base. So, I do spend a chapter trying to deal with the issue of State/Federal relationships and so forth.

The States have objected in the past and that has been a barrier, but Canada, I think, has shown very clearly that a Federal level

value added tax, and a provincial level sales tax in Canada, can operate together without difficulty. What my proposal does is, it basically brings us into line with the OECD, closer into line with Europe in terms of our overall tax on sales of goods and services, and makes us into one of the lowest income tax countries in the world. Instead of having 13 percent of our GDP devoted to the income tax, we would have about 4.5 percent.

Senator BINGAMAN. Mr. Shaviro, let me ask you. I know we are talking about all of the tax structure here in this hearing, but, if you just take the corporate tax and try to think of replacing the corporate income tax with something like a value added tax or a corporate activity tax, would it make sense? I mean, even if we could not get consensus as to moving in that direction with regard to individual income taxes, to do something on the corporate side that would get us out of an income tax and shift that to a corporate activity tax or a value added tax, or whatever?

Professor SHAVIRO. The real problem is, if you have an income tax at the individual level and you do not tax corporations on an income basis, then corporations in effect become a tax shelter for avoiding the current income tax. If you have a consumption tax through and through—and I am not saying that we are going to get there—then that is not a problem because, in effect, that is sort of the intended working.

You do not want really to have an income tax that applies unless you keep the money in corporate solution. That is the one problem, is integrating that. I think actually I personally might be willing, if I were the decider, to go towards a comprehensive progressive consumption tax, but even within a purely income tax world, I think a lot can be done to reform it even without making it less of an income tax.

Senator BINGAMAN. All right. My time is up.

Senator Bunning?

Senator BUNNING. Thank you, Mr. Chairman.

I would like to ask each of you about our business tax system, and in particular the corporate income tax. In the view of most observers, businesses pay business taxes, we do not. But some of you say that that is not the case. You say that, because of the increased mobility of capital, businesses are able to shift the burden of the U.S. corporate income tax to U.S. workers who pay it in the form of lower wages. Can each of you elaborate on this and explain why it might be important to this committee?

Professor SHAVIRO. Well, it is inherently true that only people can pay taxes. Businesses are owned by people, and it could be that the people owning the businesses pay the taxes. There are 40 or 50 years of economics literature trying to figure out which people really bear the corporate tax. At one time the wisdom was, it was mainly the owners not only of corporate stock but of capital generally.

As Professor Graetz alluded to, there is research suggesting that it is more borne by workers today. The basic mechanism is that corporations can more easily shift their investment from one country to another in a much more global world. So the fact, in terms of the chairman talking about an economic seminar or something, if there are two parties and there is a tax, and one of them can

run away and the other one cannot, the one who cannot run away is the one who ends up bearing the tax. So that is basically the mechanism for that.

The other point, I think, also made by Professor Graetz, is that even if the company stays in the U.S. it can kind of shift all of its taxable income abroad by playing games with paper, and that is not tremendously good news for the U.S. Treasury or taxpayers.

Senator BUNNING. Professor Graetz?

Professor GRAETZ. I do not have much to add to what Professor Shaviro said, except agreement. Paul O'Neill, when he was Secretary of Treasury, was fond of saying corporations do not pay taxes, they collect taxes. So the question is, who are they collecting the taxes from? There are really three possibilities: one is that the tax reduces the return to capital; another is that it is increases prices being paid by consumers; and a third is that it lowers the wage rate and is being paid by workers.

As Professor Shaviro said, while it was in dispute always, and no one has ever achieved complete agreement on who pays the corporate tax, the basic understanding until recently was that perhaps owners of capital paid it. If that were true, then it is playing an important role in the distribution of the tax burden because the owners of capital are higher-income and higher-wealth people than workers or consumers, on average, would be. If, in fact, as the new studies are suggesting, much of the tax is borne by labor in the form of lower wages, then the tax itself is not serving the distributional purpose that it might have served in the past because of international flows of capital.

I think it has always been the case that economists and lawyers who have thought about the corporate tax have never thought it is a very good tax. They have felt, as Professor Shaviro said, that, if you are going to tax income at the individual level, not taxing at the corporate level is an invitation simply to shift the income to corporations. So it is not a very good tax, and now it is probably not a progressive tax.

Senator BUNNING. Dr. Furman?

Dr. FURMAN. I agree, analytically, with what Professor Shaviro said. Just to put it in a broader context though, I think it would be an overstatement to say that there is anything resembling a consensus or definitive evidence within the economics profession on how the corporate tax is distributed. There have been one or two studies recently, but they are still in working paper form, for example, and have not been published.

There is a range of other studies with different findings. In recognition of that, the Congressional Budget Office continues to make the assumption that corporate taxes are borne in proportion to ownership of capital. I believe that is the featured assumption that the Treasury uses, for example in the President's Federal Panel on Tax Reform. Dr. Carroll can correct me if I am wrong.

I am not saying that is the right treatment, I am just saying there is a substantial amount of uncertainty as to what fraction is borne by capital and what fraction is borne by workers. There is also uncertainty about timing, so it might be that initially it is borne more by owners of capital, and then over time the burden

shifts to workers. We do not need to answer this question, though, if you want to have, for example, a revenue-neutral distribution.

Senator BUNNING. What if we want to change it? We do.

Dr. FURMAN. If you want to do what Secretary Paulson outlined and what Chairman Rangel outlined, both of whom had revenue-neutral corporate tax reforms, in a sense, regardless of what you assume about the distribution, that you are raising the same amount of corporate revenue in a more efficient manner, it is going to be distributed the same way.

Senator BUNNING. Dr. Carroll?

Dr. CARROLL. Yes. The literature on the incidence of the corporate income taxes is very interesting. It has always been uncertain, as the other panelists have indicated. It dates back to kind of a seminal piece in 1962 by Arnold Harberger that basically the profession kind of reached the conclusion back in the 1960s that the corporate income taxes are reasonably probably borne by owners of capital.

But interestingly, as early as the late 1980s, even Arnold Harberger had come forward with some work suggesting that in an open economy framework, in which we very much live today and in an increasingly global open economy, the corporate income tax is much more likely borne, in significant portion, by labor. He actually made the case that perhaps more than 100 percent of the corporate income tax could be borne by labor in the late 1980s and in the 1990s.

What is particularly powerful is this more recent literature that draws on the experience of corporate rate reductions among OECD nations over the last 2 decades, and finds that those countries that have lowered corporate tax rates the most have had the largest increase in manufacturing wages, which is highly suggestive of a linkage between taxes and corporate taxes and wages, and suggestive of the notion that a significant portion of the corporate income tax is borne by labor.

A researcher at the Congressional Budget Office put out a working paper a couple of years ago, in 2006, I believe, where, in a more theoretical model, that paper kind of broadly suggested that a reasonable assumption might be that 70 percent of the corporate income tax is borne by labor.

The work at Treasury, which I could speak to to some extent, although I am no longer with Treasury, has also evolved. It used to be very traditional for Treasury to produce distribution tables assuming that the owners, that the corporate income tax is borne by owners of capital. When we did the work when I was there on the President's Tax Panel, we decided to supplement the traditional analysis with a set of tables that included an alternative incidence assumption that assumed that some of the corporate income tax is borne by labor, really pretty much in recognition of some of the more recent work in the academic world.

More recently in the "Competitiveness Report" issued in December, we had a more detailed analysis that assumed that a significant portion of the corporate income tax would be borne by labor. I think it is fair to say that, as time goes on, the profession is thinking that it is quite likely because labor tends to be a lot less

mobile internationally than capital, that a sizeable share of the corporate income tax is borne by labor.

After going through all that, why does this matter? It probably does not matter a great deal when one is comparing a reform, a revenue-neutral reform of the corporate income tax that involves a base broadening and lower corporate tax rates, for example. But it does make a difference when one is comparing a reform that replaces the corporate income tax with a value added tax. In that type of proposal, it does make a difference. Some of the results in that regard are reported in the Treasury's December report.

Senator BUNNING. Thank you.

Senator BINGAMAN. Thank you.

Senator Wyden?

Senator WYDEN. Thank you, Mr. Chairman.

All of you have been excellent, and I have questions for each of you.

In our Fair Flat Tax legislation, Congressman Emanuel and I have put out a 1-page 1040 form. We sent it over as part of an article to the people at *Money* magazine, and they used our 1-page 1040 form and they filled their taxes out in, like, 15, 20 minutes.

Now, I am thinking of what people are going through now and are going to go through until midnight, this mindless, relentless, needless tax torture, where they are just shoveling their way out from under this avalanche of forms.

I have a question about the simplicity issue, and I want to start with you, Professor Shaviro, because I know you were involved in the 1986 legislation.

Congressman Emanuel and I have been at this since 2005, and people generally say, here are a couple of sharp guys, they have a good proposal, but, you know, tax reform is just impossible. It cannot happen. In fact, Bill Bradley always reminds me that tax reform is absolutely impossible until 15 minutes before it actually comes together.

So my first question to you is, given what a difficult task this is in terms of building a bipartisan coalition, would it not make sense to make the touchstone of reform, the starting-off point, simplicity? To be able to tell people, look, we are going to go through a variety of issues, but we are going to start by getting you out from under this unbelievable hassle. I compared it yesterday on the floor to prolonged root canal work. I mean, would it not make sense to start with the simplicity issue? Question for you.

Professor SHAVIRO. I think that is a great place to start because it is something that the public can see. So much of the root canal that they are going through really is not necessary for any policy goal. Whenever we talk about tax reform, it is very difficult politically. There are all these trade-offs. What about the social goals of one proposal or another? So much of that can really be put aside here.

Now, that said, I think you could have simplicity for individuals as a leading edge, although, if it is not losing revenue, it probably means some will pay more and some pay less.

But I think that it is also true that reforming business taxation is very important, and that does become very painful. The public does not see it, but it does have pay-offs in terms of economic effi-

ciency. It is controversial, if only because of the revenue-neutral form. If it is not exactly the same as the law before, then inevitably there are winners and losers. That is kind of less salient, it seems to me, than the first. But they are kind of linked, and I think leading with the first is a very good idea.

Senator WYDEN. Thank you. I will come back to you in a minute.

Professor Graetz, you do such fine work on a variety of issues. I just want to take up one issue that I do not think you and I have talked about. You make a very valid point about how, well, you go forward with tax reform, you "cleanse" the code, as I characterize it, and then you say, but gosh, it is going to get dirty all over again. Your proposal is that the progressive consumption tax is a way to really make reform stick.

My question to you is, as I have looked at this, one of the areas I have been interested in is saying that it is critically important, when you get tax reform, to set in place a new set of procedures so you cannot unravel the work of tax reform. I think there is a lesson to be learned, for example, in what has been done on the spending side with respect to earmarks. It is going to be tougher, for example, to get earmarks in the days ahead.

So what would you think of the idea of, if you get tax reform—and when you get it, if Congressman Emanuel and I have our way—you say, it is going to be accompanied this time by a new set of procedures that make it vastly tougher to go out and rifle-shot all of these tax breaks in once more. As you know, we have had 16,000 tax changes since the last big reform. It comes to three for every working day in the last 20-some years.

I want to make it tougher to do that again when we reform the tax code. For example, you could say that any set of tax changes would have to have a recorded vote, anything other than, say, technical changes. Would that be responsive, at least to some degree, to your point of trying, when you cleanse the code, to actually keep it from getting dirty again?

Professor GRAETZ. Senator Wyden, that is a terrific question. I was involved in negotiations in the 1990 Budget Act, which created procedures that I think, for at least a decade, kept the Federal Government's budget in closer balance. So, I am a believer that procedures matter in these regards. Certainly putting in sunlight and recording votes would help on what you describe as these rifle-shot provisions. I think that that is correct.

But that is not the problem that I have been concerned with of late, having watched the unraveling of the 1986 Act. I should say the first thing I wrote on this subject was intended to be a defense of the income tax and to call for a reform, much like the Wyden-Emanuel reform. I ended up where I did because of the proliferation of general interest provisions.

The education incentives are a perfect example. I was trying to figure out my children's education incentives. There are seven education incentives. There are two different credits; one covers room and board and one does not cover room and board. You cannot draw down out of an education savings account if you take one of the credits. I have tried to teach this to Yale students: you cannot possibly understand these provisions.

The reason is that everybody has a little different idea, but the goal is not a narrow goal. The goal is to lower the cost of higher education for a broad segment of the American people who have faced rising higher education costs that are only second to rising health care costs in the United States. So, there is a real problem. There is a real need, and we have seven tax provisions to deal with it. These were done in sunlight and subject to filibusters. You do not need a reconciliation bill in order to get these things passed. Everybody is for them.

The reason people are for them is that they then claim, well, we have solved the problem of higher education. So my concern, which I really have come around to, is that, if you keep the vast majority of the American people within the income tax, a 1-page form or a postcard form will soon begin to have a whole series of credits and deductions and so forth that are not rifle-shot provisions, but are designed to help people with real problems. I really think this is not a solution, not an approach that has been working for the American people.

Senator WYDEN. My time is up on this round. I want to say, I want to explore this with you further because I think it is possible to do both. I think it is possible to shed the sunlight on the costs of unraveling the code and have a debate on the more general interest kinds of provisions.

Regrettably, that has not happened, even during the Clinton years. I think we will all recall, Bill Clinton talked about reforming the tax system because it had been a long time since 1986, and then he went forward with exactly the kind of general interest provisions that you are talking about, the changes in the tax code. But it really did not become part of a broader debate about what we needed for individuals and businesses in our country, and I think that could happen if we reformed the tax code and made the right kinds of changes in our rules. We are seeing that happen with earmarks on the spending side. The spending side of the budget is really starting to change. It is obviously not going to affect everything; it does not affect entitlements, but it is a start.

I am going to come back to you, Dr. Furman—you have done great work over the years, and you Dr. Carroll, as well—when I get a second round.

Senator BINGAMAN. Let me pick up one of the suggestions that you made, Dr. Furman, the idea that we should eliminate deductions and go to credits. I think you said we should go to uniform refundable credits.

Dr. FURMAN. It depends on the context. In some cases that is appropriate, in other cases it is not.

Senator BINGAMAN. Let me just ask some of the other panelists if you agree that, as a general matter, it would be a good practice for us to shift from deductions to credits. To the extent that we are going to try to favor a particular activity, to the extent that we are going to write these rifle shots into the tax code, would it make sense to say that, as a general matter, we ought to do it by the enactment of credits rather than the enactment of deductions? Dr. Carroll, do you have a point of view on that?

Dr. CARROLL. Yes. I guess I have always been intrigued by the notion of replacing some of the deductions with credits. I would

point to really two areas. The housing tax subsidies in the code and the health care area, as well as the employee exclusion for employer-provided health insurance, are two areas where that approach might make sense. I would make two points. One, by converting those provisions to credits, it redirects and rechannels the benefits that underlie those subsidies a great deal. So, if one wanted to maintain distributional balance in a broad proposal, one would need to consider what to do.

As you reduce the benefits going to higher-income individuals, when you convert those deductions into credits, do you then lower tax rates for higher-income individuals, flattening the rate schedule, which would, in and of itself, provide some economic benefits by removing or reducing the distortionary effect of taxes? So that is one consideration: how does one think about distributional balance in that context?

But the other point is, I think, fundamentally, those provisions are designed to increase home ownership and provide assistance to those who are purchasing health care. In the current tax code, the current tax treatment is such that the housing tax subsidies, in large part, encourage individuals to buy larger homes and to basically have a higher degree of leverage when they purchase those larger homes.

In today's economic environment, we probably would not want to suggest that that be curtailed. At a point in time when the housing market was not in distress, it might be appropriate. In fact, when you look at the housing market or if you turn the clock back 3, 4, or 5 years to the early part of the decade, you could equally argue that the tax bias and the business tax system for debt finance might have amplified some of the distress in the business community during the last recession.

On the health care side, it is the same sort of thing, I think, that the current tax provision, the current tax treatment, encourages individuals to purchase more generous policies, more generous health insurance policies. The nature of the provision, the exclusion for employer-provided health insurance, carries with it a number of biases. Reconfiguring that provision in the form of a credit would rechannel the benefits to lower-income individuals who are much more likely to be uninsured, so it probably directs the benefits to those who are in more need, and it probably would address a number of important distortions that are introduced from the current tax treatment.

Senator BINGAMAN. Professor Graetz?

Professor GRAETZ. I think it depends on the specific question. For example, I would be inclined to agree with both Dr. Furman and Dr. Carroll on health care and home ownership, although there are lots of dislocations on home ownership. On the other hand, the charitable contribution deduction, I think, is very importantly a deduction and not a credit because I think the elasticity of giving is much more important at the high income levels. I think it has much more bang for the buck in terms of stimulating giving.

The point is, we do not want to tax an amount that has been diverted to charity as if it were consumed by, or income of the individual who gave it. The way to do that is through a deduction. I would say the same thing about the current benefits for pensions,

IRAs, and 401(k)s. I think when you are eliminating barriers that the income tax may create for a particular kind of activity, sometimes deductions make sense.

Accelerated depreciation would be another example that I think would be better than the Investment Tax Credit in some circumstances, although probably a mix of the two is appropriate. But I think in general, if you want something that goes to everybody and you want it to go to people who pay no income taxes as well, then a refundable tax credit is the way to deliver it, if you insist—I am going to come back to my conversation with Senator Wyden—on using the tax system as the way to do this.

Senator BINGAMAN. Good.

Senator Bunning?

Senator BUNNING. Thank you very much.

Professor Graetz, this is for you. I would like to ask you about tax, trade, and exchange rates. As you pointed out, many foreign governments are able to rebate taxes on their exports and impose them on our imports. We cannot because of the structure of our corporate income tax and the rules of the WTO. Some economists say this lack of so-called border adjustment is not important because exchange rates will adjust.

But as you point out, that has not happened in the case of China. Would you say that, as a result of China's currency policies that have kept the yuan between 30 percent and 40 percent undervalued, products imported from China are less burdened with tax than domestic products produced here in America?

Professor GRAETZ. Senator Bunning, I think it is fair to say that all economists—I have never met one who does not—agree that currency exchanges will deal with the economic problem from taxing imports and exports, but they do assume that currencies adjust freely. The point that I made in my testimony is that, when you have a very big, bilateral relationship with a country like China that is not allowing its exchange rate to float, then one must take that point with a little skepticism. So, I come to it with a little skepticism.

I want to say one other thing, though, about border adjustments. I think they are extremely important in terms of the compliance with a consumption tax. This was the judgment of the President's Panel. They did not dispute the currency adjustment point, but instead concluded, based on work by David Weisbach at the University of Chicago and others, that you need to have border adjustments in order to make a consumption tax work. Were we to get out of line with the rest of the world and impose a consumption tax on all production in the U.S. while other countries do not impose a consumption tax on exports and impose it only on imports, it would cause major problems of enforcement and compliance.

The final thing I would say is that I think politically, explaining to an American businessman that U.S. tax on the full value of his production in the U.S. is going to be imposed, but on the value of imports, the U.S. would tax only the U.S. markup, would be difficult. An automobile, for example, made in the U.S. is going to pay the full U.S. tax, but an import is only going to pay tax on the dealer mark-up. All economists in the world can tell that businessman that the currency rates are going to make him just as well off, and

he would say, thank you very much, I would appreciate a border adjustment, and I would rather tax the imports and exempt the exports.

So, I think this is a very important point for enforcement reasons, for political reasons, and because, in the real world, sometimes countries tinker with the value of their currency rather than allowing it to float, as the economists assume. But the analysis is simply mathematical. That is, it is not controversial among economists that, if exchange rates flow freely, that they would take care of this problem. It just does not seem to me to answer the question about border adjustments.

Senator BUNNING. Thank you very much.

Thank you, Mr. Chairman.

Senator BINGAMAN. Senator Kerry?

Senator KERRY. Thank you very much, Mr. Chairman.

Senator BINGAMAN. I am the closest thing we have to one right now.

Senator KERRY. Well, we like you.

Senator BINGAMAN. Go ahead.

Senator KERRY. As Senator Wyden said to me, "The inmates are running the institution." [Laughter.] Here we are.

Thank you for being here, everybody. This is a big topic, one that we have revisited so many times. Senator Bingaman and I were here during the great 1986 tax simplification. I remember Russell Long pointing the tax gun at the real estate industry, with a lot of warnings from others, that it would create a crisis. Indeed, we saw the savings and loan outgrowth from that. We have gone through various permutations since then.

I can remember voting for Ronald Reagan's tax simplification—I think it was rates of 28 percent and 15 percent, if I recall—which we quickly had to revamp and put a firm rate into because it just did not work, and then that went up to 39.6 percent, whatever, from where we had been.

But the thing that confounds everybody—obviously I am sure you have heard some of this today—is that in 1940, the 1040 tax instructions were about 4 pages long, and now there are a hundred pages of instructions just for the 1040, and thousands and thousands of pages for different specialized deductions and so forth.

Most Americans agree that this system is insulting to them and to a sense of equity, fairness. So there seems to be a consensus gathering that we need "tax reform." There is not a consensus, however, about what that means, so this is a worthwhile discussion.

Let me ask you, all of you, if you would sort of comment as a framework, perhaps. Generally speaking, when we are talking big, broad swaths of tax reform, we sort of say, well, would it not be great if we just made the system fair, had three, four simple rates, everybody understands what they are, get rid of all these deductions except for, and then you get into the critical sort of, low-income housing credit, charitable mortgage deduction, a few of those.

Are there some inviolable deductions that really do matter in terms of the economy and how money, capital behaves, or are they

just inviolable politically, or both, perhaps? That is a powerful combination. If so, what are they? That is what I want to say.

Dr. Carroll?

Dr. CARROLL. Sure. I think that is a very interesting and terrific way to kind of ask us to frame the issue. Yes. I think it depends on which provisions one is talking about. I think that some of the provisions are politically very difficult to tackle. The home mortgage deduction would be a very, very obvious example. When I was at Treasury after the Tax Panel report was released, we probably got more letters on the home mortgage proposal that the Tax Panel had put forward in some of their recommended options than any other, followed by, perhaps, some of the life insurance provisions. So, I think it very much depends on which provisions one is talking about.

I think one way to approach it, to really frame the current tax reform discussion and put it into historical context is, back in 1986 we were starting from a point where rates were fairly high. We had rates at 70 percent prior to 1981, and we had the top rate on the individual side at 50 percent prior to 1986. Then the task was, how much lower could we get the rate? There was a lot of room to broaden the base and lower rates.

But now we are in a world where the rates are not at those levels. Today the top rate is, of course, 35 percent, soon to go up, perhaps, to 39.6, but not nearly at the level. So in terms of trying to bring the rates down and broaden the base, it is very hard to do that. I think some of the proposals that have come forward in the last several years kind of make that point in the structure of the proposals. The top rates in a lot of the proposals we have seen remain not that very different from the 35 percent rate in place, the top rate in place today.

Senator KERRY. But you have to look behind the rate, do you not?

Dr. CARROLL. Yes.

Senator KERRY. As Warren Buffet has said. Warren Buffet has challenged any CEO in America who can show him that they are paying an effective tax rate that is higher than their secretary, that he will give them a million dollars. Nobody has collected.

Dr. CARROLL. Right. So then I think the next point to make is that it does matter a great deal whether certain types of income are subject to much lower rates. In my written testimony I make the point that one of the fundamental choices in tax reform is whether you are trying to move towards an income tax base or move towards a consumption tax base, recognizing that today we are starting with a hybrid income consumption tax base where a great deal of the return to savings and investment—perhaps much higher than people think—already receives consumption tax treatment, where the return to savings and investment is not taxed; 35 percent of a household's financial assets already receive that type of treatment in the form of IRAs, 401(k)s, and defined benefit plans.

Senator KERRY. But you have not gotten to the question of, can you throw the rest of that out and just narrow it down, and are there a group of inviolate deductions.

Dr. CARROLL. Well, I think one of the key choices is not so much, how low are the overall rates, but at what rate do you want to tax the return to savings and investment, with the notion that the tax and the return to savings and investment is particularly important to capital formation, labor productivity, and living standards in the long run? And it is also related to an earlier discussion we had on kind of the incidence of capital income taxes and who ultimately bears those.

Senator KERRY. Dr. Furman?

Dr. FURMAN. Yes. I think, Senator, some of this is a question of how you do it, not whether you do it. So, for example, it would be terrible if we did not have anything in our fiscal system that encouraged people to have health insurance, in fact, to encourage everyone to have health insurance. You could do that outside the tax system or you could do that inside the tax system. If you did it within the tax system, you would want to do it very differently than what you are doing today. I talked in my testimony about a refundable progressive tax credit to replace the tax exclusion.

Similarly, on savings we have about $200 billion a year of tax incentives to encourage people to save. A large fraction of that money is spent as a windfall on people who would have saved anyway. Very little of that money goes to low- and moderate-income families whose savings decisions might really be affected if they had an incentive to save more. Since those were put in place, the personal savings rate has plummeted and is, today, about zero. So again, I think we need to do something to encourage retirement savings. I think, in the absence of government policy, people would save too little and be unprepared for their retirement.

I think the way that we do it right now, though, is highly inefficient. Again, we could solve that in the tax code by making it more of a credit, taking the saver's credit and making it refundable, reforming the existing deduction, or we could solve it outside of the tax code. But I think to some degree it is, what goals do you want to accomplish and what are the best ways to accomplish them, is the way I would ask the question.

Senator KERRY. Anybody else want to add anything?

Professor GRAETZ. I would just add that I agree with what has been said. I should say at the outset that a lot of these provisions can be consolidated and revised to be more effective. Certainly you need a substitute if you are going to get rid of the retirement savings or health care proposals in the code. I tend to think the home mortgage provisions are more political than they are substantive, but I will not linger over that one.

I would just like to talk about the charitable deduction for a moment. I have to say, I really feel that it would be a big mistake to try and do the charitable deduction in some other way. I think it would substantially change the system for providing money to charity, even though the current system favors the charities of high-income people versus the charities of middle-income people, because the deduction is worth more to them. I think it stimulates charitable giving.

It also has important aspects for particular kinds of charities that would not otherwise receive as much money. Much of the giving that goes on by both high-, middle-, and lower-income people

would go on anyway, which is not to say that the charitable deduction could not be improved by a floor, for example, or by reforming it in terms of the way it deals with appreciated property or other things. But that is one that I would add to the list. I think this is a very good way to think about these questions.

If you also ask, can we do this outside of the tax code or must we do it inside of the tax code, I, Senator Kerry, have been emphasizing the education provisions. The education provisions that came in in the 1990s are the largest amount of expenditure of the Federal Government on education since the GI bill. If you ask yourself, which one of the two worked and which one of the two has worked a lot less well, doing a lot of these things through the tax system is simply not the best way to do it.

Senator KERRY. I know my time is up, but I have one more question. Is it possible——

Senator BINGAMAN. I think, Professor Shaviro, you are anxious to add something.

Professor SHAVIRO. I was just going to say that, suppose we had always had a broad-based income or consumption tax without all these things. I think there is little doubt that, in many respects, we would have been fine. So the issues are really politics, and also transition, in the sense that, for example, if one yanked out the home mortgage interest deduction overnight, obviously it does not take a lot of imagination to see how that would be a bad problem.

But I would say, though, most of these things we really do not need. It is just a question of how fast, how stably one could get rid of them. But honestly, the health care situation in the U.S., as is well known, is a huge pending crisis which has huge fiscal implications. So, without judging doing it through the tax system, that is how we do it now and that is something that has to be addressed.

Senator BINGAMAN. Senator Wyden, were you waiting to ask another question?

Senator WYDEN. I was. But if Senator Kerry has one——

Senator BINGAMAN. All right. Go ahead, Senator Kerry, with your question. Go ahead.

Senator KERRY. Thanks, Mr. Chairman. I appreciate it, and I thank you, Ron.

The other question I would like to ask—I mean, there are obviously hundreds of questions and we could spend a long time going through this. But just within the framework of this morning, I would like to ask you this. I heard mentioned a moment ago when I first came in this discussion of what happens abroad in other countries. I have been concerned about this for some period of time. I began to focus maybe 15 years ago on this offshore game that gets played—the Cayman Islands, the brass plates. We have seen it most recently with KBR, that used that as away to not pay Social Security, Medicare, and so forth.

But in effect, the globalization that has taken place in the last 20 years dramatically changes the competitive playing field. If I were managing capital of large amounts or running a business, I would have to sit here and take into account return on investment and the best means of being competitive. You have to sit there and figure out how, as a country, we are going to be able to best position ourselves.

We have never done that sufficiently, it seems to me, in how we figure out our tax code. I am wondering to what degree now we really have to do that. Some countries do not even collect taxes. You can go to some European countries and they do a pathetic job of actually holding people accountable, all kinds of games are played. We all know the Bank of England, Jersey, Guernsey, the offshore islands, and Channel Islands, you used to have Hong Kong, and then you have all kinds of attractive entities for people to hide money and avoid their responsibility, in a sense, corporate citizenship. They can avoid responsibility and go offshore, and it leaves the average American holding the bag.

When you add that to the discrepancy that has occurred in income—in the 1980s, 10 percent of America's income went to the top 1 percent of income earners; in the 1990s, it was 16 percent; in 2005, it was 22 percent of America's income that goes to the top 1 percent, the same people. So there is what the *New York Times* has called the "New Gilded Age." We see how hard it is now on the average worker in America, and people struggling, the middle class, and you have this competitive picture that is obviously a big piece of this. But does that change how we need to think about our tax code and how we need to go about tax reform?

Dr. FURMAN. I think if you look at our international tax system, and by a lot of estimates it essentially loses money, so you could eliminate taxes on all foreign operations of corporations. Do not let the company take the deductions associated with those overseas operations, and they would end up paying more taxes than they are paying today.

What I think is inefficient, and what I talked about in my testimony, is a lot of the lack of neutrality in the tax system. So, being taxed on an overseas operation, you are paying much lower taxes than you are paying in the United States. Because of these changes in the global economy you alluded to, I think it would be important to neutralize those taxes so we could lower taxes here and raise taxes on the overseas operations of U.S. businesses.

I do not think the tax code should be encouraging you to go overseas. I do not think it should be discouraging you from going overseas either. I think it should be making it so that, as a business, you can make decisions for purely economic reasons and not spend all of your time thinking about this tax shelter in the Caymen Islands, or this way of locating your real investment or your financial transactions overseas. I think if we did that, we could have lower tax rates as part of the package that moved us towards a more neutral tax system, one that you have obviously talked about a lot in the past.

Professor SHAVIRO. I want to mention a bit of what I would call low-hanging fruit that distracts from some of these tough choices between, for example, a worldwide system where U.S. companies are taxed at full U.S. rates on outbound investment and an exemption system. That is, we have a system of deferral now that results in lots of inefficiency and in lots and lots of tax planning relative to the revenue raised.

Some economists, Rosanne Altshuler and Harry Grubert, have written about what they call a burden-neutral repeal of deferral, that basically you repeal deferral but you lower the rates so that

basically the revenues and the burdens are the same as they were before. Now, that might not be the ideal system because there are arguments making it either higher or lower, but compared to what we have now, by wiping out all the games associated with deferral, it almost seems like a no-brainer.

Now, when I say it is easy, or low-hanging fruit, obviously if it is burden-neutral or revenue-neutral, some companies are going to win and some companies are going to lose, and I rather guess the ones who will lose might have something to say about it. But from a policy standpoint, it is a pretty easy call, I would say.

Professor GRAETZ. Senator Kerry, I guess I want to disagree. We have been largely in agreement. I want to agree with the thrust of your question and disagree with some of my panelists here. I think that the investment flows in and out of the United States are now 5 times—more than 5 times—greater than they were in 1986 when we dealt with tax reform by increasing taxes on corporations and using it to fund individual income tax relief.

I think that we are at a point now where our domestic tax policy and our international tax policy absolutely have to be thought of together. I think that individuals are different from companies when we think about this.

I think with individuals there may be ways to create entities and put money offshore that is very difficult for us to collect, but there may be ways, through information sharing and other multilateral opportunities, to know where the money is and to tax it to people who are living in the United States.

I think the corporate tax is really different than it was earlier because you can create "tax people" by just incorporating new companies. To the extent that other countries in the world provide benefits for their companies to go overseas and build power plants in China, or whatever example you want to use, we have to think about what kind of system we want.

I do not believe that we can assume we are going to collect the money by going down the road, saying, "Are we going to tax these foreign operations the same as domestic operations?" Those operations will be conducted, but they will be conducted in a manner where the company on top is not located in the United States.

The combination of technological changes—which I think, in fact, are more important to the inequality point that you made earlier than globalization—in combination, the technological changes and globalization allow you to move money around at the drop of a hat, to create entities at the drop of a hat, to stack them and devise them in all sorts of ways, to create novel financial instruments that we had not even thought of in 1986 as a way to game the rules about source, that is, our source rules which say an interest is sourced this way, and other expenditures are sourced that way. Well, all I have to do is change the financial instrument and it is no longer interest, it is something else.

I have concluded—and I have written a lot about international income taxation down in the weeds of these provisions—but I have concluded that the internationalization of the economy and the question that you are raising really do make it important for us to have a low statutory corporate tax rate so that companies do not

have the incentive, for example, to locate interest deductions here and income in Ireland where the rate is 12.5 percent.

All that requires them to do is to borrow here instead of there. The transfer pricing problem, which the IRS is devoting huge resources to, where related companies are jiggering the prices so that the profits are moved around to the lowest tax entity, are problems that we are not even beginning to solve.

I know the Joint Committee staff is beginning to study this question as well. These problems operate in the current environment to the great disadvantage of the U.S. because of our high rate and other countries' low rates. What we really need to do is to create a system where there are not those incentives. Now, the question of where we find the revenue for that, and so forth, is a very difficult question. These issues are extremely difficult.

But I have to say, I am very concerned about the idea that a U.S. company investing abroad is somehow substituting that investment for an investment that it would make in the United States. That was the view in 1963 when President Kennedy proposed a whole series of international tax reforms. There is a lot of evidence—but I am not saying that I am clear about it, I do not know the answer—that investment abroad and investment domestically are complementary.

If you talk to the head of Caterpillar, for example, which is a very successful exporter—and exports are driving the U.S. economy at the moment—he will tell you that they have to be abroad, they have to be in markets in order to produce the jobs here. I think that it is a difficult question, when you want to credit that and when you do not want to credit that. But I would be very cautious about assuming that a dollar invested abroad is necessarily a problem for U.S. workers. Sometimes it is, but not always.

Senator KERRY. Thanks, Mr. Chairman.

Senator BINGAMAN. Sure. Senator Wyden?

Senator KERRY. Thank you, Senator Wyden.

Senator WYDEN. Thank you, Mr. Chairman.

Dr. Furman, I want to ask you a different question about the 1986 law. I think all of you know, over the last 3 years I have asked all of the panelists who come before the Finance Committee whether they essentially like the frame of the 1986 law, which was to clean out the special interest breaks, broaden the tax base, and hold rates down, in effect, while guaranteeing progressivity.

But today, since virtually everyone who has come before the Finance Committee has said yes, that those principles of 1986 do make sense, I want to ask you a little bit of a different question, Dr. Furman. That is, given this period where all the surveys indicate that there is this economic pessimism that has really set in in our country, would an additional benefit of this kind of an approach that Congressman Emanuel and I are talking about not be that it would give everybody an opportunity to get ahead?

In other words, it moves us away from what Senator Kerry has been touching on in the debate about Warren Buffet and his secretary, and it allows everybody to say, we are going to have some incentives to get ahead, and that that kind of attitude could well help address the economic pessimism that we are seeing today.

Dr. FURMAN. First, I will say, allow me to put myself on the record with the answer of yes to the first question that you did not——

Senator WYDEN. I think you did it once before. But let the record show, Mr. Chairman, I think I have now asked 17 witnesses who have come before the Finance Committee over the last few years, when Senator Baucus and Senator Grassley have been holding the chair, whether they think the basic frame of 1986 is sound. Starting with Connie Mack and John Burr, they have all said yes. I am happy to have a good, resounding "yes" from Dr. Furman as well.

Dr. FURMAN. As intelligent as a tax reform is, we could not design one under which, for example, everyone paid lower taxes but we would collectively collect more revenue. So, there are certain things that a tax reform cannot accomplish. But what it can accomplish is, for example, everyone has an easier time filing their taxes than they have today, where everyone faces a set of incentives around decisions they make related to going to college, saving for retirement, buying health insurance that are more efficient and less distorted than the incentives that they face today.

Finally, I think most importantly, a tax code that gives people more confidence in their government and in their fiscal system as a whole and just leaves them less frustrated, which I think is intangible but quite important, and tax reforms like yours, I think, would accomplish a lot of those goals.

Senator WYDEN. I may have one additional question for you on health care in a minute.

But Dr. Carroll, I want to ask you a question about what happened in 1986. I have really gotten the sense that in 1986, President Reagan and Bill Bradley—and there were others obviously involved—made the judgment that marginal rates are hugely important in terms of how people look at investment, but they also made the judgment that preferences, by and large, were not. Preferences were not such a big deal. That was really the cement for moving to clean out a lot of the special interest breaks and all the stuff that has mucked up the tax code over the years.

I still like that philosophy. I still subscribe to that, that marginal rates, with the rate you pay for the last dollar you have earned, that is a huge deal. The preferences, most of them, really are not. Do you subscribe to that theory?

Dr. CARROLL. Generally I do subscribe to that. I think, as I mentioned earlier, one very big difference between the world of 1986 and the world today is that the starting off point in terms of how high the rate was when we started was much higher, at 50 percent, than it is at 35 percent now. The economic costs of high rates rises disproportionately with the tax rate. Starting off with lower rates means the economic cost today is not quite as great as it was back in 1986 when we were considering those reforms.

Then the other point I would make is, I think a great deal of emphasis does need to be given to, what is the tax rate on the return to savings and investment? I think there is a fair amount of evidence that suggests that that is important to capital formation and that capital formation is important to labor productivity and rising living standards in the long run.

It is also very important, as a number of the panelists have mentioned and a lot of the questions have forced us to consider, to think about tax reform in an international context, where capital can flow freely across borders, and the reduction in tax rates abroad on the return to savings and investment through greater reliance on consumption taxes or lower corporate tax rates is another important consideration.

Senator WYDEN. Dr. Furman, let me wrap up with you with a question on the cap side of the health care debate. We now, in the Healthy Americans Act, have 14 Senators sponsoring it, 7 Democrats, 7 Republicans. It is the first time in the history of the Senate where there has been that kind of bipartisan support. Right at the heart of it, in our view, is this question of the tax code and health care. It really strikes me that you do not see anybody out on the street driving a car from 1948, and yet in 2008 the employer-based system is not all that different than what we had 60 years ago.

We want to give employers who choose to the opportunity to keep offering it, but we do want to modernize the system. We want to modernize the employer-employee relationship to hold down the costs for the employer and to give the worker a more portable product, something that workers can take from job, to job, to job.

How important do you think it is to the American economy to make reforms in the tax code as it relates to health care? I like the way you put it, a question of making it more neutral. That strikes me as beneficial. But it also strikes me as extremely important that, for the first time, particularly for 153 million people who get their health care through their employer, that people actually know what is being spent in their name and have more options. How important do you think it is to make changes in the tax code as it relates to health care?

Dr. FURMAN. It is interesting. One of the traditional topics in tax reform has been the debate between a consumption tax and an income tax, and there have been thousands of papers written on the topic. If you look at the quantitative estimates of how much of what economists call "dead-weight loss" there is associated with that choice, it actually is probably smaller than the dead-weight loss associated with the problems caused by the current tax treatment of health care.

In other words, quantifying it in a traditional economic way, there would be more gains to reforming the tax treatment of health care, because you are leveraging up the way in which essentially 16 percent—17 percent this year, actually—of the economy is conducted, than all the other traditional concerns of tax policy. Whether or not that comparison is exactly right, it is certainly the case that this is a very important area.

Senator WYDEN. I like your drift.

Dr. FURMAN. And it is an area that does not require us to necessarily raise taxes or raise revenue on net if we are willing to use the resources that we are already putting into the system today, just putting it in in a way that no one really designed or intended to do. That is the way I think that we should be reforming the health system, and something that is done in your legislation.

Senator WYDEN. I thank you for it. It is striking, because until Senator Bennett and I really got into it, we did not even see the

enormity of the resources. We had a briefing recently. It is usually said that something like $200 billion on the health care side amounts to revenue foregone. We just got a briefing where some experts said they thought it was quite a bit larger than that. So what you have is a system that is essentially 60 years old, rewards inefficiency, rewards regressivity, and virtually nobody in the country knows anything about it.

When I am out talking about it, people sort of look at me blankly when I mention the tax code and health care. Usually when I say something like, well, the reality is that the top-line CEO can go out and get a designer smile put on their face and write off the cost of it on their taxes, and a hardworking woman in a local furniture store who does not have a plan gets nothing but essentially the right to subsidize Mr. High Flyer.

So if the four of you—and I noted the comments were made about the health care portions of the tax code by several of you—will help us weigh in loud and clear on this, this is a chance, in my view, for Democrats and Republicans to come together. This is something that I think will meld together Democratic philosophy of covering more people and getting everybody decent, affordable health care, with Republican theories about markets and incentives.

So this has been a terrific panel. I am looking forward to seeing you four a lot as we tackle tax reform with Chairman Baucus and Senator Grassley's leadership. I am pretty partial to the current Chairman today, too.

So, thanks for all the extra time, Mr. Chairman.

Senator BINGAMAN. Thank you all. I think it has been useful testimony. We will undoubtedly be calling on you as we proceed through the rest of the year.

Thank you very much.

[Whereupon, at 11:51 a.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

STATEMENT FOR SENATOR BUNNING
SENATE COMMITTEE ON FINANCE
"Tax: Fundamentals in Advance of Reform"
April 15, 2008

Thank you, Mr. Chairman.

Today is tax day. Millions of Americans who owe tax will go to a post office today to meet their annual tax filing obligation. Over 140 million taxpayers will file a tax return this year, according to the IRS, and each one of them is making a civic contribution. We owe it to them to think carefully about the structure of our tax code and about how it is helping or harming our economy.

It is important to understand that the flawed tax code we have today is not the product of careful deliberation. Often, its distortions are the result of political compromises negotiated in the distant past in a different political and economic environment. Although it is easy to see how our economy might be more efficient if we undid these compromises, undoing them is difficult, because whole segments of our economy have grown up around them.

One case in point is the deduction for interest paid on home mortgages. As part of the 1986 Tax Reform Act, Congress disallowed deductions of personal interest expense and most personal tax shelters, but it spared one deduction. Congress left in place the deduction for interest on home mortgages. As a direct result, taxpayers loaded up on home mortgage debt.

Today, the favorable treatment of home mortgage debt is built into the prices of homes. Any effort to limit the home mortgage interest deduction would suddenly lower the price of residential real estate, and it would be particularly unwise today.

The same is true of the capital gains rate. Any sudden increase in the rate will immediately be reflected in lower stock prices that will impact the retirement of nearly every American.

Base broadening and lowering tax rates may be the right economic policy, but taxpayers also have a right to settled expectations.

As difficult as it is to make changes in the tax code, we can't afford to ignore the task. Our economic competitors around the globe at work every day changing their tax laws to attract capital and high paying jobs. Our children's standard of living will be lower if we leave the current system in place.

If we work together, we can avoid that fate, and I appreciate the Chairman's initiation today of a series of hearings for that purpose.

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Tax: Fundamentals in Advance of Reform
A Hearing Before the Senate Committee on Finance,
United States Senate

April 15, 2008

Chairman Baucus, Senator Grassley, Distinguished Members of the Committee.

Thank you for the opportunity to appear before you today to discuss tax reform. The Tax Foundation, now in its 71st year, is a non-profit, non-partisan research group whose mission is to educate taxpayers about sound tax policy.

The economic sluggishness we read about each day has prompted many suggestions of short-term economic fixes, but tax reform remains one of the most important long-term economic challenges. Tax reform offers significant opportunities to promote a growing economy by removing or minimizing the many ways in which our tax system interferes with economic decision making and create in its place a tax system where household and business decisions are based more on economic merit than on an array of complex and difficult to understand tax rules.

Today, the U.S. tax system remains a complicated web of tax rules that impose substantial compliance and economic costs on the economy. The number of special tax provisions with complex phase-ins and phase-outs continues to grow. These provisions may be well intentioned, but they increase compliance burdens, narrow the tax base and require higher tax rates to raise a given amount of revenue. Moreover, despite becoming a poster child for tax reform, the alternative minimum tax (AMT) remains a significant feature of the income tax. While the Congress continues to limit the AMT's grasp with temporary one-year patches, the growth in the size and scope of this parallel tax system will make these temporary fixes increasingly difficult from a budgetary perspective.

The compliance costs of the income tax system are substantial. According to the Internal Revenue Service (IRS), the compliance burden of the income tax system is about $140 billion annually. Moreover, the complexity has driven most taxpayers to use paid preparers or tax software: Today roughly only one of every eight taxpayers prepares their *own* tax returns.

In addition to the compliance burden, the tax system also interferes with household and business decisions in economically important ways. For households, for example, the income tax affects the decisions of how much to work, save, invest, give to charity, and borrow when purchasing a home. For businesses, it affects their decisions about how much to invest, where to invest internationally, the source of funds for investment (e.g., debt, equity), whether to invest in the corporate or non-corporate form, and how to distribute profits. A more tax neutral environment would mean that households and business would make decisions more based on economic merit rather than their tax treatment. Eliminating or reducing the various ways the tax system distorts economic decisions can produce substantial economic benefits. For example, estimates of how much larger the economy could be in the long-term with dramatic reform – nearly 9 percent – are suggestive of the large economic costs associated with the current tax system. In today's 14 trillion economy, this economic gain would translate into an additional $1.3 trillion in economic output.

In evaluating how to go about reforming our tax system it is useful to start with a set of objectives. It is easy enough to agree on a broad set of principles such as a tax system that is simple, fair and pro-growth. But, as we begin to scratch the surface, to dig more deeply, a more complex and fundamental set of issues need be addressed. For example, should the tax system focus on taxing income or consumption, what constitutes a fair distribution of the tax burden, and to what extent should citizens be relieved of having to remit taxes to the government at all? Also, to what extent does the United States need to consider its place in the world economy? Considering the possible answers to these questions provides a starting point for tax reform.

Taxing Income or Consumption?

The key difference between a tax system that taxes income versus one that taxes consumption is that a consumption-based tax does not tax the return to saving and investment, while an income tax does. Taxing the return to saving and investment results in less capital formation, which gives workers less capital with which to work, thereby reducing labor productivity. Lower labor productivity translates into lower living standards than would otherwise occur. These are the key relationships – investment, capital formation, labor productivity and living standards –which proponents of consumption taxes point to.

There are numerous ways of moving towards a tax system based more on taxing consumption. A national retail sales tax is perhaps the most obvious form of a consumption tax. But the European-style value-added taxes are also equivalently taxes on consumption with remittance of tax at the business level rather than by consumers. The so-called X-tax is another approach that more closely resembles the general structure of the current tax system by retaining a tax imposed at both the business and individual levels. In contrast to the current system, however, this approach would allow all investment to be written-off immediately and the individual level tax would only apply to compensation. While each of these approaches differ substantially in form, they would all transform the current tax to one that no longer taxes the return to saving and investment.

In large part because of the negative economic consequences of taxing the return to saving and investment, the current U.S. tax system already deviates from income tax principles in important

ways. Although the current U.S. income tax system is nominally called an income tax, it is very much a hybrid income-consumption tax. Tax-preferred savings accounts, such as IRA's and 401(k)'s, remove the tax on the return to saving within these accounts. Accelerated depreciation, provided primarily for equipment, reduces the effective tax rate on the return to investment. Some estimates suggest that roughly 30 to 35 percent of U.S. household financial assets effectively receive consumption tax treatment.

Proponents of moving further towards a consumption tax anticipate that by further reducing the tax on the return to saving and investment, the additional capital formation will eventually result in a larger economic pie. Estimates of very far reaching reforms that broadly include all consumption in the tax base and replace the progressive tax rate schedule with a flat tax rate suggest that, in the long-run, the overall size of the economy would be 9 percent larger.[1] Even the more modest and perhaps more politically plausible reforms recommended in 2005 by the President's Advisory Panel for Federal Tax Reform suggest substantial positive economic gains with an in increase in the overall size of the economy in the long-run by roughly 2.5 percent to 3.0 percent.[2]

What Constitutes A Fair Distribution of the Tax Burden?

One of the criticisms of moving the income-consumption tax pendulum further towards a consumption tax base is the widely-held view that consumption taxes are regressive. The reasoning behind this view is that savings is held disproportionately by higher income taxpayers, so removing the tax on the return to saving and investment will disproportionately benefit those that hold these assets. This view, however, misses several key points.

First, it presumes that taxes on the return to saving and investment are borne by owners of capital. The proponents of consumptions taxes, however, have stressed the economic benefit that removing or reducing the tax on the return to saving and investment can have on capital formation, labor productivity and living standards. Underlying this linkage is the notion that the tax on the return to saving and investment is borne primarily by labor, not capital. That is, taxes on saving and investment are reflected primarily in lower real wages, not lower returns to capital, in the long run.

Importantly, recent research helps support this view. Drawing on the international experience over the past several decades researchers have examined the relationship between corporate income taxes and wages.[3] Generally, this research has found that those countries that have reduced their corporate taxes the most have experienced the largest increases in real manufacturing wages and are suggestive that workers, not owners of capital, bear a substantial portion of the corporate tax.

[1]Altig, David, Alan Auerbach, Laurence Kotlikoff, Kent Smetters and Jan Walliser, "Simulating Fundamental Tax Reform in the United States." *American Economic Review* Vol. 91(2001): 574-595.
[2] Carroll, Robert, John Diamond, Craig Johnson and James Mackie III, "A Summary of the Dynamic Analysis of the Tax Reform Options Prepared for the President's Advisory Panel on Federal Tax Reform," Report of the U.S. Department of the Treasury, Office of Tax Policy, May 2006.
[3]For a recent review of this research see: William Gentry, "A Review of the Evidence on the Incidence of the Corporate Income Tax," OTA Working Paper 101, U.S. Department of the Treasury, Office of Tax Analysis, December 2007.

Second, this view does not recognize that many types of consumption taxes exempt from tax only a portion, but the economically important part, of the tax on the return to saving and investment. The tax on the portion of the return needed to make the investment – the so-called "normal" return or "opportunity cost" of capital – is removed under many types of consumption taxes, while the return in excess of the normal return – the so-called "super" normal or "infra-marginal" return – continues to be taxed. This is important because some estimates suggest that super normal returns may well represent a substantial portion of the total return to investment and would be taxed under both an income and consumption tax.[4] This suggests that consumption taxes may not be as regressive as some have suggested.

Finally, moving towards a consumption tax base and maintaining the progressivity of the tax system are not mutually exclusively objectives. Progressive tax rates and broadening the base in ways that limit the benefit of special tax provisions to higher income taxpayers, while enhancing their benefit to lower income taxpayers is one recipe for a distributionally balanced reform. As shown in Chart 1, the current tax base is roughly 55 percent of the size of a comprehensive income tax base and roughly 70 percent of the size of a comprehensive consumption tax base. In terms of revenue and their effect on the structure of the tax system, just a handful of the more than one hundred special tax provisions dominant: 1) the exclusion for employer-based health insurance, 2) the home mortgage deduction, 3) the charitable giving deduction, and 4) the state and local tax deduction. Limiting or redirecting the benefits of these provisions could satisfy the dual objective of minimizing their effect on economic decision making and more carefully focus their benefits on those with fewer resources.

Indeed, there is a significant cost associated with channeling tax benefits through targeted tax provisions: the higher tax rates imposed on all taxpayers. As an illustration, repeal of the roughly $100 billion annually in housing tax subsidies could finance an across-the-board reduction in tax rates of roughly 14 percent. Importantly, the economic cost of high tax rates grows more than proportionately as the tax rate increases; that is, high tax rates have a disproportionately high economic cost associated with them.

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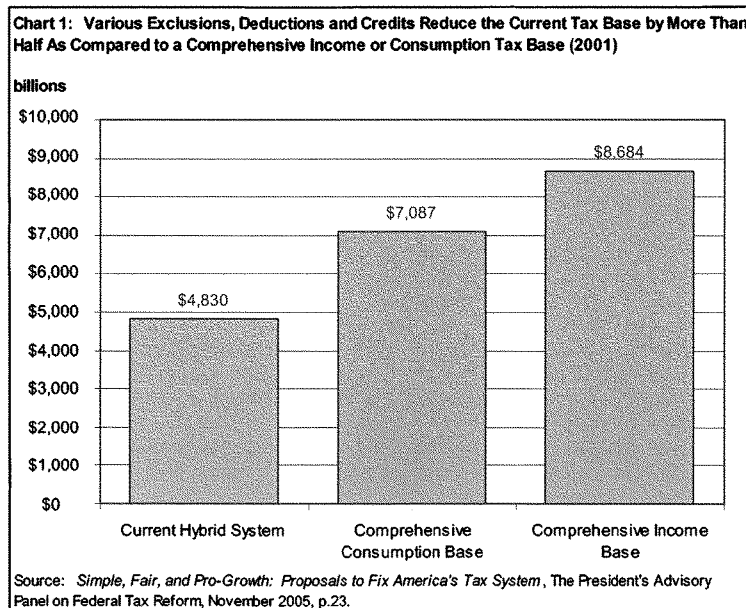
[4]Gentry, William M. and R. Glenn Hubbard, (1997) "Distributional Implications of Introducing a Broad-Based Consumption Tax," NBER Working Paper No. 5832, Cambridge, MA: National Bureau of Economic Research.



Removing Taxpayers from the Rolls a Means to Simplicity?

One measure that is sometimes used to gauge whether a reform is simpler is the extent by which it minimizes the interaction of taxpayers with the IRS or, in the extreme, removes them from the rolls altogether. Some reforms, for example, that would replace a significant portion of the income tax with some type of value-added tax could remove millions of households from the income tax system. These households would, in effect, continue to pay tax through the value-added tax when purchasing goods and services, but would not themselves remit tax to the federal government.

Alternatively, others have considered moving towards a return-free system whereby most taxpayers would have their taxes exactly withheld during the year by their employers and financial institutions. One potential advantage of this approach is that many of the special tax provisions would likely need to be eliminated in order to include a significant number of taxpayers in the return free system. That is, the return-free structure itself might help motivate reform towards a more streamlined tax code with fewer special provisions. Also, such a system might be less subject to change in the future because changes would involve increasing the number of taxpayers who would have to file separate returns and interact with the taxing authority.

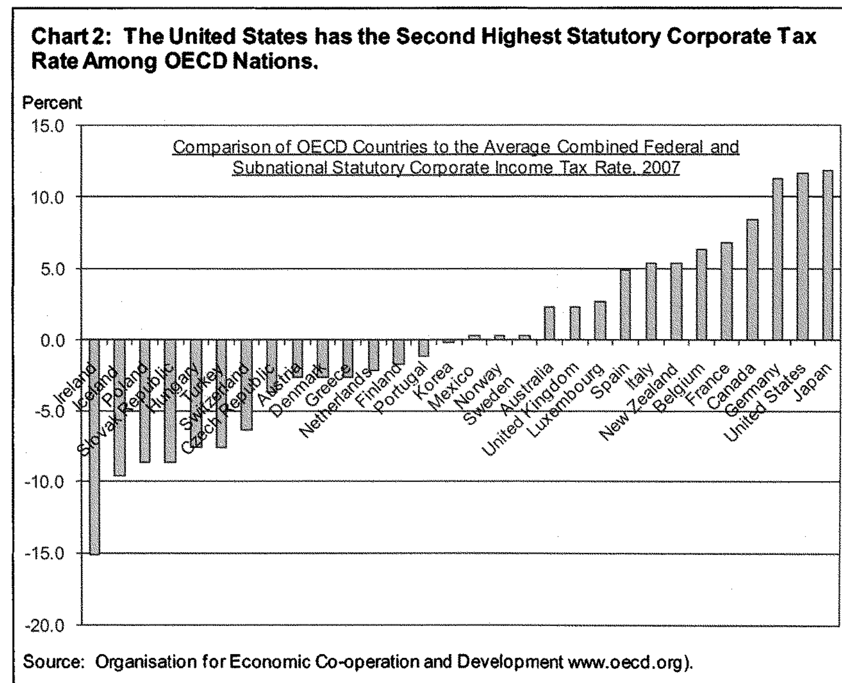
While these approaches may be well-intentioned, reducing the interaction of households with the taxing authority could have more far reaching effects on the extent to which citizens have a stake in the government.

The U.S. Tax System in an Increasingly Global Marketplace

The ability of the United States to continue to attract investment and further increase living standards depends, in part, on how its business tax system compares to its major trading partners. While the United States economy was once characterized by its dominance in the world marketplace, it now operates in an increasingly open world economy where capital flows freely across borders.

The U.S. business tax system, however, may have fallen behind. During the past two decades the Unites States has gone from a country with a low statutory corporate tax rate to one with a high statutory corporate tax rate as compared to member nations in the Organisation for Economic Co-operation and Development (OECD). As show in Chart 2 (see below), the U.S. now has the second highest combined federal-state corporate tax rate among OECD nations, exceeded only by Japan.

Chart 2: The United States has the Second Highest Statutory Corporate Tax Rate Among OECD Nations.



Source: Organisation for Economic Co-operation and Development www.oecd.org).

Moreover, the distance between the U.S. corporate tax rate and the lower corporate tax rates abroad is growing, further disadvantaging the United States as a place to invest. In just the past two months, at least six countries have announced plans to cut their corporate tax rates: Canada, Hong Kong, Korea, South Africa, Spain and Taiwan.

What is the effect of U.S. government inaction while other nations continue to reform their business tax systems? In a world of greater economic integration and increased trade and capital flows, a firm's decision about where to locate and expand its operations will be increasingly influenced by factors such as a country's statutory corporate tax rate and overall investment climate.

By standing still, the United States can expect to see reduced inflows of foreign capital and investment because the United States will be a less attractive place in which to invest, innovate and grow. U.S. firms will face a higher cost of capital than foreign firms, making it more difficult to compete in foreign markets. In the near-term, this would translate into slower economic growth, a slower advance in labor productivity, and less employment. The industries that are being hurt the most are those that manufacture or buy capital-intensive products.

The recent Treasury report, *Approaches to Reform of the U.S. Business Tax System for the 21st Century*, found that wholesale replacement of the U.S. corporate income tax with a consumption-based tax would increase economic output by between 2.0 percent and 2.5 percent in the long-run. Importantly, because this estimate does not fully capture the positive effects of free-flowing capital in a global setting, it is likely to be a conservative estimate of the potential benefits of reforming the U.S. business tax system.

A more disturbing possibility emerges as the disparity grows between corporate taxation in the United States and its trading partners: a slower pace of innovation in the United States. A key determinant of economic growth, innovation tends to take place where the investment climate is best.

Summary

Reforming the U.S. tax system poses significant political challenges, but offers the opportunity to rationalize many aspects of the tax system in a way that reduces the compliance burdens imposed on households and businesses and creates an environment for greater economic growth in a manner that is appropriately fair.

Thank you again, Mr. Chairman, Senator Grassley, and Members of the Committee for the opportunity to appear before you today.

The Concept of Neutrality in Tax Policy

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The Brookings Institution

Testimony Before the U.S. Senate Committee on Finance Hearing on "Tax: Fundamentals in Advance of Reform," April 15, 2008

Chairman Baucus, Ranking Member Grassley and other members of the Committee, thank you for inviting me to testify at this hearing on tax policy. In my remarks I will focus on the concept of "tax neutrality." The basic concept is simple: generally the tax system should strive to be neutral so that decisions are made on their economic merits and not for tax reasons. In some cases, neutrality is impossible and policymakers have to accept a certain level of distortion to behavior as inevitable. In other cases, neutrality may be undesirable if policymakers intend to promote specific goals like the provision of health insurance or contributions to charity. Examining ways that the tax system approximates or departs from neutrality can be a helpful lens for thinking about a range of tax policy and economic problems.

Tax neutrality is a widely accepted concept in principle. In practice, however, tradeoffs between different concepts of neutrality and different goals can be difficult to resolve. But in several cases this concept can provide a useful way to cut through some of the debates about tax policy and identify a more economically efficient way to organize the tax system.

In my testimony I first provide a general introduction to the concept of neutrality and then applications to five specific areas of tax policy. To preview my substantive conclusions in these areas:

1. The concept of neutrality is the underpinning of the canonical goal of tax reform: achieving a broader base with lower rates.

2. To the degree that policymakers depart from neutrality to achieve specific goals like encouraging homeownership or childcare, it is generally better to implement these measures through refundable tax credits rather than deductions.

3. The tax treatment of healthcare is the most economically important way that the tax code departs from neutrality. Reforms to this tax treatment can make it more neutral with regard to some decisions (like how much insurance to purchase) while providing more incentive to purchase basic insurance.

[1] Parts of this written testimony draw on previous work, including "Achieving Progressive Tax Reform in an Increasingly Global Economy," a Hamilton Project Strategy Paper co-authored with Lawrence Summers and Jason Bordoff. The views expressed in this testimony are those of the author alone and do not necessarily represent those of the staff, officers, or trustees of The Brookings Institution or the members of the Advisory Council of The Hamilton Project.

4. The tax code also departs from neutrality to discourage specific activities, like smoking and alcohol consumption. In these cases, the tax should be set to capture the cost of the activity that individuals do not take into account. This is also the principle underlying carbon taxes and cap-and-trade systems to address climate change.

5. Although the proper level of capital taxation is highly controversial, there is little or no justification for the widely varying rates on different forms of capital income. Establishing more uniform rates would improve the allocation of investment and finance, reduce wasteful tax avoidance expenditures, and ultimately enhance the productivity and stability of the economy.

The Concept of Tax Neutrality

The primary purpose of the tax system is to raise the revenue needed to pay for government spending. As such, the goal is to raise this revenue without distorting the decisions that individuals and firms would otherwise make for purely economic reasons. For example, an efficient economic system people would choose between chocolate chip cookies and oatmeal cookies based on their own personal tastes and the costs of these products. If policymakers imposed a tax on chocolate chip cookies but not on oatmeal cookies the result would be that people would now factor taxes into their choice about which type of cookie to consume—and possibly end up consuming the less desirable cookie because it was cheaper.

In addition to distorting choices, non-neutralities in the tax system also lead people and firms to devote more socially wasteful effort to transforming the form or substance of their activities to reduce their tax payments, for example by hiring lawyers and accountants to structure financial transactions in a manner that minimizes tax liability.

In some cases deviations from a neutral tax system are unavoidable. It is widely agreed that tax payments should increase with some measure of well-being, like income, consumption or wages. One inevitable consequence of this agreement is that the market consumption of goods and services will be taxed, either directly (as in a consumption tax) or indirectly (as in an income or wage tax, both of which tax the money used to purchase consumption goods). Time spent outside of work, what economists label as "leisure," is not taxed. As a result, people will consume relatively more leisure—which is equivalent to a reduction in labor supply. Whether this is a quantitatively large or important effect is another question, but at a conceptual level this is a way that the tax system departs from the neutral ideal.

In other cases, deviations from a neutral tax system reflect the goals of policymakers. The tax system is designed to encourage home ownership, contributions to charity, health insurance, and higher education and to discourage smoking and drinking alcohol. Whether these goals are all appropriate or the tax system is the best way to achieve them is another question, some aspects of which will be discussed further below.

Five Applications of Neutrality to Policy Issues

This general discussion motivates the application of the concept of neutrality to five specific issues.

(1) Overall Tax Reform: A Broader Base and Lower Rates

One of the traditional mantras of tax reform is to "broaden the base and lower the rates." This involves two objectives: (1) broadening the base helps make the tax code more neutral between different activities by including more types of income in the definition of income and allowing fewer deductions and credits for specified activities, and (2) lowering tax rates makes the tax code more neutral about the choice between working and not working. Both halves of the process potentially improve efficiency.

One way to gauge the deviation of the tax code from the ideal of a pure income tax is to examine tax expenditures which are defined in statute as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of liability."[2] The Office of Management and Budget and the Joint Committee on Taxation regularly release itemized reports on tax expenditures. In the last budget the Treasury listed a total of $987 billion in tax expenditures for FY 2008, including $878 billion for individuals and $108 billion for corporations.[3] This total approaches the total amount of discretionary spending ($1,114 billion in FY 2008) and non-interest mandatory spending ($1,527 billion in FY 2008).

If, for example, $500 billion worth of tax expenditures were eliminated that would permit a 32 percent reduction in all individual and corporate income tax rates. Economists generally presume that a tax code with a broader base and lower rates will be more efficient and conducive to economic growth. A number of specific proposals have been made that embody these basic principles, including Senator Ron Wyden and Congressman Rahm Emanuel's Fair Flat Tax Act (S. 1111) and the proposals put forth by the President's Advisory Panel on Federal Tax Reform.

(2) Using the Tax Code to Encourage Desired Behavior: Credits Instead of Deductions

In some cases, policymakers may want to encourage desired activities like homeownership or a college education. In these cases it is worth examining whether the specific goal could be better accomplished through a spending program or through the tax code. In many cases a spending program can be more effectively targeted and delivered to serve the goal in question. But in some cases subsidizing these activities through the tax code may be more efficient. Although administering social programs through the tax code increases the burden on the Internal Revenue Service and can increase the complexity of tax returns. But if these tax

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[2] Public Law 93-344, The Congressional Budget Act of 1974.

[3] Note that these totals are indicative of the extent of tax expenditures but are not an estimate of the revenue that would be raised by repealing these tax expenditures because they ignore behavioral effects and the interaction of tax expenditures with other provisions in the tax code and other tax expenditures.

expenditures were converted to spending programs, that complexity would simply be shifted to another government agency. Duplicative paperwork would, in fact, likely increase the overall administrative burden for the government, not to mention the burden on families struggling to provide the same information on multiple forms to multiple government agencies. Moreover, many spending programs phase out benefits as incomes rise in a manner that is not fully transparent and not integrated across programs. As a result, it is common for beneficiaries to discover that, for every $1 they earn, they lose 50 cents to $1 in reduced benefits plus higher taxes. Locating social expenditures in the tax code makes their phase-out rates more transparent and easier to harmonize in order to prevent the effective marginal tax rates in excess of 50 or even 100 percent that are often observed in the current tax and transfer system.

But to accept—and in some cases even embrace—tax expenditures is not to defend how they are presently structured. For years tax analysts of widely differing philosophies have written about the benefits of shifting tax expenditures from deductions to uniform, refundable tax credits. A deduction of $1 is worth 35 cents to someone in the 35 percent marginal tax bracket, but only 15 cents to someone in the 15 percent bracket. A credit, by contrast, provides the same tax subsidy regardless of one's tax bracket, and a refundable credit does so even if the credit exceeds one's total tax liability. Lily Batchelder, Fred Goldberg, and Peter Orszag laid out the most comprehensive case for the efficiency benefits of using credits rather than deductions to encourage desired behavior that may have broader benefits than accrue to the individual alone (what economists call positive externalities).[4]

Batchelder, Goldberg and Orszag point out that the goal of tax expenditures is often to encourage people to consume more of something—for example, college attendance. But since deductions reduce the after-tax price more for high-income families than for low-income families, they generally produce too much added consumption by the former and too little by the latter. In the absence of evidence on how much families at different income levels will respond to a given tax incentive, the authors suggest that credits should be the same for all. In reality, however, it is likely to be more economically efficient to make subsidies progressive, with larger subsidies to lower-income households. For example, a uniform credit might be too little to encourage a lower-income family to purchase health insurance, yet more than enough for a high-income household that would have purchased the insurance in any case. If credits are to be effective in encouraging behavior among low-income households, it is also critical that they be refundable.

It is also important to design tax credits so they are non-neutral in the ways that are economically efficient and maximize their cost effectiveness. For example, many tax expenditures are designed to encourage specific activities, whether owning a home or going to college. But policymakers facing limited budgets may not be interested in subsidizing more of these activities—owning a larger home or going to a more expensive college. In these cases the subsidy should take the form of a flat credit for undertaking the activity, or be capped at a certain level. In this way, the tax code would not be neutral between owning a home and not owning a home, but would be neutral between owning a medium-sized home or owning a large home.

[4] Lily L. Batchelder, Fred T. Goldberg, Jr., and Peter R. Orszag. 2006. "Efficiency and Tax incentives: The Case for Refundable Tax Credits." *59 Stanford Law Review 23.*

These considerations are especially important in designing the tax treatment of health insurance, the topic I turn to in the next section.

At a minimum, any new tax expenditures with a behavioral motivation should be implemented as credits rather than deductions and should be based on sound behavioral considerations. But the big gains will come only from reforming the existing system of tax expenditures. These reforms could be designed in a manner that also serves other goals, like reducing the nation's large fiscal gap or offsetting some of the increase in inequality in recent decades. But even a revenue- and distribution-neutral reform of tax expenditures would pay substantial dividends, making the tax code fairer and more efficient while promoting goals that policymakers have identified as important, such as increasing college enrollment or homeownership.

(3) The Tax Treatment of Health Care: Shifting to a Progressive Tax Credit

One of the most important roles that tax policy plays is in health care. Health spending is 17 percent of the economy. The tax treatment of health care plays an important role in how the roughly half of this spending that is private, $1.3 trillion in 2008, is spent. It also affects the number of Americans that are uninsured, currently estimated at 47 million by the Census Bureau. In fact, the quantitative magnitude of the inefficiencies associated with the tax treatment of healthcare may exceed the inefficiencies associated with many of the other traditional concerns of tax policy, like a broader base and flatter rates.

Healthcare is subsidized through the tax code in a number of ways, but the most important of these is that employer contributions to insurance premiums are excluded from earnings for the purposes of determining income and payroll taxes. The federal cost of this exclusion and other tax benefits for healthcare is about $200 billion annually, roughly the same as federal spending on Medicaid. This tax treatment, originally a historical accident, creates several non-neutralities in the tax code:

- *More favoritism for purchasing health insurance than other goods.* The most important non-neutrality introduced by the tax treatment is an incentive to purchase health insurance rather than other goods. In effect the tax treatment reduces the after-tax price of health insurance for the typical worker by about 20 percent. In the absence of this non-neutrality the number of Americans without insurance would likely be substantially larger.

- *More favoritism for health insurance through employers than through the individual market.* If your employer does not offer health insurance, or you choose not to buy it, you cannot get the same tax advantages when you purchase insurance in the individual market. This, together with other historical accidents and objective advantages of employer-sponsored insurance, underpins the employer-sponsored system that provides insurance to 177 million, or 88 percent, of the privately insured. This non-neutrality in the tax system helps pool people together, solving the adverse selection problem and other market failures that would otherwise impair the health insurance market. But there

is a serious question as to whether the tax non-neutrality is the most efficient or desirable way to solve these problems.

- *More of a subsidy for insurance for high-income households than low-income households.* As discussed above, a tax deduction or exclusion provides a larger subsidy for households in higher tax brackets. For example, consider an employer contributing $8,000 to a family policy and requiring a $2,000 contribution by the worker. A low-income worker facing a marginal tax rate of 10 percent, the typical marginal tax rate for a worker at the 30th percentile, would have to give up $9,200 in after-tax income for this policy—effectively an 8 percent subsidy for insurance.[5] In contrast, a high-income family might be in the 40 percent marginal rate—and thus have to give up $6,800 in after-tax income for this policy—effectively a 32 percent subsidy for insurance. If the lower-income worker receives a smaller tax-advantaged employer contribution to his or her insurance the disparity will be even greater. This is not only unfair, but it also leads firms with disproportionate numbers of lower-income workers to be less likely to offer insurance or pay a large fraction of the premium, both of which lead to less insurance coverage for lower-income workers.[6] If the goal of the tax subsidy is to increase the number of Americans with insurance then this form of provision is inefficient because the current subsidy is evidently too small to encourage low-income people to demand insurance and is likely higher than it needs to be to ensure that high-income people are covered.

- *More of an incentive to spend money on healthcare.* The exclusion and other tax benefits for health care reduce the after-tax cost of that spending, leading to more spending on health care and less spending on everything else than would be the case in the absence of these incentives. The design of the current tax incentive magnifies this effect because the combination of the employer exclusion with the general lack of a tax deduction for out-of-pocket expenses leads to insurance plans with lower co-payments and deductibles and thus higher spending. Two studies suggest that eliminating the tax exclusion for health insurance premiums could result in a 41 to 65 percent increase in the coinsurance rate, which could lead to anywhere from a 9 to 38 percent reduction in health expenditures for the privately insured. Both economic theory and evidence from the RAND health insurance experiment and other studies suggest that such a reduction in spending would result in little if any worsening in health outcomes.

A number of health reforms are motivated by this discussion of non-neutralities, including The Healthy Americans Act (S. 334), introduced by Senators Ron Wyden and Bob Bennett. The common element of these reforms are: (1) an attempt to improve on the core non-neutrality by making it even cheaper for the uninsured to purchase insurance, especially for households with lower incomes; (2) a way to replace the pooling currently provided by the

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[5] These marginal tax rates are consistent with the ones estimated by Congressional Budget Office, "Effective Marginal Tax Rates on Labor Income," (2005). The CBO estimates are adjusted to reflect the additional Social Security benefits accrued as a result of having a higher taxable income. This is both the economically correct treatment and is also consistent with the budgetary treatment of Social Security used in estimating the $200 billion cost of the tax expenditures for healthcare.

[6] This tax incentive is compounded by the availability of Medicaid and the State Children's Health Insurance Program (SCHIP) to lower-income workers or their dependents.

employer-sponsored system with some other method so that the tax treatment can be made neutral vis-à-vis the individual market without worrying about large increases in the uninsured; and (3) moving the tax system towards neutrality between purchasing some health insurance and purchasing more health insurance.

(4) Discouraging Undesired Activity: the Role of Pigouvian Taxes

Just as it can sometimes be appropriate to introduce non-neutralities into the tax system to encourage desired activities so to can it be appropriate to use the tax system to discourage undesirable ones like the smoking, drinking alcohol, or emitting carbon. In this manner, so-called Pigouvian taxes can lead businesses and consumers to take the social costs of their actions into account, helping to ensure that the outcome of decentralized decisions and market competition leads to overall social efficiency. Today, for example, gasoline is taxed at both the federal and the state level, but the evidence is that these taxes fall short of neutralizing the external harm associated with gasoline consumption, which includes not only climate change but also congestion, traffic accidents, and increased economic vulnerability to supply disruptions. Meanwhile the production of electricity and other energy from coal and natural gas is not taxed at all, despite its large contribution to climate change.

The climate problem could be addressed directly through the tax code by implementing a carbon tax that is combined with other tax cuts to ensure that it is revenue- and distribution-neutral, thus protecting low- and moderate-income families who would otherwise have a hard time paying higher energy bills.[7] Alternatively, the government could issue a limited number of permits for emitting carbon and allow them to be traded, a so-called "cap-and-trade system."[8] Like a carbon tax, a cap-and-trade system would effectively put a price on carbon that would be passed on to consumers—making it desirable to combine it with an auction system for the permits and a lump-sum compensation mechanism for households.

Another motivation for non-neutral taxes is when a myopic individual takes insufficient account of the harm that immediate actions have on his or her long-term well-being, a notion that economist Jonathan Gruber has termed an "internality."[9] In this case, the tax reduces consumption and has potentially large benefits for the individuals involved—benefits that well exceed the cost of the taxes.

(5) Corporate and Capital Taxes

Lately significant attention has been focused on the fact that the United States now has the second highest corporate tax rate in the world. Less attention has been focused on the fact

[7] Gilbert E. Metcalf. 2007. "A Proposal for a U.S. Carbon Tax Swap: An Equitable Tax Reform to Address Global Climate Change." Discussion Paper 2007-12, The Hamilton Project, Washington, DC.
[8] Robert N. Stavins. 2007. "A U.S. Cap-and-Trade System to Address Global Climate Change." Discussion Paper 2007-13, The Hamilton Project, Washington, DC.
[9] Jonathan Gruber. 2002. "The Economics of Tobacco Regulation." *Health Affairs, Vol 21(2).*

that the United States simultaneously has, in recent years, averaged the fourth lowest corporate tax collections as a share of the economy of any OECD country. According to the Treasury:

> Thus, the high U.S. corporate tax rate does not result in higher corporate tax revenue relative to GDP due to the narrowness of the U.S. corporate tax base. The narrow corporate tax base results not only from accelerated depreciation allowances, but also from special tax provisions for particular business sectors (such as domestic production activities) as well as debt finance and tax planning.[10]

In the context of my discussion today, much of this revenue loss can be ascribed to "non-neutralities" in the tax code.

The debate over the optimal tax rate on capital income is highly contentious. According to the Congressional Budget Office (CBO) the overall effective tax rate on capital income is 14 percent.[11] Proponents of a pure income tax believe that capital income should be taxed at the same rate of labor income, which is somewhat higher than this rate. They justify this argument by noting that total income is the best measure of ability to pay and that having different tax rates on different forms of income encourages sheltering and other avoidance activity.[12] In contrast, proponents of a consumption tax argue that the tax on capital income should be set at zero to avoid discouraging savings and investment.

But regardless of one's stance on the question of whether the 14 percent rate is too low or too high, there is no justification for the highly variable tax rates on different forms of capital income shown in Table 1. If a corporation finances its investment by borrowing it can take advantage of accelerated depreciation of its investments, deduct its interest, and pay a substantial fraction of the interest and dividends on its proceeds to tax indifferent parties like retirement accounts and foundations. The result is that the tax rate on debt-financed corporate investment is -6 percent. In other words, the tax system is subsidizing debt-financed corporate investment. In contrast, equity-financed corporate investment is taxed at the corporate and individual level and faces a combined rate of 36 percent.

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[10] U.S. Department of the Treasury. 2007. "Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century." Washington, DC.

[11] Congressional Budget Office. 2005. "Taxing Capital Income: Effective Rates and Approaches to Reform." Washington, DC.

[12] A more recent economic literature also justifies a positive tax on capital income as a way to proxy for the underlying ability of the individual or to provide insurance against wage shocks, although in these cases the tax would not necessarily be equal to the tax on labor income. See Emanuel Saez. 2002. "The Desirability of Commodity Taxation under Non-Linear Income Taxation and Heterogeneous Tastes." Journal of Public Economics 83: 217—230. See also Shinichi Nishiyama and Kent Smetters. 2005. "Consumption Taxes and Economic Efficiency with Idiosyncratic Wage Shocks." *Journal of Political Economic, Vol 113(5).* And Mikhail Golosov, Aleh Tsyvinski, and Ivan Werning. 2006. "New Dynamic Public Finance: A User's Guide." *NBER Macroeconomics Annual.*

Table 1. Effective Tax Rates on Capital Income	
Type or Form of Investment	
Overall	14%
Debt-finance corporate	-6%
Equity-financed corporate	36%
Non-corporate business	21%
Tenant-occupied housing	18%
Owner-occupied housing	-5%
Computers and perip equipment	37%
Manufacturing buildings	32%
Mining structures	10%
Petroleum and natural gas structures	9%

Source: CBO (2005)

The 42 percentage point disparity between debt and equity financing encourages corporations to finance themselves more heavily through borrowing. This leverage in turn increases the financial fragility of the economy, an effect we are seeing quite dramatically today. The disparity also encourages an industry of exotic financial instruments designed to exploit the tax distinction between debt and equity. In principle, revenue-neutral reforms could preserve the same average tax rate on corporate investment by raising the tax rate on debt-financed investment and cutting it on equity-financed investment.

The tax system is also highly non-neutral towards other forms of capital investment. Non-corporate investment is, on average, taxed more lightly than corporate investment, discouraging the use of the corporate form. Housing is heavily tax favored, and owner-occupied housing faces a negative tax rate. This can lead to the over-building of and over-borrowing on houses.

A complex and inconsistent set of depreciation rules means that different assets are taxed at very different rates ranging from above 30 percent for computers and manufacturing structures to 10 percent or lower for mining, petroleum and natural gas structures. This encourages underinvestment in some areas and overinvestment in other areas, reducing the long-run productivity of the U.S. economy.

Finally, the corporate tax system is not neutral relative to investment in the United States and investment abroad. In this case there are a number of competing and sometimes contradictory neutrality concepts.[13] One of the classic concepts is "capital export neutrality." The current system violates this form of neutrality because it gives a tax advantage to overseas investment in the form of a deferral that is not available to domestic investment. Specifically, the U.S. government taxes U.S. multinationals on income earned both at home and abroad. Income earned abroad, however, is generally not taxed until it is repatriated (and firms receive a credit for any foreign taxes paid on that income). This "deferral" of taxation allows foreign-earned

[13] Mihir A. Desai, and James R. Hines Jr. 2003. "Evaluating International Tax Reform." *National Tax Journal, Vol 56(3).*

income to grow tax free, distorts investment decisions, potentially leads to overinvestment abroad, creates an incentive for firms to earn (or report) profits in low tax countries, and reduces U.S. corporate tax revenue. Making the tax code more neutral with respect to international transactions could also be done in a manner that lowers the corporate tax rate overall.[14]

Moving towards more neutral taxation of business income need not require increasing the deficit or reducing the overall progressivity of the tax systems. There are a number of models policymakers could contribute, the most comprehensive being the Business Enterprise Income Tax (BEIT) developed by Edward Kleinbard.[15]

Conclusion

The longstanding shortcomings in the tax code are compounded by three major imminent issues: the 2010 expiration date for the tax cuts enacted since 2001, the expansion of the Alternative Minimum Tax, and the worldwide trend towards lower corporate tax rates. These issues give policymakers an opportunity to reform the tax code.

A number of considerations are important in such a reform. The large increase in income inequality provides a rationale for making the tax code more progressive. The tax code could be substantially simpler. And, the topic of my testimony today, the tax code could be more efficient if it were more neutral vis-à-vis different economic activities and if deviations from neutrality were better designed.

[14] Rosanne Altschuler and Harry Grubert. 2006. "Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income."
[15] Edward D. Kleinbard. 2007. "Rehabilitating the Business Income Tax." Discussion Paper 2007-09, The Hamilton Project, Washington, DC.

United States Senate Committee on Finance Hearing
Tax: Fundamentals in Advance of Reform
April 15, 2008

Questions Submitted for the Record

Questions for Jason Furman:

Senator Baucus

1. Congress has continually amended the Code, adding back in much of the complexity the 1986 reforms tried to eliminate. This question is for the entire panel.
    a. As Congress begins to consider tax reform, what principles should we keep in mind to help prevent a reoccurrence of what has happened post-1986 and help develop more stable tax reform that will not be undone soon after?

    b. How do we develop strong policy that will hold up to amendments?

    c. Are we destined to go through this process every 20 to 30 years?

First it is important to put what has happened in perspective. The 1986 reform broadened the base and lowered the top rate from 50 percent to 28 percent. Since then the base has narrowed and the top rate has risen to 35 percent. So in one sense the majority of the 1986 reform is still intact.

That said, the large number of changes and complications since 1986 have clearly been undesirable and a similar process should be avoided in the future. One way would be to establish a radically new tax base, along the lines proposed by Professor Graetz. In the absence of such a change, Congress would have to consider procedural rules. For example, Bill Gale from the Brookings Institution has proposed making it more difficult to adjust the tax base. Policymakers would be free to raise or lower rates to achieve their revenue targets but if they wanted to narrow the base they would need to pass a supermajority requirement.

Finally, I believe that it may be inevitable to have major tax reforms periodically for three reasons. First, the next reform may not solve every problem so it may be necessary to come back and improve the tax code still further. Second, legislation between major tax reforms may complicate the tax code. Finally, tax reform should respond to evolving conditions. These include evolutions in our understanding of the tax code and its economic effects, evolving technologies that affect tax administration, changing corporate practices, and changing tax practices by other countries.

2. You all point out different goals for tax reform.

    a. What should be the most important goal? What should Congress focus on?

    b. How should Congress prioritize these goals?

I personally believe that the two biggest challenges facing the American economy are the massive increase in inequality, which manifests itself in the form of relatively slow income growth for low- and middle-income households and the long-run fiscal gap. For this reason my recommendation is that Congress may make the tax code more progressive. And that it reduce the fiscal gap through a combination of spending reductions and revenue increases.

I recognize, however, that it may be easier to approach fundamental tax reform with the ground rules that the reform be revenue neutral and distribution neutral. Such a reform could still have major benefits for the economy and society. If these are the ground rules, then I believe the most important goal is efficiency, defined not just in the narrow economic sense of encouraging work and saving but more broadly making the tax system efficient at accomplishing any other goals that are set for it, such as encouraging the purchase of health insurance. Tax neutrality, the subject of my testimony, is the most important part of making the tax code more efficient.

3. We're looking towards 2010 when the tax cuts expire, the alternative minimum tax has the potential to encompass 30 million taxpayers, and Congress is extending several expiring provisions a year.

    a. What is the biggest challenge to tax reform?

    b. How does Congress conquer that obstacle?

    c. When does tax reform become unavoidable or an emergency? Have we gotten to that place?

The biggest challenge is political: the ability to overcome the inertia in the political system and the dynamics of a political process where the losers from tax reform are potentially more vocal in opposition than the winners are in support.

I wish I could say that tax reform will become unavoidable or an emergency. But simply extending some of the tax cuts and the AMT patch are certainly a feasible, if undesirable, policy option. So tax reform is not inevitable. Instead, I believe that Congress needs to work on a bipartisan basis together with the President. Another Commission is not necessary, but should only be considered if there is substantial advance buy-in from all the relevant parties – a condition that was absent with the last tax reform commission.

4. Mr. Furman, in your testimony you point out that there are highly variable tax rates on different forms of capital. For example, the effective tax rate on debt-financed corporate investment is much lower than for equity-financed corporate investment, which encourages financing through borrowing.

    a. The tax rate could be raised on debt-financed investment and cut on equity-financed corporate investment. If you could make one other change, what would be your highest priority?

Given the revenue needs and the distributional issues, I would raise the tax rate on debt-financed corporate investment.

Senator Grassley

1. This question is for the panel. I read with interest the discussion in the report of the President's Advisory Panel on Federal Tax Reform about how our tax policies send a strong message in favor of debt financed investment as opposed to equity investments. To the point where the report concludes that the reward for debt-financed investment is greater than if there were no taxes at all – it is actually a negative tax.

    I'm also especially troubled by some research that suggests this policy encourages corporations to pile on debt. This preference may be increasing risks of bankruptcy and financial distress particularly when there is an economic downturn. Research also reveals that the different treatments between debt and equity also create opportunities for tax shelters.

    In these times, we've been disturbed by heavily leveraged entities in the financial services industry. I'd appreciate your expanding on these points and your suggestions for reform in this area.

I agree with the problem you have identified, as I stated in my written testimony: "The 42 percentage point disparity between debt and equity financing encourages corporations to finance themselves more heavily through borrowing. This leverage in turn increases the financial fragility of the economy, an effect we are seeing quite dramatically today."

The solution to this problem could come from greater integration of the tax system at the individual and corporate level. One proposal that accomplishes this was developed by Ed Kleinbard, currently Chief of Staff to the Joint Committee on Taxation. Another solution was proposed by the Treasury in 1992 and is known as the Comprehensive Business Income Tax (CBIT).

2. The Chairman, Senator Conrad, myself, and others have talked about the tax gap. In testimony a few years ago, David Walker of the General Accountability Office

("GAO") analyzed the link between tax complexity and the tax gap. I'd like to re-visit this linkage with the panel.

a. Do you agree with the GAO that fundamentally reforming our tax system has the potential to improve compliance? That is, the complexity of, and frequent revisions to, the tax system make it more difficult and costly for taxpayers who want to comply to do so.

b. First, wouldn't you agree that by reducing complexity, we should be able to reduce the amount of the tax gap attributable to unintentional noncompliance?

c. Second, do you know of any new data that have looked at how much of the tax gap is attributable to unintentional noncompliance due to the complexity of the tax code?

d. And third, it has been said that the rate at which taxpayers voluntarily comply with our tax laws has changed little over the past three decades. What impact did the Tax Reform Act of 1986 have on the tax gap?

I agree with GAO that fundamental tax reform that simplifies the tax code would help reduce the tax gap, especially that portion due to unintentional noncompliance. I do not know of any new data that would help illuminate the magnitude of this contribution. Finally no one has comparable data that would make it possible to compare the tax gap at different points in time.

3. The landmark 1986 Tax Reform Act contained scores of transition rules. The Philadelphia Inquirer published a Pulitzer Prize winning series on the legislation. Much of that material focused on the transition rules. As a result of that controversy, Finance Committee Chairmen, from Senator Bentsen forward, on a bipartisan basis, implemented a practice prohibiting "rifle shots." Many practical observers of the process for the 1986 legislation would contend that the transition rules were necessary to secure political support for passage.

   The political imperative of transition relief is an issue we cannot ignore. Setting aside revenue neutrality for an instant, how do you recommend treating transitional items such as credit carryforwards and the loss of depreciation deductions, interest deductions, and deductions for the recovery of inventory?

I agree that transition relief is critical not just to the political success of tax reform but also the fairness and potentially even the efficiency because the expectation of, for example, lost depreciation allowances could have a chilling effect on investment in the runup to tax reform. I do not think that such transition relief should be considered "rifle shots."

As to the specifics, this goes beyond my own expertise and would depend on the specific context of the reform.

4. In general, U.S. citizens are taxed on their worldwide income. To avoid double taxation, the U.S. system employs a credit system that allows taxpayers a foreign tax credit to offset U.S. tax liability on foreign income.

   Another way to avoid double taxation would be to exclude foreign income from U.S. taxation altogether. This is the type of double tax relief provided by territorial tax systems. Under current law, the foreign earned income exclusion allows U.S. citizens to, in effect, elect territorial treatment with respect to a limited amount of foreign earned income.

   Many commentators have suggested adopting a territorial system for corporations. For instance, the President's tax reform panel recommended that approach. The most common reason given by supporters of a territorial system is that such a system is common to many industrialized countries and it would therefore enhance the competitiveness of U.S. businesses.

   Based on those same arguments, there have been recent proposals to enact a territorial regime for individuals by removing all restrictions on the foreign earned income exclusion. Yet, in its recommendations, the tax reform panel, for instance, retained worldwide taxation of U.S. citizens.

   Should we consider a territorial system for individuals?

I think we should consider a territorial system both for individuals and for corporations. But in doing so it is important that in addition to being exempt from tax on income individuals and corporations should also lose tax deductions and credits associated with overseas activities. That said, although such a system should be considered I think a worldwide system is more desirable on the neutrality grounds I outlined in my written testimony.

Senator Hatch

1. Dr. Furman, as you know, in recent years the tax law has become riddled with tax credits of various kinds, mostly intended to encourage one type of behavior or another. For example, Congress has utilized tax credits extensively in an attempt to further energy policy. How do these kinds of tax credits fit in with your concept of neutrality in tax policy?

As I discussed in my testimony, I think the ideal system would use either a carbon tax or a cap-and-trade system combined with auctioned permits to put a price on carbon emissions. With such a price, individuals and corporations would have the right incentives to take into account the full consequences of their actions by, for example, engaging in more research, conservation, and other activities to limit carbon emissions. Such a system would be <u>neutral</u> vis-à-vis different ways of reducing carbon emissions and would not pick winners or losers.

In contrast, energy tax credits are a very imperfect way of capturing some of the benefits of this broader system because it involves the government picking winners and losers and would also not be a comprehensive solution to our climate and energy problems. In the absence of a carbon pricing mechanism such imperfections may be better than nothing due to the climate challenges we face. But with a better policy, these tax credits would surely be superfluous at best.

2. Dr. Furman, it seems to me that health policy reform and tax policy reform are closely intertwined. Can we approach them separately, or must we really do both at once?

You are correct that they are closely entwined. And I think it is possible to address them together, a step proposed by the President's Advisory Panel on Federal Tax Reform, for example.

It is, however, completely possible to undertake either reform on its own – there is more than enough that could be changed in the tax system while keeping the tax treatment of health insurance unchanged. And you could change the tax treatment of healthcare without making any other changes in the tax system. In practice, my guess is that Congress would find it easier to address these two issues separately.

Statement of Michael J. Graetz, Professor of Law, Yale Law School
At a Hearing of the Senate Finance Committee
on Fundamental Tax Reform
April 15, 2008

Mr. Chairman and Members of the Committee---

Thank you for inviting me to testify here today on this important and difficult subject.[*]

The Need for Fundamental Reform

Our nation's tax system is badly broken. No one quarrels with that.

First, our nation's basic tax structure came into place in the World War II era, when the United States essentially had all the money there was. Even a horrid tax system – with income tax rates up to 91% – could not then stall our economic progress. From 1946 through 1973, when OPEC quadrupled the price of oil, the economy grew by an average of 3.8% a year and unemployment averaged 4.5 percent. Since 1973, our economy has grown more slowly and so have the wages of middle income Americans. Today, the United States' economy must compete for the investment capital essential for economic growth – capital necessary to produce a rising standard of living for the American people – with many countries throughout the world, including not only places like Europe and Japan, but also Brazil, Russia, China, and India. Our tax system should advance the competitiveness of American workers and businesses not stifle it.

Second, our tax revenues are not quite adequate to pay for our current spending, and, much more importantly, will fall short of producing the revenues necessary to fund our government after the baby boom generation retires and is collecting the benefits of Medicare and Social Security. Everyone agrees that, absent dramatic changes in our spending or tax policies, a large long-term gap between spending and revenues will emerge. An aging population and rising health care costs will make our current tax policy unsustainable. Social Security, Medicare and Medicaid benefits will likely have to be reduced somewhat, and those programs may even be dramatically restructured, but it is foolhardy to assume that taxes will not also have to be raised. While in the short-term, we need not increase taxes, down the road--even assuming that Congress reduces the costs of the Medicare, Medicaid and Social Security programs--only by

[*] This testimony is largely adapted from my recently published book: *100 Million Unnecessary Returns—A Simple, Fair, and Competitive Tax Plan for the United States* (Yale University Press 2008). References have been omitted.

restructuring our nation's tax system can we effectively finance our government. Although not all tax reformers agree on how to proceed with fundamental reform, there is now broad agreement that our situation is sufficiently grave that we must act.

Third, the scheduled expiration in 2010 of large tax cuts enacted in 2001 and 2003 builds a large tax increase into the current tax law. If Congress fails to act, income tax rates will rise, as will tax rates on capital gains and dividends, and people will lose many other current benefits, including credits for children and relief from marriage penalties. Under current law, the estate tax exemption rises to $3.5 million next year with a 45% top rate, the tax is repealed in 2010, and in 2011 the tax comes back with a $1 million exemption and a 55% top rate. This cannot actually occur. And, as this committee knows well, the Alternative Minimum Tax (AMT) is currently structured in a way to catch millions more Americans and must be fixed or repealed.

If the tax cuts are allowed to expire in 2011 as scheduled, the Congressional Budget Office (CBO) estimates that federal revenues will exceed 20 percent of GDP, a level reached only once since World War II. In contrast, if the tax cuts are extended and the exemption from the AMT is indexed for inflation, tax revenues will be about 18 percent of GDP. This is a large difference in revenues amounting to hundreds of billions of dollars each year. Congress therefore needs to reexamine our nation's tax laws by 2010.

If we don't solve the problem of a grossly inefficient system of raising revenues, all the other challenges our government faces will eventually be overwhelmed by one over-arching reality: we will have too little money and will lack the means to raise it without damaging our economy. Doing nothing is not an option.

Fourth, our current income tax is a mess because presidents and the Congress ask it to do too much. The result is a level of complexity that baffles experts, let alone ordinary Americans at tax time. Presidents and members of Congress from both political parties seem to believe that an income tax credit or deduction is the best prescription for every economic and social problem our nation faces. In the process, we have turned the Internal Revenue Service from a tax collector into the administrator of many of the nation's most important spending programs. To keep track of all this, the federal budget each year is required to contain a list of "tax expenditures," defined as all tax credits, deductions or exclusions that deviate from a "normal" income tax. The number of these tax expenditures has grown enormously in recent years. Forty-five percent —66 of 146—listed in the 2006 budget have been added since 1986. Their total cost in lost revenues is estimated at about $700 billion a year.

I am not talking here about narrow special interest tax loopholes to benefit this company or that. Mostly, these are tax breaks widely available to broad

segments of the general public—tax cuts for the large middle-class. The largest of these are very popular: tax advantages for employees' payments for health insurance and retirement savings, deductions for home mortgage interest, state and local taxes, and charitable deductions.

And yet we know that trying to solve the nation's problems through "targeted tax breaks" does not work. Take health insurance, for example. Our nation, contrary to others throughout the world, has long relied on a tax benefit for employers and employees as its main mechanism for covering Americans who are neither poor nor aged. What has been the result? Our health-care costs are the highest in the world and more than 45 million Americans remain uninsured. Moreover, these costs are making American businesses and products less competitive in the world economy and are gobbling up wage increases of American workers. Nor has our tax-based energy policy produced better results. Nor do tax credits for working parents produce affordable childcare. I could go on and on.

Historically when competing policy ideas aimed at a common goal emerged in Congress, the leaders of the tax writing committees would fashion a compromise provision. Now, Congress often compromises by enacting *all* of the ideas, leaving unsophisticated taxpayers bewildered about how to cope. For a vivid illustration, consider the income tax incentives for paying for higher education. There are eight tax breaks for current year education expenses: two tax credits, three deductions and three exclusions from income. Five other provisions promote savings for college expenses. In 1987, there were only three provisions encouraging college expenditures or savings. The 1997 Act alone added five provisions that were estimated to cost $41 billion over five years; together they represented the largest increase in federal funding for higher education since the GI Bill.

Comprehending the tax savings provided by these provisions, their various eligibility requirements, how they interact, and their recordkeeping and reporting requirements is mind-boggling. Each of the provisions has its own eligibility criteria and definition of qualified expenses. For example, they do not provide consistent treatment of room and board, books, supplies and equipment, sports expenses, nonacademic fees, or the class of relatives whose expenses may be taken into account. A student convicted of a felony for possession or distribution of a controlled substance is not eligible for one of the education credits, but such a conviction is no bar to another one. And this is just the tip of the iceberg.

Relying, as we do, on income tax deductions and credits is about as successful a solution to our national needs as handing out more gunpowder at the Alamo. We must be weaned away from using tax deductions or credits as a cure-all for our nation's ills. I believe that the only path to success is to remove most Americans from the income tax altogether.

Our income tax is a mess. Today, no matter what their income, Americans confront extraordinary complexity in filing their taxes. Today the instruction booklet spans more than 100 pages and the form itself has more than 10 schedules and 20 worksheets. No wonder more than 60 percent of income tax filers hire tax preparers (and many of the rest rely on computer programs) to tell them what to do. And tax return preparers have become notorious for peddling other products of dubious value to their customers, most notoriously so-called "refund anticipation loans," which often advance tax refunds by a few days at an exorbitant interest cost.

The income tax has become so complex and riddled with perverse incentives that Americans spend an estimated 3.5 billion hours each year preparing and filing their taxes. Families, businesses, and the federal government now spend a staggering $150 billion each year just to calculate and administer the system. It is $150 billion of wasted money.

In fact, the income tax so confuses ordinary Americans that 2 million people paid more than $1 billion extra because they made the wrong choice about whether to itemize or take the standard deduction. And while these people overpaid because of the complexity, far more pay too little –many deliberately. The IRS estimates that taxes are underpaid by about $300 billion every year, which requires honest taxpayers to pay more than $2,000 each to make up the loss.

In addition to these losses, the incentives in today's tax law for unproductive expenditures, coupled with the efforts of individuals and businesses to structure their affairs in a tax-favorable fashion, are estimated to cost our economy a further $1 trillion dollars a year. For a long time after the Second World War, we could endure such waste and hardly notice. But today, when American businesses and workers are engaged in a highly competitive global economic environment, these are costs that we can no longer afford.

Tax Reform Principles

Except in extraordinary circumstances, the minimal requirement for a tax system should be that it raises sufficient revenue to pay for government expenditures. A good tax system ought to do so fairly, keeping its costs of compliance and administration as low as feasible. It ought to be conducive to economic growth. Finally, it ought to promote freedom by interfering minimally with private decision-making. Our nation's tax system fails on every count.

It should be a simple truth that tax revenues ought to be adequate to finance the government's spending. Economic conditions, to be sure, may

occasionally call for deficits to provide a short-term economic stimulus. And unforeseen circumstances—a terrorist attack or a devastating hurricane, to name two—may create a temporary shortfall in government collections that will take time to correct. But routinely financing government with borrowing simply shifts the taxes to our children and grandchildren, and running up interest on the federal debt will inevitably require higher taxes from someone down the road. But because "someone down the road" does not yet vote, deficit finance is catnip to many politicians. As Herbert Hoover put it, "Blessed are the young for they shall inherit the national debt."

Deficit finance increases our economic vulnerability when it is coupled with a substantial imbalance in trade. Because we import far more than we export, other nations accumulate dollars, which they use to purchase U.S. assets, including government debt. And they are accumulating many more dollars everyday. If they were to dump those bonds or dollars on the market, it would cause a precipitous decline in the value of the dollar and might destabilize our economy. Allowing foreign governments such control over our economic well-being may ultimately prove harmful not only to our economic health but also our national interest and security. As Harvard economist Benjamin Friedman puts it: "Government deficits sustained year after year even when the economy is operating at full employment, reduce net capital formation and induce foreign borrowing. Both effects accumulate over time. Both are harmful."

We have been unwilling either to pay for the government we have or to have a substantially smaller government. The time has come to put our fiscal house in order. We must stop pretending that we can continue to live with a tax system inadequate to finance what we are spending. Controlling that spending—and cutting it down whenever we can—should be a priority. But our federal government cannot continue to spend 20 or 21 percent of GDP while raising only 16 to 18 percent in taxes.

Although the income tax now affects nearly everyone, that hasn't always been so. It wasn't until World War II that the federal government expanded the income tax beyond wealthy individuals to tax nearly all middle and moderate income Americans. Sixty years later, this system is badly broken and unable to produce adequate revenues for the future without threatening economic growth. Relying as heavily as we do on income tax revenues to fund our government has become a liability in the current competitive international marketplace.
In a world immeasurably more interdependent than the world of the mid-twentieth century, when our current system of taxation took shape, a vital question for any reform proposal is: Will it make American workers and businesses more competitive in the global economy, while maintaining the progressive structure that fits with our nation's historical insistence on fairness?

We need a tax system that will encourage investment in the United States to create good jobs and will help make the goods and services our businesses and workers produce more affordable to consumers around the world.

Let me conclude this brief discussion of principles with a few words about the fair distribution of taxation's burdens.

In our country today, the gap between the wealthy and the poor is wider than it has been in a long time. One has to go back to the 1920s to find a chasm so big between the ultra-wealthy and the least well off in our society. Some insist that to even notice this fact, much less do something about it, amounts to an endorsement of some utterly leveling socialism or even communism. This is nonsense. And dangerous nonsense at that. As Andrew Jackson and Teddy Roosevelt, to name just two, understood, the establishment of a permanent economic aristocracy is inimical to the American ideal of fairness for all its citizens. George W. Bush in February 2007 recognized the issue: "The fact is that income inequality is real; it's been rising for more than 25 years." And Henry Paulson, in his first speech as Bush's Treasury Secretary identified "wage growth and income distribution" as one of the major economic challenges facing our nation. Any serious reform of our tax system must retain as one of its first principles the progressive structure we have used for nearly a century.

As James Q. Riordan, a staffer for the conservative Tax Foundation said, "the need for a progressive tax system is imprinted on the American DNA." This sentiment has been echoed by the liberal congressman Richard Neal (D. Ma.) who said "From the Boston Tea Party to now, tax fairness is firmly parked in the American psyche." The need for a progressive tax system is not a partisan issue.

Today's tax reform debate has re-opened the contest between what Stephen Weisman in his book *The Great Tax Wars*, labeled "virtue", on the one hand, which views "wealth as a product of hard work, thrift, ingenuity and risk taking"--something the state should encourage and protect--and "justice", on the other, which, according to Weisman, is taxation based on ability to pay with progressive taxes on income or wealth. Weisman, like most Americans, views progressive taxation as necessary to "soften the edges of the distribution of wealth in the interest of justice and fairness".

Drawing appropriate lines in the battle between virtue and justice has always haunted tax lawmaking. Today's tax reform debate raises fundamental questions that many thought were settled by the enactment of the income tax nearly a century ago--- questions that have not been at issue since the income tax was extended to the masses to finance World War II. Advocates for replacing the income tax with a "flat tax" or a national sales tax are quite willing to sacrifice tax justice to promote economic virtue and reward success. One need

not view the current tax distribution as ideal to know that tax reform should not be used to shift the tax burden away from those at the top down the income scale.

In addition to producing a simple tax system that will raise adequate revenue without inhibiting economic growth, the critical challenge for tax reformers today is to fashion a tax reform that will better reward virtue and promote economic growth *without* sacrificing tax justice, *without* shifting the tax burden downward. Last century's solution--the progressive rate income tax--has fallen into disrepair and disrepute. Relying--as we now do and have since World War II-- exclusively on the income tax as the solution to this dilemma no longer seems wise.

The current income tax is a horrible mess. But it is quite progressive today. More than two-thirds of the total income tax is paid by the highest 10% of earners, more than one-third by the top 1 percent. It is impossible to duplicate this distribution by substituting a flat rate tax on consumption for the income tax. In restructuring our tax system, we need not, and should not, enact a massive tax reduction for the country's wealthiest people--those who least need such relief--while increasing taxes for those with less income or wealth.

In 1986, Congress was able to achieve a bipartisan tax reform only by agreeing to leave the distribution of the tax burden as it was. Maintaining the existing distribution of the tax burden may somewhat complicate the task of tax reform and limit the options available, but, at a minimum, it is essential if reform is to be fair. Despite several tax reform plans currently before Congress that throw into question the century-old American principle that taxes should be distributed in accordance with people's ability to pay, replacing much of our income tax with a tax on goods and services need not strip away the progressivity we have in our system. As the Competitive Tax Plan, described in my recent book, demonstrates, this distribution can be maintained with a new mix of taxes in a far simpler system that can produce adequate revenue as our population ages--and in a manner much more conducive to economic growth.

Tax Reform Alternatives

Tax reform will not be an easy task. When this committee and the Congress tackle tax reform, you will not have the luxury of federal budget surpluses that might be tapped to finance an-overall tax cut to sweeten the bitterness from the inevitable reduction and elimination of many tax breaks. This option was available in 2001, but the president and Congress took a different path.

Income Tax Reform

Although an income tax was used to help finance the Civil War, it did not become a permanent part of our nation's financial picture until World War I. The

corporate income tax dates from 1909, but it was not until after the 16th Amendment was ratified in 1913 that a tax on individual incomes was enacted. From the end of the Civil War until 1913, the federal government raised its revenue almost exclusively from tariffs on imported goods and excise taxes on this or that. By the beginning of the 20th Century, however, there was great dissatisfaction with this system. Tariffs and excise taxes raised the costs of goods for everyone, while large fortunes accumulating in real estate, corporate stock and other investments were left untaxed. In 1893, for example, an Atlanta newspaper complained that "most of our tariff taxes...fall heavier on the poor." The income tax was adopted--with the extraordinary public support necessary to amend our constitution--to fund a reduction in tariffs and to counterbalance the effect of taxes on consumption with a tax more closely linked to people's ability to pay. When first enacted, the income tax was expected to contribute only a small portion of ordinary government revenues and to supplement other revenue sources in times of emergency.

So the income tax was not originally supposed to play the central role in financing the federal government that it now does. Until World War II our income tax had exemptions that shielded most Americans from having to pay it. During World War I, these exemptions were lowered and rates increased so that the income tax played a crucial role in financing the war, but after that war ended, the tax was rolled back to its original limited scope. From 1918 to 1932 only 5.6 percent of the population filed taxable income tax returns, and from 1933 to 1939 that number dropped so that on average only 3.7 percent of the total population filed taxable returns. Public opinion polls in 1938 and 1939 showed large majorities of Americans favored an exemption level that would exclude at least 75% of the population from income taxes. Thus, through the economic shocks of the Great Depression and the creation and expansion of the New Deal, the reach of the income tax remained quite limited: true to its original conception, it was a low-rate tax on a relatively small group of higher-income Americans. But World War II changed everything.

Legislation in 1940 and 1941 increased the number of Americans subject to the income tax by 400 percent, from 7.4 million to 27.6 million. After the U.S. entered the war, the number of income tax payers expanded dramatically. By 1943, taking into account both the regular income tax and a so-called "Victory Tax" (a 5 percent tax on incomes over $624) 50 million Americans—nearly 70 percent of the population—were required to file income tax returns.

As we now know, the imposition of the income tax on nearly the entire population has led to perverse results in terms of complexity and congressional policy making. And as our history shows us, it needn't be so. What we should do now is return the income tax to its original, manageable purpose. That is the collection of a simpler tax on high-income earners who tend to have multiple income sources.

The Tax Reform Act of 1986 was widely heralded as the most significant change in our nation's tax law since the income tax was extended to the masses during World War II. It was the crowning domestic policy achievement of President Ronald Reagan, who proclaimed it "the best anti-poverty measure, the best pro-family measure and the best job-creation measure ever to come out of the Congress of the United States." The law's rate reductions and reforms were mimicked throughout the OECD. Even at the time, however, reading the paeans to this legislation was like watching a Tennessee Williams play: something was terribly wrong, but nobody was talking about it.

Two decades later, the changes wrought by the 1986 act have proven neither revolutionary nor stable. The legislation was a rearrangement of the income tax law in which marginal tax rates were reduced and the tax base was broadened by limiting or eliminating various loopholes, deductions, and exemptions. The act did enhance both the equity and efficiency of the income tax, but it was far from the purist cleansing of the tax code that some of its more ardent admirers implied.

The 1986 act substantially increased the permissible amount of tax-free income, removing about six million low-income people from the income tax rolls; lowered and flattened income tax rates; shut down mass-marketed tax shelters for high income individuals; curtailed the ability to shift income to lower-income family members subject to lower tax rates; and taxed capital gains at the same rates as ordinary income. An increase in corporate tax revenues was used to finance an overall reduction in individual income taxes, although, by cutting back on deductions for plant and equipment, Congress found the money to reduce the corporate tax rate (from 46 to 34 percent).

The Tax Reform Act neither spurred American productivity, as some of its admirers hoped, nor destroyed it, as many of its detractors had warned. University of Michigan economist Joel Slemrod estimated that the 1986 Act may have spurred as much as a 1 percent increase in hours worked -- a genuine benefit, but hardly a new American revolution. In addition, the act ultimately fell short of creating a substantially fairer income tax because it left in place many avenues for tax-favored treatment. Complex new rules limited personal interest deductions to homeowners, disadvantaging renters who lost their ability to deduct interest on their credit cards. Many provisions offering incentives for specific investments were continued, and new ones were added. Hundreds of scatter-shot "transition" rules were enacted to give special tax breaks to particular companies or individuals.

Compromise is often the handmaiden of tax complexity, and the 1986 legislation was forged out of hundreds of political compromises. Rather than eliminating provisions of dubious merit, Congress settled for reducing their benefits or restricting their use. Examples abound: the tax law now contains rules distinguishing at least 17 different categories of interest expenses; the 1986 rules

for international investments were stupefying in their complexity; and the alternative minimum tax (AMT) provisions require two different ways of calculating income, each with its own rate schedule.

In the two decades since 1986, Congress has amended the code annually, adding thousands of pages of new legislation. In retrospect, the inherent weaknesses of the 1986 Tax Reform Act have become easy to identify. First, as I have said, the fragile political coalition that enacted the law left in place a variety of ongoing complexities, inequities and inefficiencies. Second, the 1986 Act had little public support even when it was passed. Third, and most importantly, the 1986 tax act was based on retaining and strengthening the income tax itself, rather than heeding the calls of many economists and politicians to replace all or part of it with some form of tax on purchases of goods and services.

Given the internationalization of economic activity during the past two decades, the 1986 Act's reliance on increased taxation of income from capital and corporate income has made the United States economy less competitive with other national economies that tax corporate income at a relatively lower rate. For all these reasons, tax experts now regard the 1986 Act as a promise failed. There are, however, many people who continue to think that the best path for tax reform is to reprise the 1986 Act and simply improve the income tax.

Income Tax Reform Proposals

There are two recent prominent proposals for income tax reform, echoing the 1986 reform, that I shall discuss here. The first is the "simplified income tax" (SIT) proposal offered by President Bush's tax reform panel; the second is the "Fair Flat" tax proposal introduced in Congress in 2005 by Senator Ron Wyden (D. Ore.) and Congressman Rahm Emmanuel (D. Ill.). Both would eliminate the AMT and cut down on deductions and other tax breaks to pay for it.

Two weeks before George Bush's second inaugural, on January 7, 2005, he issued an executive order establishing the "President's Advisory Panel on Federal Tax Reform." He charged it to submit to the Treasury Secretary "revenue neutral options for reforming the Federal Internal Revenue Code." Bush picked two former senators to head this group: Connie Mack (R. Fla) and John Breaux (D. La).

Bush's nine-person panel traveled the country, holding twelve public meetings in five states and in Washington D.C. It took testimony from experts of all political persuasions, who offered devastating criticisms of the current income tax and many suggestions for how to fix or replace it. In November 2005, four months later than originally anticipated, the panel issued a 272 page report detailing two proposals that it supported unanimously and a third option, closely related to the plan I recommend in my recent book, which it described as "worthy

of further discussion." The panel also explained in detail why it had rejected complete replacement of the federal income tax with a "flat tax" or a national sales tax.

With its extensive study and thoughtful report, the president's hand-picked panel injected an unwelcome dose of reality into the tax reform debate. The panel's report carefully considered the two ideas that have garnered the most political support among congressional Republicans--a "flat tax" and a national sales tax--and rejected them both. Instead, the panel proposed two alternatives: an income tax restructuring along the lines of the 1986 tax reform and the combination of a new consumption tax with a tax on some income from capital. Both of the panel's two recommended plans would (1) reduce the top marginal tax rate—to 33 and 30 percent respectively; (2) eliminate the alternative minimum tax (AMT), which now requires people to calculate income tax two different ways and pay the higher amount; (3) replace the earned income tax credit and refundable child credits with a refundable "work credit"; (4) replace personal exemptions, the standard deduction, and child tax credits with a "family credit"; (5) eliminate all deductions for state and local taxes; (6) extend tax breaks for interest on home mortgages and charities to non-itemizers, but reduce the amounts that can lower tax; (7) cap the fringe benefit for employer-provided health insurance; and (8) expand and simplify tax-favored savings opportunities. President Bush's panel also would maintain, but revise, the tax benefits for dividends and capital gains. Both plans also would eliminate many other income tax deductions and credits.

Once the Panel decided to eliminate the AMT, which would cost more than $1 trillion during the next 10 years, it was not able to reduce tax rates much and it had to struggle to find offsetting revenues. This required attacking political sacred cows, such as the mortgage interest deduction, the charitable deduction and the deduction for state and local taxes.

The Wyden/Emmanuel proposal has much in common with the panel's plan, but there are some important differences. It has three tax rates—15, 25 and 35 percent. It would also eliminate many deductions, exclusions and credits and promises a shorter tax form. Senator Wyden and Congressman Emmanuel would retain many of the most popular provisions, including deductions for home mortgage interest and charitable gifts, the EITC and child credits, savings incentives for healthcare, retirement and education, and various benefits for the elderly, disabled, soldiers and veterans. They also would add a new refundable credit for 10% of state and local taxes. And they would tax dividends and capital gains at the regular tax rates.

For those interested in more detail, the table at the end of this testimony contains a side-by-side comparison of the main features of the two plans. As Senator Wyden has said, both would give the tax code "a good cleansing." He adds that this is what the "tax code desperately needs."

While either of these proposals would certainly improve current law, they do not, in my view, go far enough. As we now know, it doesn't take very long after a "good cleansing" for things to get very dirty again. Even those who applauded the 1986 Act as a wildly successful tax reform must concede now that this legislation was not a stable solution. Over time, many of its reforms have been reversed. Its broad base and low rates have been transformed into a narrower base with higher rates. How can anyone remain optimistic about fixing the income tax without radical surgery? What the nation needs is a new and better tax system, one that is far simpler, fair, and more conducive to economic growth.

It is the central contention of my book, and the centerpiece of my proposal, that the fundamental reform required to create an internationally competitive, administratively efficient, and viable long term solution to our funding requirements is to make a different choice. We should eliminate the income tax for the overwhelming majority of Americans and replace it with a broad-based tax on sales of goods and services. While I am by no means the first to propose the adoption of a consumption tax, my plan, unlike some national sales tax proposals such as the "FairTax" currently making the rounds in our capital, offers a non-ideological, reasoned, fiscally sound, and feasible way to modernize our tax system.

A Role for Consumption Taxes

When it comes to meeting its funding requirements, a government has four basic choices as to what it can tax: income, wages, consumption or wealth. From these four basic categories of revenue, we in the United States have since World War II chosen two—income and wages—as our primary forms of government funding. While it is true that our Federal government has at one time or another imposed more than fifty kinds of taxes on everything from filled cheese to cotton futures, from telegraph messages to the manufacture of tires, none of these revenue streams could ever suffice today to fund today's government budget. Put together, our individual and corporate income taxes along with our payroll tax on wages account for about 92% of federal revenues annually. State and local governments rely on their own versions of these taxes in addition to taxes on sales and property. And while the federal government imposes a handful of excise taxes—on alcohol, tobacco and gasoline, for example—unlike the rest of the world, we do not have a national tax on the third category, consumption. That is a tax on people's purchases of goods and services.

Overall, the U.S. is a relatively low tax country. But we are not a low income tax country. Looking at total taxes including federal, state and local taxes, as a percentage of total economic output (GDP) the U.S. at about 25 percent (including state taxes) has considerably lower taxes than the EU, which averaged about 40 percent before the recent addition of 10 new lower-tax

members, mostly from eastern Europe. Our taxes are also lower than the approximately 36 percent of GDP average of the thirty countries of the Organization for Economic Cooperation and Development (OECD). Our income tax level is comparable, however. We collect about 12 percent of our GDP in corporate and individual income taxes, while the OECD nations average about 13 percent and Europe around 14 percent. The biggest difference in our tax structure is that most other nations rely much more heavily on consumption taxes than we do. Indeed, we are the only OECD nation that does not impose a national-level tax on sales of goods and services.

The most common types of modern consumption taxes are retail sales taxes and value-added taxes (VATs). As you know, retail sales taxes in the United States are commonly imposed by state and local governments. States vary in their sales tax coverage and exemptions, and many local governments also impose sales taxes. In 2006 there were 7,588 separate retail sales tax jurisdictions in the United States. Large multi-state corporations commonly file more than 200 different state and local sales tax forms monthly.

Elsewhere in the world, the most common form of consumption tax is the VAT, a tax on value-added. The difference between the value of a business's purchases and its sales is the value it has added to its products or services, and it is this increase in value that is taxed. A VAT is much like a retail sales tax, except in a value-added tax system it is not only retailers who collect the tax and pass it on to the government. Wholesalers and manufacturers also withhold tax as a product moves through the chain of production, distribution, and sale. In other words, a retail sales tax only taxes sales to directly to consumers, while a VAT collects a portion of the tax at each level of production. The cumulative value added at all stages of production and distribution of a good or service necessarily equals the total value of the retail sale, with the result that a retail sales tax and a VAT of the same rate are economically equivalent.

After reading the previous paragraph it might sound as if the real difference between a retail sales tax and a VAT is that the VAT simply taxes more levels of production. Indeed, many people who oppose such taxes characterize them as if they actually taxed the same retail sale many times. This, however, is simply incorrect. In a value-added tax, businesses receive a tax-credit for the amount of VAT they have paid on their own purchases of goods and services from other businesses.

Value-added taxes are now imposed by all of the other OECD countries and by nearly 150 countries worldwide. In the OECD, the VAT rates range from a low of 5 percent in Japan to a high of 25 percent in Sweden, Hungary, Norway, and Denmark. In Ireland—which has been called by the *Wall Street Journal* the "Hong Kong of the west with the fastest pace of economic growth and jobs in the Eurozone" for its low 12.5% corporate tax rate—and other low income tax

countries, VATs generate significant revenues that make low income rates possible. Ireland, for example, imposes a VAT at a 21% rate.

Another key feature common to consumption taxes, regardless of how they are structured, is that the total tax base is generally sales, and thus the tax does not impose any burden on savings or investments. If a person spends less than her current income, the difference—her savings—is exempt from taxation. If a person spends more than her current income by either drawing down prior savings or borrowing to finance the spending, a consumption tax should be imposed on such spending.

Our federal government has frequently considered imposing a national consumption tax. For example, in 1921, when the income tax was only eight years old and a fraction of its current size, Ogden Mills, then a Congressman from New York, who later served as Herbert Hoover's Secretary of the Treasury, argued that Congress should substitute a tax on "spendings" for the income tax. Mills' proposal for taxing consumption rather than income was not a new idea, even in the 1920s. John Stuart Mill had been a fan of taxing consumption, and Alexander Hamilton had only praise for consumption taxes.

In 1942 Franklin Roosevelt's Treasury Secretary Henry Morgenthou advanced a progressive, graduated rate tax on spendings to finance the Second World War, but Congress again rejected it. Instead, the Revenue Act of 1942 began the conversion of the income tax, which had applied only to high income people, into a tax on the masses. Had this episode turned out differently, the income tax might have remained narrowly targeted to high income people, and a consumption tax, rather than the income tax, might have become the federal government's mainstay revenue raiser.

After that, from time to time, presidents and members of Congress have considered taxing consumption rather than income, but when Ronald Reagan and the Congress retained and strengthened the income tax in 1986, rather than replacing it with a consumption tax, many observers thought that signaled the demise of the political movement to replace all or part the income tax with a consumption tax.

After the Republicans' sweep of the Congressional elections of 1994, however, proposals for substituting a consumption tax for the income tax vaulted back into the forefront of the nation's political dialogue. Republican Senate Budget Committee Chairman Pete Domenici of New Mexico and Democratic Senator Sam Nunn of Georgia in 1995 introduced legislation to replace the individual income tax and a portion of the social security payroll tax with a progressive rate tax on consumption and to substitute a valued-added tax for the corporate income tax. Ways and Means Committee Chairman Bill Archer of Texas and 1996 Republican Presidential candidate Senator Richard Lugar of Indiana said that they too wanted to replace the income tax with a consumption

tax. Chairman Archer never said what kind of consumption tax he favored. Senator Lugar proposed a retail sales tax to be collected by the states, which he claimed would put the IRS out of business. This torch is now being carried by Congressman John Linder and the "FairTax" movement. In 1995 Dick Armey of Texas, the new Republican majority leader, and Republican Presidential candidate Steve Forbes urged replacing the corporate and individual income taxes and the federal estate tax with a flat-rate tax on consumption –a variation of a subtraction-method value added tax-- which they call a "flat tax". The Princeton economist David Bradford added a second rate to the flat tax to make it more progressive and named this the X-tax. In 2005 President Bush's tax reform panel added a third rate and a supplemental income tax on dividends, interest and capital gains, turning it into a hybrid of an income and consumption tax, and called it the "Growth and Investment Tax Plan." All the rejiggering and relabeling makes it impossible for the public to know exactly what kind of tax system is being proposed.

The recent ascendancy of consumption tax proposals raise three fundamental questions. First, should the United States adopt a national tax on sales of goods and services? Second, if so, in what form? How should such a tax be structured? And, third, what should the revenues from such a tax be used for? In particular, what other tax reforms should accompany introduction of a national consumption tax? The answers to these questions will determine whether and how much tax reform will improve the simplicity, fairness and economic wisdom of our tax system.

The simplification advantages of a consumption tax depend on how it is implemented. Retail sales taxes and VATs are collected from businesses rather than families, greatly easing the compliance burdens of households and freeing them from having to deal with the tax collector. Other forms of consumption taxes such as the "flat tax" (which is a consumption tax although the public may believe it to be an income tax) tax the wage element of value added to individuals and thus require households to file tax returns. Since under the "flat tax" only wages would be taxed to individuals, and all deductions, exclusions and credits would be eliminated, its proponents claim that the annual return will shrink to a postcard that everyone would be able to fill in quickly and easily. Adding more than one tax rate as, for example, the president's panel recommended, does not substantially complicate matters.

The fact is, both the flat tax and the GIT are variations on a form of value-added tax that in fact resembles an income tax. They are what is called "subtraction-method value-added taxes." This kind of VAT taxes the difference between the total receipts from a business's sales of goods or services and the total amount of the business's purchases of goods or services from other businesses. The difference between sales and purchases is the business's value added and the tax rate is applied to that amount. This subtraction-method VAT seems to be enjoying great favor among some consumption tax advocates.

At the same tax rate, a retail sales tax, a subtraction-method VAT and the much more common credit-method VAT should produce similar results. The flat tax and the panel's GIT proposals essentially split the collection of a single rate subtraction-method value-added tax between businesses and individuals. Rather than denying businesses any deduction for wages, as is usual under a value-added tax, the flat-tax allows businesses to deduct wages in addition to purchases from other businesses. This type of consumption tax is collected at each stage of production, as under a typical value-added tax, except that the tax on wages is directly remitted by individual wage-earners. In combination, the total of the business and individual tax bases should equal total sales, putting aside any exemptions.

The principal advantage of dividing a value-added tax between businesses and individuals is that it enables the exemption of a certain amount of wages from tax and may thereby eliminate, for wage earners, the regressivity of a standard flat-rate tax on consumption. The amount of the exemption or standard deduction will, of course, vary depending on the flat tax rate and the other exclusions, deductions or tax credits allowed. (As my recent book details, there are other methods of addressing this issue under a VAT or retail sales tax.) This division of the consumption tax base tax also allows the imposition of progressive rates on wages, as the panel's GIT demonstrates, though it is a bit mysterious why only wages and not investment income should be subjected to progressive tax rates.

Two problems remain, however. First, the flat tax (and its variations) are consumption taxes invented by academics, which are untried and untested anywhere in the world. All experience warns us that even if such a tax could be enacted in its pure form with all deductions, exclusions and credits eliminated—a real long shot—the tax would stay neither pure nor flat for very long. Tax breaks for homeownership, charitable gifts and education expenses, to name only a few, would soon make their way back into the tax code. Second, as the president's panel discovered, taxing only individuals' wages and not their income from investments offends our notions of tax justice. This is why the panel—hardly a bunch of liberals and none of whom, as John Breaux has reminded us, is standing for re-election—coupled their consumption tax proposal with a tax on interest, dividends and capital gains, albeit at a lower 15% rate. The panel concluded -- correctly in my view -- that the American public will not accept taxing families only on their wages and not on the income they receive from their investments or savings.

In the 1990s Senators Sam Nunn and Pete Dominici proposed coupling a VAT with a progressive rate tax on consumption—a so-called expenditure tax. The Senators called their tax a "Uniform Savings Allowance," or "USA" tax. The senators designed their proposal this way to avoid the substantial tax cut for high-income families which would occur under flat-rate consumption taxes that

entirely replace the income tax. Again, unlike the VAT or retail sales tax, a progressive consumption tax is essentially untested, although it has long been discussed and often applauded in academic circles. Only India and Sri Lanka have ever enacted an expenditure tax, and both repealed the tax shortly after it was enacted.

Senators Nunn and Domenici modified the standard form of expenditure tax in an effort to make their proposal more appealing politically. Their proposals would exempt, for example, much consumption financed out of sales of people's existing assets and would defer the tax on consumption from borrowed funds. These modifications required complex rules to track both borrowing-financed consumption and consumption from dispositions of pre-enactment assets. Indeed, the Nunn-Domenici plan floundered because of its inability to solve problems of transition from an income tax to this type of consumption tax and its failure to tax consumption financed with borrowing. In combination, these two problems allowed people with assets or the ability to borrow to avoid the tax. The personal tax was essentially a tax on wages, but by borrowing for consumption and reinvesting the proceeds of asset sales, people could have avoided even the wage tax. Senators Nunn and Domenici also concluded that it was necessary politically to retain a number of existing income tax preferences, including, for example, not taxing interest on state and local bonds. This created other opportunities to consume tax free.

The Nunn-Domenici experiment suggests that enacting a coherent progressive tax on consumption is probably not politically viable. This is hardly surprising since no other nation relies on such a tax.

What all this history of attempts to enact a consumption tax teaches us is that in order for such a tax to become a politically viable alternative to our current income tax system it will have to produce an outcome that is better for businesses, better for savings and investment, feasible, and fair to moderate-income Americans. I believe that my proposal, which is described briefly below, meets these criteria. Unfortunately, other plans currently popular in Washington don't.

For example, both the "flat tax" and "FairTax" proposals would reduce taxes on those at the top and make up the lost taxes from people with less income or wealth. This seems particularly inappropriate when between 1979 and 2006 the income of the richest one percent of Americans nearly doubled, while the income of middle-class Americans increased by only about 11½ percent, according to the most reliable numbers. Over the same period, the wage at the 10th percentile, near the bottom of the wage distribution, rose just 4 percent, while the wage at the 90th percentile, near the top of the distribution, rose 34 percent. The share of after-tax income garnered by the top 1% of households increased from 8 percent in 1979 to 14 percent in 2004. Even within the top 1 percent the distribution of income has recently widened. And although the

nation's economy grew by 11.7% in the period 2001-2005, the income of the median household fell by 0.5% in that period.

Wealth is even more unevenly distributed than income, with the wealthiest one percent owning about one-third of all wealth in the United States. The bottom 50 percent hold just 2¼ percent of all wealth. As University of Chicago economist Austan Goolsbee has pointed out, "The average net worth of the top 10 percent of American families is almost 30 times greater than the average net worth of families in the middle 50 percent of the spectrum -- and these disparities in net worth have been growing even faster than the disparities in income."

To be sure, people move in and out of these wealth and income classes; some of the rich lose money and some poor people become rich over time. But, while Americans can debate forever what constitutes a fair distribution of taxes, surely it is not appropriate to shift the tax burden downwards now when those at the very top are doing so very much better than everyone else. This, however, is exactly what proposals like the "flat tax" and the FairTax would do.

Those who advocate such a shift claim it to be essential for economic growth, but they offer little credible evidence for that proposition. They also cite polls showing that many people regard a single tax rate as "fair." Their opponents shout: "Tax cuts for the rich, tax cuts for the rich." And they reply, "class warfare, class warfare." This shouting match is a prescription for stalemate—or, if something is enacted, for future instability and uncertainty.

A Major Problem with Many Consumption Tax Alternatives: They Do Not Work Well Internationally

Every schoolchild knows that we live in a more globally competitive economic environment than we did in the years of the post-war economic boom. American businesses and workers are now competing with a vastly increased array of foreign companies and economies. In the 1960s the total value of all our imports made up just 3.2% of our GDP. By 2005, that number had risen to 13.6%. Amidst all the talk of how to make our economy more competitive, one issue that is rarely brought to the public's attention is the idea that our tax system might itself be a drag on our economic efficiency in the realm of international trade and investment.

While my proposal would harmonize our tax system with international standards and thus open up the possibility of real cost-savings for companies doing business in more than one nation, the unusual nature of the methods used to collect the flat tax and GIT create large difficulties under our international tax and trade treaties. The value-added taxes of the standard credit-invoice sort that I am proposing fit well with these agreements. They can be –and usually are—imposed only by the country where the consumption takes place. They therefore tax imports and exempt exports, so that the location where a good is produced is

irrelevant. In contrast, income taxes are typically imposed on all domestic production and the tax on production abroad is generally ceded to the country where the production occurs.

Mostly for compliance reasons, the president's panel decided—rightly in my view—that any U.S. consumption tax should be border adjusted and imposed in the standard manner: on a destination basis. Otherwise, imports would not be taxed but exports would. The latter kind of tax is said to be imposed on an "origin" basis. This occurs under the flat tax. Thus, for example, if Ford sells cars manufactured in the United States to be used in the United States, their full retail sales value would be included in the flat tax base. Likewise, if Ford or any other U.S. automobile manufacturer sells automobiles in the U.S. to a foreign dealer for use abroad, the manufacturer's sales price would be subject to the U.S. flat tax. But a U.S. dealer of cars made in Japan, Germany or another foreign country would be taxed only on the excess of the dealer's total receipts from its sales over the costs of the cars from the foreign manufacturer. As a result, the costs of manufacturing cars abroad would not be included in the U.S. consumption tax base; only the foreign car dealer's markup would be subject to U.S. taxation.

Economists, including the inventors of the flat tax, claim that we should be indifferent to this distinction because currency exchange rates — the value of the dollar relative to other currencies — will adjust to compensate for these tax differences. But U.S. automobile manufacturers and other U.S. companies that compete with products from abroad will not readily accept the economists' assurances that exchange rates will adjust so perfectly. Especially when the country with whom we have the largest trade deficit, China, has yet to allow its currency to float freely against the dollar. Domestic businesses undoubtedly will resist rules that impose a U.S. tax on the full retail price of products manufactured in the United States, but tax only the dealer markup of products manufactured abroad. They will view such a tax as fundamentally unfair to American businesses and perhaps as seriously disadvantaging U.S. manufacturers competitively. Moreover, the president's panel determined that imposing a consumption tax on an origin basis would raise major enforcement difficulties. In my view, border adjustments of a consumption tax will be an important -- perhaps even decisive -- issue.

The president's panel acknowledged that its recommended consumption tax, the GIT, along with other consumption taxes such as the flat tax, which allow businesses to deduct wages and tax the wages to individuals, cannot be imposed on a destination basis without violating our major trade treaty (the GATT) and all 86 of our existing bilateral income tax treaties. Tax reform proposals so out of sync with international trade and tax arrangements to require renegotiation of all our trade and tax treaties are essentially unrealistic.

It is puzzling to me that U.S. economists and policy-makers have struggled to fashion novel consumption tax alternatives, like the flat tax or the Growth and Investment Tax, when there is a well-functioning consumption tax—the value-added tax—being used throughout the OECD and in nearly 150 countries worldwide. Given the interconnectedness of the world economy, this does not seem the right place to insist on American exceptionalism.

While, as we have seen, there are a variety of methods for imposing and collecting a consumption tax, the best alternative is the credit-invoice method of the sort used throughout the world. Experience demonstrates that such a tax works well. Since sellers of goods and services collect taxes and receive credits for VATs paid on their purchases, tax revenues are collected regularly throughout the year from companies at all levels of production, rather than just from retailers, thereby easing enforcement. A credit-method VAT also facilitates exemptions for small businesses (and for specific goods or services if such exemptions become necessary politically). The key point is this: the consumption tax should be collected only from businesses, and the tax should be imposed on a broad enough base to raise sufficient revenues to free the vast majority of Americans from any income tax liability and any requirement to file tax returns.

Consumption taxes are used in the states and throughout the industrial world as a part of tax systems that typically also contain progressive income taxes. Clearly consumption taxes have a role to play as a part of a modern tax system. Enacting a VAT—a national sales tax with withholding by businesses other than retailers—would permit a major restructuring of our tax system into one that is vastly simpler and far more conducive to savings, investment and economic growth. And this can be accomplished in a way that is fair, a way that neither increases the tax burden of low and moderate-income taxpayers nor shifts taxes away from those at the top of the income scale. There is a limit, however, to how much we can rely on consumption taxes to finance our government. Today, we rely too little on such taxes, but those who would rely solely on such taxes to finance the federal government are playing Pollyanna. A national sales tax at a rate of 30% or higher, as the FairTax plan requires, for example, is much higher than elsewhere and is simply not a practical alternative.

Corporate Income Taxes

An important goal of tax reform should be to create better conditions for American workers and businesses, domestically and internationally. America needs to be an attractive place for both domestic and foreign investments, and American companies need to be positioned to take full advantage of the new global marketplace.

In order for this to happen, as part of the overall reform of our tax system, we should lower corporate tax rates considerably. My proposal calls for reducing the corporate income tax rate to 15% to 20%. This would improve the competitive

position of the American economy, reduce tax-sheltering behavior, and if done right, need not worsen our fiscal position.

The corporate income tax is an odd phenomenon, even by the mysterious lights of the tax law. Corporate taxes are quite popular with the public. People think the taxes remitted by corporations, especially large multinational companies, are paid by someone other than themselves. But as Paul H. O'Neill, George W. Bush's first Treasury Secretary, observed, "corporations don't pay taxes, they collect them."

The question: who actually bears the economic burden of corporate income taxes—who ultimately pays them—has tormented public finance economists since the tax first came into existence. Three candidates come instantly to the fore: people who own the companies, people who work for the companies, or people who buy the companies' products. Since the tax may affect wages, prices, and/or returns to capital, economists believe that workers, consumers, or owners of capital generally may bear the economic costs of the tax. For many years, the conventional wisdom among economists was that the tax principally reduced returns to capital, at least in the short run, and thus the tax was considered to be quite progressive, even if economically distortive. Ultimately, however, the reduced capital due to the tax might result in lower wages, so in the long run, workers may pay. As the economy has become more open internationally, recent economic studies have concluded that the tax is less likely borne by capital generally, but rather by consumers or workers. A number of recent studies claim that more than half the burden, maybe three-fourths, burdens workers. The uncertainty in the economics profession contributes to the public view that the tax is probably paid by someone else.

Economists are unanimous, however, that the corporate income tax is a bad one. It creates incentives for investing in noncorporate businesses and housing instead of corporations, and it induces many distortions in corporate finance. For example, since interest but not dividends are deductible and thereby not subject to the corporate tax, the tax creates a bias in favor of debt over equity finance. The combination of individual and corporate income taxes also has created an advantage for corporations to repurchase shares rather than paying dividends. The invention and deployment of innovative financial products has added new distortions as companies structure their financial transactions to achieve income tax advantages. And the internationalization of businesses, along with the greater mobility of capital, has made collecting corporate income taxes much more difficult. Companies, for example, now routinely manipulate their corporate structures, finances and inter-company prices to take advantage of lower corporate tax rates in other countries. These are just some of the reasons that economists hate a tax the public seems to love.

A Tax Reform Plan

Mr. Chairman, I know that the purpose of this hearing is to examine broad issues of tax reform and that it is premature for you to seriously consider reform alternatives. I cannot, however, resist this opportunity to describe briefly here the proposal that I have detailed in my recent book. This plan would allow our government to raise the necessary revenues without limiting our nation's economic potential. It would substitute a tax on goods and services for much of the income tax, thus freeing the vast majority of Americans from having to deal with the IRS at all. Unlike many other tax reform plans that have been advanced, it would not shift the tax burden away from our wealthiest citizens to people with less income. It would be far simpler and less costly for the American people to comply with. It would be more favorable to savings, investment and economic growth than our current tax system. And it would fit well with international arrangements and improve the competiveness of American businesses and workers. Finally, it would stop the madness of relying on tax breaks as the solution to the nation's social and economic problems.

Unlike some other ideas that have become prominent in our political debate, this plan does not undermine our nation's longstanding and fundamental commitment to justice--to using progressive taxes as a fair way to alleviate our great inequalities of income and wealth. Nor does it, on the other hand, simply tinker once again within the interstices of our broken income tax as a way of responding to wasteful complexities and economic shortcomings.

The plan centers on eliminating the income tax for nearly all Americans. In doing so, we would return the income tax to its pre-World War II status—a low-rate tax on a relatively thin slice of higher-income Americans. A value-added tax imposed at a 10% to 14% rate could finance a $100,000 family exemption from income tax, eliminating 150 million Americans from the income tax rolls and allowing a simpler income tax at a 20 to 25% rate to be applied to incomes over $100,000 and a low 15 to 20% tax rate on corporate income. In combination, these two taxes would produce revenues roughly equivalent to the current income tax. This proposal, unlike the "flat tax," the FairTax, and other such proposals, would not dramatically shift the tax burden away from high-income families to middle-and lower-income families. Also, rather than relying on tax structures like the "flat tax" and progressive consumption taxes, which were invented in ivory towers and are untested in today's economy, this plan combines two of the world's most common tax mechanisms, while exploiting our nation's substantial advantages as a low-tax country.

Here, in brief, then, is what I propose:

(1) <u>Enact a value added tax</u>:

The VAT would work like a national sales tax, but instead of depending only on retailers to collect the tax, a VAT is collected piecemeal at all stages of production, so it is much more difficult to evade. This is a common tax used by nearly 150 countries on 6 continents. Its rate would be 10% to 14%.

Many countries that have enacted value-added taxes do not require retailers to state separately the amount of tax imposed on the goods they sell; the tax is buried in the price of products. But this weakness is easily cured if Congress simply requires that the total amount of tax be separately stated whenever goods or services are sold. That way people will know how much tax they are paying.

The key point is this: the consumption tax would be collected only from businesses, and the tax would be imposed on a broad base of goods and services at a level sufficient to free the vast majority of Americans both from any income tax liability and from any requirement to file tax returns. It would tax imports and exempt exports.

(2) Eliminate the Income Tax for most Americans:

All income under $100,000 (for married couples, $50,000 for singles) would be exempt from the income tax, and this cut-off would indexed for inflation. This would eliminate more than 100 million tax returns and free more than 150 million Americans from having to file them. A lower rate of tax, say, 20 to 25%, would be imposed on the taxable income of high-income individuals. The income tax that would remain for high-income taxpayers could be simplified substantially. The marriage penalties of the existing income tax should be eliminated. Most of the special income tax credits and allowances that now crowd the tax code and complicate tax forms should be repealed. But the deductions for charitable contributions and large medical expenses would be retained. The deductions for home mortgage interest could either be retained in their current form or modified. Congress would have to decide whether to keep, eliminate, or cut back on deductions for state and local taxes. Until better alternative policies are forged, employers would continue to have payroll and income tax incentives to provide their employees retirement savings plans and health insurance. Congress could tax capital gains at the standard rate of 20 to 25% or maintain a lower rate, such as the current 15%. Likewise, Congress could retain the current 15% rate on dividends, tax dividends at the regular rate, or eliminate dividend taxes completely on income where corporate taxes have been paid. There would be only one income tax calculation rather than the two that the AMT of current law requires.

(3) Lower the Corporate Income Tax Rate:

The corporate income tax rate would be lowered to 15 or 20%, making the United States a far more attractive country in which to do business and making our economy more globally competitive. In addition, the new law should require that book and tax accounting be more closely aligned to solve, at last, the tax

shelter problem that has plagued the corporate income tax for years. If Congress wants to maintain certain book-tax differences, such as for depreciation, research and development expenses, and foreign taxes, for example, these differences should be made explicit. The corporate alternative minimum tax should be repealed. The taxation of small-businesses should be greatly simplified.

(4) Introduce a Payroll Adjustment or " Smart Cards" to Protect Low and Moderate Income Workers:

To avoid what would otherwise be the regressive impact of imposing a broad-based consumption tax, this plan would replace the EITC and refundable child credits with a payroll adjustment or a " smart card" (like a bank debit card). Providing low-and middle-income workers benefits this way would allow tax returns to be eliminated for these workers without generally increasing their taxes or eliminating the EITC wage subsidy.[†] Moreover, payroll adjustments or smart cards would put money in low-income workers' pockets when their paychecks are earned rather than through a lump-sum tax refund after year-end, as the EITC now does.

The Key Advantages of this plan

The plan I have offered is fair. It is simple for the average American to understand and comply with. It is fiscally sound. It is designed to replicate existing federal government revenues in the short-term and to put in place a tax system flexible enough to permit future tax increases without crippling the economy, should we need more resources down the road.

The plan takes advantage of our status as a low-tax country, something our current income tax fails to do. It would make the United States very similar to the average of OECD countries in taxing consumption relative to GDP and in terms of tax rates on consumption. Our income tax, however, would be very much smaller—and could be very much simpler—than what people generally face abroad.

This new tax system would have a number of important advantages:

- It would be far more favorable for savings and economic growth. Most Americans would owe no tax on their savings, and taxes on savings and investment would be lower for everyone. We would also maintain incentives for employers to provide both health insurance and retirement savings plans for their employees until we can agree on a better system. The United States would be an extremely attractive place for business investments by both U.S. citizens and foreigners. This plan would stimulate economic growth and create additional jobs for American workers, producing substantial long-term benefits for the American economy.

[†] Details may be found in chapter 10 of my book.

- Unlike the current income tax, the plan would eliminate all marriage penalties, something that Congress has so far been unable to do under the current income tax.

- The U.S. would enjoy a substantial economic leg up in the world economy, while using a combination of taxes common throughout the world. Thus, this system facilitates international coordination and fits well within existing international tax and trade agreements.

- Because it retains the corporate income tax (at a much lower rate) and a dramatically shrunken individual income tax, the plan avoids the difficult issues of transition (involving the treatment of unrecovered tax basis) to an entirely new system that have haunted other proposals to move away from reliance on the income tax.

- By eliminating 100 million tax returns a year, the plan would drastically reduce compliance costs and headaches for the American people. It would also ease the IRS workload and thus allow it to perform its job far better. No politician would ever urge bringing all these people back into the income tax, absent some genuine catastrophe. After all, it took World War II to persuade Congress originally to extend the income tax to the masses.

- By diminishing dramatically the political advantages of income tax incentives, the plan would challenge our political leaders to produce policies that work and provide increased stability over the long haul, creating more predictability for both individuals and businesses.

Here is what *Forbes Global* has said about my plan: "If enacted, Graetz's proposals would make the U.S. one of the most competitive countries in the world for human capital, investment and foreign direct investment. . . .The overall tax burden of the U.S. would not change, staying, as it is this year, the third lowest in the OECD."

Our nation can no longer afford our broken tax system. It hampers our economy; it is uncompetitive; it distracts us from forging genuine solutions to our nation's most pressing problems; and it wastes enormous resources due to its overwhelming complexity. Three decades ago, when he was running for President, Jimmy Carter described our nation's tax system as a "disgrace to the human race." And it still is.

To achieve fundamental reform we must recognize that the income tax, centerpiece of our overall tax system, has grown too complex and has proven a failure as a mechanism for solving our nation's economic and social difficulties. The health of our nation's economy, the cohesion of our society, the future of our nation's children all demand major changes. This will not be an easy task.

A Side-by-Side Comparison of the Main Features of the Two Income Tax Reform Plans

Provisions	Tax Reform Panel Income Tax	Wyden-Emanuel Fair "Flat Tax"
	Households and Families'	
Tax rates	Four brackets: 15%, 25%, 30%, 33%	Three brackets: 15%, 25%, 35%
AMT	Repealed	Repealed
Personal exemption	Replaced with family credit available to all taxpayers: $3,300 for married couple, $2,800 for unmarried with child, $1,650 for singles, $1,150 for dependent taxpayer; additional $1,500 credit for each child and $500 for each other dependent	Unchanged
Standard deduction	*See* Personal exemption	$30,000 for joint filers, $15,000 for singles, $26,500 for head of household
Child tax credit	*See* Personal exemption	Unchanged
Marriage penalty	Reduced. All tax brackets, family credits, and taxation of Social Security for couples are double those of individuals	Persists
	Other Major Credits and Deductions	
Home mortgage interest	15% home credit, limited to average regional price of housing	Unchanged, except that interest paid on second home not deductible
Charitable giving	Deduction available to all taxpayers	Unchanged
Health insurance	Taxpayers may purchase health insurance with pretax dollars, up to the amount of average premium	Unchanged; requests report from Treasury on how to eliminate $10 billion in tax subsidies that create inefficiency in health insurance markets

Provisions	Tax Reform Panel Income Tax	Wyden-Emanuel Fair "Flat Tax"
	Other Major Credits and Deductions—*Continued*	
Education	Taxpayers can claim family credit for some full-time students	Unchanged
State and local taxes	Not deductible	New, refundable credit for 10% of state and local taxes available to all taxpayers
Itemized deductions	None	Eliminates deductions for wagering losses, elementary teachers' expenses, and moving expense. 2%-of-AGI floor eliminated
Exclusions from income	Eliminates exclusions for employer-provided group-term life insurance and most fringe benefits except meals furnished for the convenience of the employer	Eliminates exclusions for employer-provided group-term life insurance, worker's compensation, rental value of personage, income earned abroad, most fringe benefits, and meals furnished for the convenience of the employer
	Individual Savings and Retirement	
Defined contribution plans	Consolidated into save-at-work plans that have simple rules	Unchanged
Defined benefit plans	Unchanged	Unchanged
Retirement savings plans	Replaced with save-for-retirement accounts ($10,000 annual limit)	Unchanged
Education savings plans	Replaced with save-for-family accounts ($10,000 annual limit) covering education, medical, new home costs, and retirement saving needs	Unchanged

Provisions	Tax Reform Panel Income Tax	Wyden-Emanuel Fair "Flat Tax"
	Individual Savings and Retirement—*Continued*	
Health savings plans	*See* Education savings plan	Cafeteria plans and FSAs eliminated
Dividends received	Exclude 100% of dividends of U.S. companies paid out of domestic earnings	Taxed at regular income tax rates
Capital gains received	Exclude 75% of corporate capital gains from U.S. companies	Taxed at regular income tax rates
Interest received	Taxed at regular income tax rates	Taxed at regular income tax rates
Social Security benefits	Married taxpayers with less than $44,000 in income pay no tax on Social Security benefits	Unchanged
	Small Business	
Rates	Taxed at individual rates	Taxed at individual rates
Record-keeping	Simplified cash-basis accounting	Unchanged
Investment	Immediate expensing (except for land and buildings)	Straight-line depreciation over longer periods
	Large Business	
Rates	31.50%	35% (on all corporate income)
Investment	Simplified accelerated depreciation	Straight-line depreciation over longer periods
International tax system	Territorial tax system	Deferral eliminated

United States Senate Committee on Finance Hearing
Tax: Fundamentals in Advance of Reform
April 15, 2008

Questions Submitted for the Record

Questions for Michael Graetz:

Senator Baucus

1. Congress has continually amended the Code, adding back in much of the complexity the 1986 reforms tried to eliminate. This question is for the entire panel.

    a. As Congress begins to consider tax reform, what principles should we keep in mind to help prevent a reoccurrence of what has happened post-1986 and help develop more stable tax reform that will not be undone soon after?

    b. How do we develop strong policy that will hold up to amendments?

    c. Are we destined to go through this process every 20 to 30 years?

Answer

1. These days Congress seems to be in the business of enacting tax legislation once a year, often even more frequently. This makes achieving stability of a tax reform a very difficult matter. My proposal, which would eliminate 150 million people from the income tax, was designed with this very problem—and the unraveling of the 1986 tax reform—in mind. By shifting all of these people from the income tax, with its filing requirements and frequent changes, to a value added tax, where the challenges of change would be borne by business, the vast majority of Americans would be insulated from the costs of frequent change. I do not believe that any reform that falls short of getting these people out of the income tax altogether will accomplish this goal.

2. You all point out different goals for tax reform.

    a. What should be the most important goal? What should Congress focus on?

    b. How should Congress prioritize these goals?

Answer

2. The most important thing Congress can do is to put in place a tax system that is far simpler and more conducive to economic growth in the new global economy. American businesses and workers should have a tax system that will help them attract the capital necessary to improve our standard of living. As my proposal demonstrates, this can be done in a progressive system without shifting the distribution of tax burdens down the income scale.

3. We're looking towards 2010 when the tax cuts expire, the alternative minimum tax has the potential to encompass 30 million taxpayers, and Congress is extending several expiring provisions a year.

   a. What is the biggest challenge to tax reform?

   b. How does Congress conquer that obstacle?

   c. When does tax reform become unavoidable or an emergency? Have we gotten to that place?

Answer

3. Tax reform is difficult for the Congress because it will inevitably now produce losers as well as winners. This could have been avoided in 2001 when large surpluses were projected, but Congress and the president took a different path. And even in 2010, Congress can, if it wants, postpone serious reform, although that would be a disservice to the American people. As a nation, we can no longer afford the tax system we have. Imaginative and courageous leadership on both ends of Pennsylvania Avenue will be crucial to accomplish real tax reform.

Senator Grassley

1. This question is for the panel. I read with interest the discussion in the report of the President's Advisory Panel on Federal Tax Reform about how our tax policies send a strong message in favor of debt financed investment as opposed to equity investments. To the point where the report concludes that the reward for debt-financed investment is greater than if there were no taxes at all—it is actually a negative tax.

   I'm also especially troubled by some research that suggests this policy encourages corporations to pile on debt. This preference may be increasing risks of bankruptcy and financial distress particularly when there is an

economic downturn. Research also reveals that the different treatments between debt and equity also create opportunities for tax shelters.

In these times, we've been disturbed by heavily leveraged entities in the financial services industry. I'd appreciate your expanding on these points and your suggestions for reform in this area.

Answer

1. Achieving a better balance between debt and equity financing and enacting international tax rules that diminish incentives for multinational companies to locate their borrowing in the United States should be a priority for tax reform. The most dangerous change would be to enact expensing of plant and equipment without restricting or eliminating interest deductions.

2. The Chairman, Senator Conrad, myself, and others have talked about the tax gap. In testimony a few years ago, David Walker of the General Accountability Office ("GAO") analyzed the link between tax complexity and the tax gap. I'd like to revisit this linkage with the panel.

    a. Do you agree with the GAO that fundamentally reforming our tax system has the potential to improve compliance? That is, the complexity of, and frequent revisions to, the tax system make it more difficult and costly for taxpayers who want to comply to do so.

    b. First, wouldn't you agree that by reducing complexity, we should be able to reduce the amount of the tax gap attributable to unintentional noncompliance?

    c. Second, do you know of any new data that have looked at how much of the tax gap is attributable to unintentional noncompliance due to the complexity of the tax code?

    d. And third, it has been said that the rate at which taxpayers voluntarily comply with our tax laws has changed little over the past three decades. What impact did the Tax Reform Act of 1986 have on the tax gap?

Answer

2. a. Clearly, tax reform has the potential to improve tax compliance.

    b. Yes, I agree.

    c. Apparently, more than 1 billion of taxes is *overpaid* each year simply because of the complexity faced by ordinary Americans.

d. I think the 1986 Act had a major impact in shutting down tax shelters widely marketed to individuals. Other charges, such as reducing opportunities to shift income to children, also helped compliance. But there is alot of evidence that a growing number of Americans—especially among young people—feel little or no moral reason to comply with tax requirements.

3. The landmark 1986 Tax Reform Act contained scores of transition rules. The Philadelphia Inquirer published a Pulitzer Prize winning series on the legislation. Much of that material focused on the transition rules. As a result of that controversy, Finance Committee Chairmen, from Senator Bentsen forward, on a bipartisan basis, implemented a practice prohibiting "rifle shots." Many practical observers of the process for the 1986 legislation would contend that the transition rules were necessary to secure political support for passage.

   The political imperative of transition relief is an issue we cannot ignore. Setting aside revenue neutrality for an instant, how do you recommend treating transitional items such as credit carryforwards and the loss of depreciation deductions, interest deductions, and deductions for the recovery of inventory?

Answer

3. The need for transitional rules depends entirely on the nature and details of the reform. These questions cannot be answered in the abstract. I have designed my proposal to minimize the need for the kinds of transitional relief you are asking about.

4. In general, U.S. citizens are taxed on their worldwide income. To avoid double taxation, the U.S. system employs a credit system that allows taxpayers a foreign tax credit to offset U.S. tax liability on foreign income.

   Another way to avoid double taxation would be to exclude foreign income from U.S. taxation altogether. This is the type of double tax relief provided by territorial tax systems. Under current law, the foreign earned income exclusion allows U.S. citizens to, in effect, elect territorial treatment with respect to a limited amount of foreign earned income.

   Many commentators have suggested adopting a territorial system for corporations. For instance, the President's tax reform panel recommended that approach. The most common reason given by supporters of a territorial system is that such a system is common to many industrialized countries and it would therefore enhance the competitiveness of U.S. businesses.

   Based on those same arguments, there have been recent proposals to enact a territorial regime for individuals by removing all restrictions on the foreign

earned income exclusion. Yet, in its recommendations, the tax reform panel, for instance, retained worldwide taxation of U.S. citizens.

Should we consider a territorial system for individuals?

Answer

4. No. The issues are very different for individuals than for corporations.

Senator Hatch

1. Professor Graetz, as I understand it, your idea would be to keep the income tax only for higher income Americans, and implement a broad-based tax on goods and services for everyone. Is this correct? Would any kind of broad-based tax on goods and services work, or would it have to be a value-added tax?

Answer

1. This is correct. Other types of broad based taxes on goods and services could work as long as the tax is collected entirely at the business level. A retail sales tax, for example, could substitute for a value-added tax. But a credit-method value-added tax has important substantive advantages over the alternatives. Other forms may enjoy political advantages. Perhaps we could just call a value-added tax something else; the Canadians and Australians call theirs a goods and services tax (GST), for example.

2. Professor Graetz, when you say that it is impossible to duplicate the progressive nature of our current income tax by substituting a flat rate tax on consumption for the income tax, are you referring to the flat tax and also the national retail sales tax?

Answer

2. Yes, I am—when they are *full* substitutes for the income tax, as their proponents have recommended.

3. Professor Graetz, you said our current income tax system is "quite progressive" today. Do you think it is too progressive, not progressive enough or is it just about right?

Answer

3. This is a difficult question about which people will disagree. In general, current income tax progressivity seems "about right" to me, although given the nature of current law, with its scheduled expirations, this allows for a reasonably wide range of provisions—ranging from the top to the bottom of the income scale—that one might view as "our current income tax system."

Statement of Senator Chuck Grassley
Senate Finance Committee Hearing
Tax: Fundamentals in Advance of Reform
April 15, 2008

Good Morning, Mr. Chairman.

Just about everybody agrees that our tax code is too complex. The tax form instruction book is probably the most unwelcome piece of mail many taxpayers get. The complexity means taxpayers can't be confident that they've received all the breaks coming to them, or that they haven't paid more than they owe. As today's tax filing deadline comes to a close, millions of hard-working American taxpaying families know about the complexity first hand. As we note the complexity, we should note a point, one of the key 1986 Tax Reform Act architects has made many times. Former Senator Packwood was fond of saying "many taxpayers accept complexity that favors them."

When we consider the complexity of the regular tax system and the creeping effects of the alternative minimum tax ("AMT"), and you have a recipe for disaster. As an example of the problems from the AMT side, if we do not extend the hold-harmless or "patch" for 2008, 25 million tax filers, mostly families, will be affected by the AMT. Twenty-five million families. Think about that, Mr. Chairman. And, because of the way the AMT is structured, with no indexing, this AMT problem grows exponentially from year-to-year. The revenue loss for last year's patch was $50 billion and it grows to $65 billion this year. We are facing an AMT train wreck.

So, there's no question that we have a big problem.

It is a problem that the committee should focus on.

Let me say that I have no pre-conceived notion of which direction we should go. Whether we're talking about a flat tax, national retail sales tax, value-added tax ("VAT") or substantial modification of the current system.

Let me also note that, over three years ago, I instructed the Finance Committee tax staff on our side to develop simplification proposals in all income tax areas. The staff have worked up some proposals.

While we all agree something should be done and we should be open-minded about what reform would look like, I'd like to remind folks that there is a key premise to tax reform that needs to be fleshed out.

The premise I refer to is whether we assume current year law levels of tax relief in effect or whether we assume that the bipartisan tax relief plans of 2001 and 2003 have expired. If we use the latter assumption, i.e. that the post -2010 record level tax increase goes into effect, then tax reform really becomes an historic tax increase.

Let me repeat that point in a different way. This hearing is a kick-off hearing. If we are to enter the tax reform playing field, we need to know the rules, including the size of the playing field in revenue terms. Are we assuming tax reform is not possible without a record tax increase? This is a question that all policy makers should have to answer. This is a question that the Presidential candidates should have to answer.

I hope the answer is the goal of a tax reform exercise ought to be to maintain current law levels of taxation.

If the goal is different, a record tax increase, upwards of 10% on the American taxpayer, then I have very serious reservations about whether we can or, more importantly, should undertake the effort .

Mr. Chairman, I look forward to the testimony from our distinguished panel.

OPENING STATEMENT
SENATOR KEN SALAZAR
FINANCE COMMITTEE HEARING
"Tax: Fundamentals in Advance of Reform"
April 15, 2008

Thank you, Chairman Baucus and Ranking Member Grassley, for holding this morning's hearing.

In the two decades since the last major reform of our tax code in 1986, our tax system has become more complicated and less fair. At the same time, the problem of the Alternative Minimum Tax (AMT) continues to grow, and a large number of significant tax provisions – including changes to our current rate structure, to the way the tax code treats capital gains and dividend income, and to the estate tax – that were enacted into law in recent years are scheduled to expire at the end of 2010.

Under these circumstances, it is extremely difficult to examine, and to craft appropriate solutions to, narrower but legitimate problems that exist in the code today. Over the past year, this Committee has examined our tax policies with respect to energy production and conservation, the individual housing market, the commercial real estate market, the estate tax, and the treatment of so-called "carried interest" income. While we made excellent progress on some of these issues, the time will soon come when it is no longer enough to take a piecemeal approach to these and other matters.

With that in mind, I am pleased that this Committee is taking the first step in the extremely important and complicated process of reforming our nation's tax code. As we undertake this process, I want to emphasize what I believe must be the guiding principles for this Committee and for Congress as a whole.

First, the tax code must be simple. In our effort to make the tax code more dynamic, to encourage certain kinds of economic and social behavior, and to provide targeted relief for certain segments of the population, we have loaded up the code with countless deductions and credits that have served to make it more burdensome and complicated than we ever intended. Families and businesses deserve a straightforward and simple tax code that they can understand and comply with.

Second, the tax code must be fair. As a result of the misguided policies of President Bush, the code has become heavily skewed in favor of the wealthiest Americans, while low- and middle-income families struggle to afford higher payroll and property taxes, and, increasingly, the cost of the AMT. I support much of the middle-class tax relief Congress has considered and passed in recent years, but I believe we must carefully reexamine how the tax burden is distributed and take steps to ensure that everyone pays their fair share.

Third, the tax code must help create economic conditions that allow American businesses – both large and small – to succeed. That means a tax code that is easier for small business owners to navigate and that encourages them to invest and grow, and it means a tax code that preserves America's status as the best place to do business in the world. This is not about corporate tax breaks – it is about strengthening American's competitiveness in an increasingly global economy.

Fourth, our tax system must be equal to the budgetary challenges our government will face in the coming decades. With the impending retirement of the Baby Boomer generation and the resulting pressures on Social Security and Medicare, and with the intense competition for funding among many important federal programs, we must ensure that we have the fiscal flexibility required to meet those budgetary challenges. While a responsible approach to this question has as much to do with our spending priorities as it does our tax-related priorities, we must recognize that the way we structure our tax code is a critical component of the effort to put the government's fiscal house in order.

Finally, despite the very real philosophical differences that separate Democrats and Republicans on the question of taxes, it is imperative that any effort to act meaningful tax reform be bipartisan. As a result of the inevitable shifting of the tax burden away from some Americans and onto others that accompanies any kind of wholesale tax reform, there will be clear winners and losers in the short term. Only a strong bipartisan effort will generate the necessary support to enact tax reform that will benefit all Americans in the long term.

Again, I want to thank Chairman Baucus and Ranking Member Grassley, for their commitment to laying the groundwork for meaningful tax reform. I would also like to thank our witnesses for appearing before the Committee today to offer their general views on the issues that will shape this debate. I look forward to a productive and enlightening discussion.

Thank you.

PRINCIPLES FOR COMPREHENSIVE INCOME TAX REFORM

Daniel N. Shaviro
Wayne Perry Professor of Taxation, NYU School of Law

Testimony Before the United States Senate Committee on Finance
April 15, 2008

Good morning, Mr. Chairman, Ranking Member Grassley, and Members of the Committee. My name is Daniel Shaviro, and I am the Wayne Perry Professor of Taxation at NYU Law School. Thank you for the opportunity to testify before you today on alternatives for comprehensive reform of the U.S. federal income tax system. My testimony makes three main points:

1) The most fundamental maxim of tax reform is that, holding revenue and distribution constant, we should broaden the base and lower the rates. Politics is always pushing the tax system in the other direction, as taxpayers come in to make arguments about special circumstances that ostensibly call for more favorable treatment. Although these arguments often sound appealing, the long-run effect of special rules is to make the system more complicated, less efficient, and less fair. While base-broadening is therefore fundamental to tax reform, I will argue that we need to be sophisticated in several respects about defining it and implementing it. Moreover, we should clearly distinguish between (a) arguments about the proper definition of base-broadening, which raise technical and economic issues, and (b) "non-tax" arguments for maintaining particular preferences notwithstanding the general case for base-broadening.

2) Second, our rules for taxing business enterprises are badly broken. At the business level, the fact that major corporations commonly report high book income to their shareholders and low taxable income to the I.R.S. is an important diagnostic, suggesting that something is wrong. At the investor level, the disparate tax treatment of corporate debt and equity, while decades old, is becoming ever more problematic. Increasingly, given financial innovation, it simply provides an investor election to pay tax at the corporate rate or one's own rate, whichever is lower. Finally, our system for taxing the outbound income of U.S. multinationals imposes enormous tax planning and transaction costs relative to the revenue raised. Our tax law in this area tries to split the difference between the rival tax policy goals of worldwide taxation and territorial taxation. We have ended up, however, with something that is worse than either. This suggests that the area is ripe for reform.

3) Finally, the tax system needlessly aggravates and complicates the lives of lower and middle income taxpayers. Congress can and should address this, by making filing and compliance less painful, even insofar as taxes paid by such individuals remain approximately constant.

I. GENERAL BACKGROUND

The old Chinese curse, "May you live in interesting times," has perhaps never been more applicable to U.S. tax policy than it is today. We are facing a perfect storm on a number of different fronts. Most obvious are the questions of what to do about expiring tax cuts from 2001 and 2003, the ever more costly and burdensome process of dealing with annual "extenders," and how to respond to the startling rise of the alternative minimum tax (AMT), which may apply to 30 million taxpayers by 2010 if Congress takes no action to prevent this.[1]

From a broader policy standpoint, the biggest long-term challenges are twofold. First, revenues are simply inadequate to meet the long-term spending path of the U.S. government, suggesting that we may be headed for a major fiscal crisis down the road.[2] Congress relied on bipartisanship in making tough budgetary choices from 1982 through 1990, or most of the last era when deficits were so prominent, and clearly that approach helps when painful medicine must be taken. Second, while rising income inequality at the top of the distribution[3] may lead some policymakers to favor increased tax progressivity, a common way of doing this, by increasing taxes on capital income, becomes ever harder as rising worldwide capital mobility makes it easier to shift both the actual location of economic activity and the reported site where income is earned. For example, several recent econometric studies suggest that, due to worldwide capital mobility, corporate income taxes are now mainly borne by labor, rather than capital.[4] Increasingly, the consensus among academic tax policy experts holds that distributional concerns should be addressed through a progressive consumption tax, rather than through the capital income component of the current income tax,[5] but I recognize that this is not a direction in which policymakers currently seem inclined to go.[6]

Even if neither of the long-term challenges relating to fiscal adequacy and progressivity is addressed right away, having a better and more stable tax system in place is a vital precursor to being able to act effectively in the future. Both the instability of current law, and the tax system's generally declining coherence and efficacy since comprehensive tax reform was last addressed in 1986, make a major reform effort extremely desirable. Indeed, the 1986 approach of taking key ideological differences off the table by being both revenue-neutral and distribution-neutral provides an obvious blueprint for facilitating bipartisan cooperation on tax reform. Making the tax system

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[1] See Statement of Leonard E. Burman Before the Subcommittee on Select Revenue Measures, House Ways and Means Committee, March 7, 2007 (available on-line at http://www.urban.org/UploadedPDF/901051_Burman_IndividualAMT.pdf).

[2] See Daniel N. Shaviro, TAXES, SPENDING, AND THE U.S. GOVERNMENT'S MARCH TOWARD BANKRUPTCY. New York: Cambridge University Press, 2007.

[3] See Greg Ip, *Income-Inequality Gap Widens*, Wall Street Journal, October 12, 2007.

[4] See the discussion in William M. Gentry, *A Review of the Evidence on the Incidence of the Corporate Tax*, U.S. Treasury Department, Office of Tax Analysis, OTA Paper 101 (2007).

[5] See Daniel Shaviro, *Beyond the Pro-Consumption Tax Consensus*, 60 Stan. L. Rev. 745 (2007).

[6] Thus, even the most consumption tax-like plan developed by the President's Advisory Panel on Federal Tax Reform in its 2005 report continued an add-on income tax-style component. See the discussion in Daniel Shaviro, *A Blueprint for Future Tax Reform? Evaluating the Reform Panel's Report*, 109 Tax Notes 827 (November 7, 2005).

fairer and more efficient should be appealing without regard to how one thinks about distribution issues or overall revenue needs.

II. BROADENING THE BASE AND LOWERING THE RATES

A. Base-Broadening Generally

The central tax reform principle for decades – and rightly so – has been that Congress should use a broad base and low rates to raise desired revenues, rather than a narrower base that necessitates higher rates. Needlessly high rates are bad in themselves, and gaps in the tax base compound the damage by distorting taxpayer behavior through the encouragement of what would be bad economic choices on a pre-tax basis. Indeed, while gaps in the tax base reduce observed revenues, they actually make the government bigger, rather than smaller, so far as its distorting impact on economic decisions and market outcomes is concerned. For example, taking a government spending program and converting it into a tax preference does absolutely nothing to make the government truly smaller, even if it shrinks officially reported taxes and spending.[7]

Even where government intervention in the economy is desirable, the tax system is often a bad place to do it. For example, the benefit derived from a special exclusion or deduction depends, often perversely, on the taxpayer's marginal rate. Thus, a dollar of home mortgage interest deductions saves you 15 cents if your marginal rate is 15 percent, and 35 cents if it is 35 percent. This special feature of deductions and exclusions – shared by tax credits insofar as they are nonrefundable (i.e., limited to one's overall positive liability) – often has no discernible connection to the policies that ostensibly are being advanced.[8] Moreover, these problems are not limited to tax preferences for individuals, even though marginal tax rates for C corporations are relatively flat. Due to nonrefundability, corporations generally cannot use special incentives if they already have a net loss.[9]

Members of the public often think of base-broadening as increasing horizontal equity. Academic experts, by contrast, tend to think of it as increasing economic efficiency, on the view that the value of a tax preference is likely to be competed away as it draws additional business activity into the tax-favored sector. For a simple illustration, suppose that all taxpayers paid tax at a 30 percent marginal rate, that corporate bonds paid interest at 10 percent that was taxable income to the recipient, and that municipal bonds (as under present law) offered tax-free interest income. It might be natural to think that, if there is a problem with the municipal bond interest exemption, it must relate to fairness as between corporate bondholders (who receive taxable interest income) and municipal bondholders (who receive tax-free interest income). This analysis does not really stand up, however. After all, if corporate bonds offer a 10 percent return before tax

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[7] See Daniel Shaviro, *Rethinking Tax Expenditures and Fiscal Language*, 57 Tax L. Rev. 187 (2004).

[8] See Lily L. Batchelder, Fred T. Goldberg, Jr., and Peter R. Orszag, *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 Stan. L.Rev. 23 (2006).

[9] The inability to get any tax benefit from net losses has become an increasing problem for U.S. corporations in recent years, apparently reflecting greater dispersion and volatility in business outcomes. See Alan J. Auerbach, *Why Have Corporate Tax Revenues Declined? Another Look* (2006), available online at http://www.econ.berkeley.edu/~auerbach/AJA_CESifo_revised.pdf.

but only 7 percent after tax, then state and local governments should be able to sell bonds (otherwise comparable to the corporate bonds in their terms and risk) that pay only 7 percent both before and after-tax. This eliminates any possible unfairness as between the different bondholders, all of whom are earning 7 percent after-tax. Accordingly, if there is a problem, it must relate to efficiency, reflecting that borrowing is being subsidized (permitting bond issuance at a lower interest rate) in one sector as compared to another.[10]

A real-world analysis of municipal bonds or other tax-favored assets would admittedly be more complicated than this, given the multiplicity of taxpayer marginal rates and differently-taxed assets. Moreover, redefining the key problem caused by tax preferences as one of inefficiency, rather than horizontal inequity, arguably is immaterial since the policy recommendation, in favor of revenue-neutral base-broadening, is the same either way. Nonetheless, it may be helpful to understand the stakes properly, and to see that base-broadening can increase our society's prosperity and productivity by causing pre-tax profitability to guide the allocation of investment, rather than turning on what are often quite debatable intuitions about the importance and definition of horizontal equity.

Neutral taxation as between different activities or industries can be advanced by repealing various income tax preferences,[11] and by making cost recovery rules less biased as between different assets. The main obstacle to achieving greater neutrality is political, rather than reflecting serious disagreement among experts (other than on a handful of issues) about how to define tax neutrality between assets or activities. The places to look for special rules are well-known as well. Both the Joint Committee on Taxation and the U.S. Treasury Department have long published tax expenditure lists that are substantially in agreement, despite various definitional fine points on which they differ.

As applied to individuals, base-broadening potentially targets a number of highly popular items. Consider, for example, the itemized deductions for home mortgage interest and for state and local taxes, along with the statutory exclusion for employer-provided health insurance. However, in addressing these hot-button issues, one should keep in mind the following:

--Under present law, the value to taxpayers of itemized state and local tax deductions is already being undermined by the rising applicability of the alternative minimum tax, which does not allow those deductions. Likewise, existing ceilings on the amount of home mortgage loan principal that can trigger deductible interest expense ($1 million for acquisition indebtedness and $100,000 for home equity indebtedness)[12] are

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[10] I ignore here the possibility that there might be efficiency arguments for subsidizing borrowing by state and local governments, such as by reason of positive spillover effects attributed to local capital investment.

[11] While defining an item as a tax expenditure may depend on whether one adopts an income tax or consumption tax baseline, identifying disparities in treatment does not depend on this. According to leading consumption tax proponent (and former chair of the Council of Economic Advisors) R. Glenn Hubbard, eliminating differential taxation of competing activities and industries may be more important than choosing between income and consumption taxation. See William M. Gentry and R. Glenn Hubbard, *Distributional Implications of Introducing a Broad-Based Consumption Tax*, in James. M. Poterba (ed.), TAX POLICY AND THE ECONOMY, Vol. 11. Cambridge, MA: MIT Press, 1997. This implies that greater inter-asset conformity may generally be worthwhile even if it increases the degree to which the hybrid U.S. system effectively functions more like an income tax and less like a consumption tax.

[12] See Internal Revenue Code section 163(h)(3).

effectively declining in real terms over time due to inflation. These ceilings already are real constraints for at least a few taxpayers in parts of the country where real estate prices are higher. Finally, the strains that rising healthcare costs place on employer-provided insurance plans are causing many plans to become less generous, thereby reducing the value of the income tax exclusion for some taxpayers. In a sense, therefore, all of these tax benefits are already being reduced without Congressional action, suggesting that new rules more directly limiting them could be viewed, to a degree, as a trade-in for what is already happening.

--Repeal is not the only option when addressing these items. Other possibilities include making greater use of dollar ceilings on deductions or exclusions, and reducing (while also possibly making more uniform) the tax benefit per dollar claimed of a given item. For example, both the noted Bradley-Gephardt tax reform plan of the early 1980s[13] that helped inspire the 1986 tax reform, and the 2005 report of the President's Advisory Panel on Federal Tax Reform, proposed converting special deductions into percentage credits (or their equivalent) that would benefit all taxpayers claiming the items only at the lowest applicable positive marginal rate.

B. Base-Broadening With Respect to Capital Income

Inevitably, even in an ambitious and comprehensive effort at income tax reform, not all preferences would be repealed. Political compromises are bound to be necessary, and leading proponents of reform may feel that particular preferences serve sufficiently good purposes to justify their retention. Selecting such items is a delicate task, because it can risk unwinding the entire tax reform process as other political actors demand comparable concessions, but how best to balance these considerations in practice is not a subject on which tax policy experts can claim special expertise.

The taxation of capital income, however, raises some special technical issues in properly defining and applying the base-broadening concept, wholly apart from questions of pursuing broader social policy goals through the tax code. Four points in particular are worth making:

1) As is well-known, an income tax discourages saving and investment relative to immediate consumption, raising questions about whether "base-broadening" is really the right term for having an income tax (with its nominally broader base) rather than a consumption tax. The reason for nonetheless, within an income tax framework, regarding as a preference consumption tax-style treatment (such as expensing) for particular investments is that such treatment biases taxpayer choices between assets. However, general income tax preferences for saving in any form, such as individual retirement accounts (IRAs), are not subject to this criticism. Accordingly, the general economic benefits of base-broadening are not advanced by having smaller, rather than larger, deductions or exclusions for individual retirement accounts. This conclusion is independent of whether one favors encouraging (or reducing discouragement of) retirement saving as a social policy goal.

[13] The Fair Tax Act of 1983, H.R. 3271, 98th Cong., 1st Sess. (1983); S. 1421, 98th Cong., 1st Sess. (1983).

2) One serious design problem with preferences (from an income tax standpoint) for saving or investment – whether they are narrow, like expensing for a particular asset, or broad, like IRA provisions – is that they may fail to have *any* net encouraging effect on saving or investment insofar as they are effectively (but not necessarily detectibly) debt-financed by the taxpayer. Thus, suppose I both (a) put $1,000 in a traditional IRA, generating a $1,000 deduction and annual exclusion of the interest income I earn until withdrawal, and (b) borrow $1,000 through a home equity loan. I have not saved on balance, but I get a $1,000 deduction, the tax savings on which I can use to fund further consumption, and then in subsequent years I can deduct my interest outlay while deferring my interest accrual, generating further tax savings that can help fund further consumption. This is a simple example, but the point is much broader. Allowing interest deductions plus savings and investment incentives (from an income tax standpoint) is a big problem that needs to be better addressed, and not simply through rules that attempt to trace particular uses of borrowed funds to particular outlays. Such rules are inevitably ineffective given the fungibility of money.

3) With respect to the taxation of corporate income, it is important to think about both levels of tax – that levied at the corporate level, and at the shareholder level via the taxation of dividends and capital gains with respect to stock. The better the tax system is operating at the corporate level to measure and properly tax corporate earnings, the less the need to impose tax at the shareholder level. (I further address corporate taxation in section III below.)

4) For capital gains, even leaving aside corporate stock, a further complexity arises because taxpayers holding appreciated capital assets can avoid the tax by the simple expedient of not selling the assets. For sales of such assets, accordingly – unlike for most ordinary income – raising the rate can actually lose revenue even at rate levels that are politically plausible. (This point differs from "supply-side" arguments that have been questioned empirically, because all it relies on is greater or lesser asset turnovers in response to capital gains rate changes.) Depending on the top marginal rate for ordinary income, therefore, there may be a case for a lower capital gains rate.[14] However, the case for a lower capital gains rate might be significantly weakened if taxpayers could not permanently eliminate (as opposed to merely deferring) the tax on asset appreciation via the step-up in basis at death.[15] The treatment of capital assets at death is a key integral part of how the tax system currently bears on capital income, because its incentive effect, discouraging the sale of appreciated assets at any time during one's life, is so pervasive. Congress should therefore seriously consider repealing section 1014 of the Internal Revenue Code, which provides the basis step-up at death.

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[14] This point potentially holds even if the top marginal rate for ordinary income is below the revenue-maximizing rate for capital gains. See Richard L. Schmalbeck, *The Uneasy Case for a Lower Capital Gains Tax: Why Not the Second Best?*, 48 Tax Notes 195 (July 9, 1990).

[15] See Internal Revenue Code section 1014.

III. TAXING BUSINESS ENTERPRISES

In several key respects, our rules for taxing business enterprises are badly broken. Fundamental reform therefore needs to revisit, not just tax preferences, but basic structural features of our rules for taxing the income earned by C corporations and other such large-scale business entities. The following briefly addresses several of the most critical issues.

A. Corporate Tax Sheltering and the Book-Tax Income Gap

Corporate tax sheltering, widely recognized as a big problem in the late 1990s and early 2000s, has not necessarily gone away. One suggestive diagnostic, indicating that it may remain a serious problem, is that the book-tax income gap, or excess of publicly traded companies' reported financial accounting income over their taxable income, remains high.[16] In theory, since accounting income is supposed to be computed more conservatively,[17] the gap should go the other way, with taxable income being higher. Evidently, however, corporate managers' incentives to make book income as high as possible while also trying to save taxes (often through economically wasteful even if technically legal tax planning maneuvers) outweighs any tendency of the tax and accounting rules to push in the opposite direction.[18] A number of different tools can be deployed to address these issues, ranging from increased audit resources, to ensuring that the Internal Revenue Service has adequate legal tools, to making penalties higher and less subject to ostensible good-faith exceptions that in fact merely encourage the procuring of "penalty shield" opinion letters.[19] I have recently suggested that Congress also consider adopting an adjustment to corporate taxable income, as otherwise computed, under which it generally would be adjusted 50 percent of the way towards the taxpayer's reported book income.[20]

B. Corporate Integration and the Distinction Between Debt and Equity

Corporate integration, designed to mitigate or even eliminate the double taxation of equity-financed corporate income, is an approach that most tax policy experts (in my view rightly) continue to favor. As noted above, however, the question of what if any tax should be imposed at the shareholder level importantly depends on how effectively tax is being collected at the corporate level. In addition, however, an approach to partial or complete corporate integration like that under expiring present law, with its special 15 percent tax rate for dividends, is open to the objection that it preserves the longstanding, but economically nonsensical, tax law distinction between debt and equity.[21] Modern

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[16] See, e.g., Joann M. Weiner, *Closing the Other Tax Gap: The Book-Tax Income Gap,* 115 Tax Notes 849 (May 28, 2007).

[17] See, e.g., *Thor Power Tool Co. v. Commissioner,* 439 U.S. 522, 542 (1979).

[18] See generally Daniel Shaviro, *The Optimal Relationship Between Taxable Income and Financial Accounting Income: Analysis and a Proposal,* forthcoming in Georgetown Law Journal, vol. 97, draft available on-line at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1017073.

[19] See Daniel Shaviro, *Disclosure and Civil Penalty Rules in the U.S. Legal Response to Corporate Tax Shelters,* in Wolfgang Schon (ed.), TAX AND CORPORATE GOVERNANCE. Munich: Springer, 2008.

[20] See id.

[21] Interest payments on debt are generally deductible at the corporate level and treated as ordinary income by recipients, and current interest amounts generally are imputed even if no cash actually changes hands.

financial innovation has made the tax distinction between the two types of instrument ever more porous and manipulable. Insofar as investors can slap whichever label they prefer on whatever sort of investment position they wish to have, the debt-equity distinction amounts to an election to use either the corporation's tax rate (via the use of equity) or one's own (via the use of debt), whichever is lower. It is hard to think of a good rationale for effectively providing such an election.[22]

C. Global Tax Competition and the U.S. Corporate Rate

The U.S. statutory corporate tax rate is among the highest in the world. In an era of increasing worldwide capital mobility, this potentially disadvantages us in two respects. Companies may choose to invest abroad rather than here, where the competing locations are otherwise good substitutes for each other, and companies with multinational business activities have extra reason to try to report their income as arising abroad rather than here. Both of these factors potentially disadvantage the United States relative to other countries, and the former (shifts in real activity) offers the most compelling explanation for recent evidence suggesting that the burden of the corporate tax increasingly is borne by workers, via effects on wages.[23] Lowering the corporate rate is therefore potentially an appealing policy change, subject to adequate consideration of (i) its revenue effects, (ii) the implications for shareholder-level taxation (which is not similarly subject to concerns about taxpayers exiting the U.S.), and (iii) achieving the desired level of overall tax progressivity.

D. Outbound Business Investment by U.S. Multinationals

The tax rules for outbound investment by U.S. multinationals badly need revisiting. Two competing approaches typically dominate policymakers' thinking about the taxation of such investment. The first holds that the U.S. should tax all foreign source income of its resident companies as soon as such income is earned, albeit subject to allowing foreign tax credits.[24] The second holds that the U.S. should instead exempt its

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Dividends on equity, by contrast, are nondeductible at the corporate level, not imputed unless paid, and (under expiring present law) generally are taxed to individual recipients at only a 15 percent rate.

[22] Two existing corporate integration proposals would generally eliminate the tax law distinction between debt and equity. First, the comprehensive business income tax (CBIT) that the U.S. Treasury Department proposed in 1992 would in effect treat debt more like equity, by denying deductions for interest at the business level and making the receipt of both interest and dividends generally tax-free to investors. See U.S. Treasury Department, Integration of the Individual and Corporate Income Tax Systems: Taxing Business Income Once (1992). Second, the business enterprise income tax (BEIT) proposal made by Edward D. Kleinbard, currently Chief of Staff of the Joint Committee on Taxation, would in effect treat equity more like debt, by causing an annual cost of capital allowance generally to be deducted at the entity level and included at the investor level. See Edward D. Kleinbard, *Rehabilitating the Business Income Tax*. Washington, D.C.: Brookings Institution Hamilton Project, 2007.

[23] See Gentry, supra.

[24] This approach is typically supported on either of two grounds. The first is the worldwide efficiency norm of capital export neutrality (CEN), under which it is optimal from a global economic standpoint if U.S. companies invest purely on the basis of pre-tax profitability. The second is the concern, from a U.S. national standpoint, that investment in the U.S. will decline if U.S. companies can lower their tax rates by investing abroad. Recent empirical evidence has tended to contradict this view. See James R. Hines, *Reconsidering the Taxation of Foreign Income* (2007). The issue here differs from that of whether lowering the general U.S. corporate tax rate will affect total U.S. investment, because the U.S. tax rules for outbound investment by U.S. companies affects only such companies, rather than all companies.

companies' foreign source active business income from bearing any U.S. tax.[25] The actual U.S. rules are an amalgam of the two that arguably manages to be worse than either. In brief, we allow deferral of any U.S. tax on U.S. companies' foreign source active business income, earned through their foreign subsidiaries, until it is repatriated or otherwise runs afoul of subpart F of the Internal Revenue Code. Unfortunately, deferral appears to give us the worst of both worlds. Given the available tax planning opportunities, observers generally agree that the current rules' efficiency costs are "extremely high relative to the revenue raised"[26] – almost the definition of a bad tax from the efficiency standpoint. The rules could almost certainly be improved by a combination of (a) repealing deferral and (b) sufficiently lowering the tax rate on foreign source income to offset the increased burden on taxpayers from repealing deferral.[27]

Others have argued that this does not go far enough, and that we should instead exempt such income from bearing any U.S. tax.[28] However, I do not entirely agree, although the fact that we discourage outbound investment by U.S. companies (rather than by other companies) when we tax it needs to be kept in mind. Suppose, for example, that the U.S. Congress decided to change current law on a revenue-neutral basis by either (a) raising the corporate rate but eliminating all taxation of U.S. companies' foreign source active business income, or (b) lowering the corporate rate but repealing deferral. Even assuming no effects on other countries' tax policies, no existing economic model convincingly establishes that one of these two approaches would be better than the other.

IV. EASING BURDENS ON LOWER AND MIDDLE-INCOME TAXPAYERS

Another key aim of fundamental tax reform should be to address pervasive public dissatisfaction with the income tax, which reflects the anxiety and needless burdens (wholly apart from taxes actually paid) that the system currently imposes on lower and middle income taxpayers. As my colleague on this panel, Michael Graetz, has noted, in 1940 the instructions to Form 1040 were just 4 pages long.[29] For the 2007 tax year, they were 155 pages long, and the basic form is supplemented by eleven schedules and

[25] This approach is typically supported on any of three grounds. The first is capital import neutrality (CIN), under which it is optimal from a global economic standpoint if all savers that might make a given investment face the same tax rate. The second is capital ownership neutrality (CON, holding that it is optimal from a global standpoint if tax considerations do not distort business ownership decisions. (CON can in principle be satisfied by achieving CEN, but in practice it is typically viewed as instead counseling movement towards exemption. See Hines, supra.) The third is national welfare-based concern about U.S. companies' ability to compete with foreign companies when they consider investing abroad.

[26] Marsha Blumenthal and Joel B. Slemrod, *The Compliance Cost of Taxing Foreign-Source Income: Its Magnitude, Determinants, and Policy Implications*. In Joel B. Slemrod (ed.), THE TAXATION OF MULTINATIONAL CORPORATIONS (1996), at 48.

[27] See Rosanne Altshuler and Harry Grubert, *Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income*, forthcoming in John W. Diamond and George R. Zodrow (eds.), FUNDAMENTAL TAX REFORM: ISSUES, CHOICES, AND IMPLICATIONS. While such a proposal could be designed to be burden-neutral or revenue-neutral for outbound investment as a whole, inevitably it would have particular winners and losers. Obviously, however, no meaningful (or indeed any) reform would be possible if everyone's burden had to remain the same.

[28] See, e.g., Hines, supra.

[29] Michael J. Graetz, *100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System*, 112 Yale L.J. 263, 275 (2002).

innumerable worksheets. What is more, some of the complexities, such as the risk of owing alternative minimum tax even if one avoids all conscious tax planning, are becoming ever more widely applicable. Tax filing is therefore on a path to continue growing ever more burdensome even if the forms and instructions stop growing ever longer.[30]

All this complexity is not just a matter of slaying trees to supply the endless cascades of paper needed for all the forms. It undermines tax compliance and broader public trust. As Joseph Bankman notes, "[t]he average citizen dislikes the tax not because it distorts or discourages investment (although it does), but because it is complicated, because she finds filing expensive, time consuming, and anxiety provoking, and because she believes that complexity (and other factors) allow others to avoid paying their fair share."[31] Addressing this problem, even without major policy or revenue changes, would be surprisingly easy. William Gale, for example, notes that "return-free filing could be achieved for as many as 50 million taxpayers with relatively minor changes in the tax code... [It] already exists in dozens of countries around the world and would eliminate the hassles of filing and compliance for the households least able to cope with them."[32]

The available reform options – several of them complementary rather than mutually exclusive – include the following:

1) Adopt a federal version of the California ReadyReturn pilot program, under which the state government, relying exclusively on information that it had in any event, sent proposed draft tax returns to all who wanted them. This program was a wild success with the taxpayers who participated in it, but lost out in the state legislature due to an unholy alliance between Intuit, the maker of TurboTax, which evidently wanted to keep selling the service that the government was now offering for free, and extreme anti-tax advocates who wanted to make sure that taxpayers would stay as angry at the government as possible (even if this required making them miserable).[33]

2) Eliminate or greatly scale back the alternative minimum tax – assuming that this very costly change is appropriately financed through other changes to taxes or spending.

3) Simplify and consolidate tax breaks for education, retirement, and families,[34] while also addressing the compliance burdens associated with itemized deductions. For example, those for state and local taxes could be reduced sharply without an actual policy change if this were coordinated with scaling back or eliminating the alternative minimum tax. Other possible changes

[30] Illustrating the ongoing trend towards increased complexity, Graetz, supra at 275, notes that the Form 1040 instruction booklet for 2001 was 122 pages long. In only six years, it has grown by 33 pages, or 27 percent.

[31] Joseph Bankman, *Simple Filing for Average Citizens: The California ReadyReturn.* 107 Tax Notes 1431 (May 31, 2005).

[32] William G. Gale, *Fixing the Tax System: Support Fairer, Simpler, and More Adequate Taxation."* Available on-line at http://www.taxpolicycenter.org/UploadedPDF/1001128_fixing_tax_system.pdf.

[33] See Bankman, supra.

[34] See Gale, supra, for a brief discussion of possible details.

include converting home mortgage interest deductions into refundable tax credits paid directly to lenders, and charitable deductions into matching grants paid directly to qualifying nonprofits.[35] Approaches of this kind have drawn bipartisan support in the past, and were included in both the Bradley-Gephardt tax reform proposal[36] that preceded 1986 tax reform and the more recent work of the President's Advisory Panel on Federal Tax Reform.

4) More dramatically, Congress could consider adopting Michael Graetz's plan to take 100 million taxpayers off the income tax rolls by enacting a huge exemption amount so that the tax only applied to high-income individuals, while replacing the lost revenue through enactment of a broad-based value-added tax (VAT).[37]

V. CONCLUSION

Fundamental tax reform seems almost impossible, but the income tax system is facing enough rising stress points to make doing nothing almost as painful as doing something controversial. Of the three main areas for reform effort that I have addressed, base-broadening is possibly the most painful but also potentially with a huge positive payoff for our society. Reform of the rules for taxing business enterprises has the potential to produce massive improvements even if overall policy (such as the level of taxation of saving or outbound investment) remains approximately the same. Easing burdens on lower and middle-income taxpayers could produce huge political rewards – and deservedly so, if millions of taxpayers' lives have been made a bit easier on and around each April 15 – although there, too, tough choices and the creation of both winners and losers cannot be entirely avoided.

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[35] See Leonard E. Burman, *The Urgent Need for Tax Reform and Why It Might Happen* 9 (2008).

[36] Fair Tax Act of 1983, H.R. 3271, 98th Cong., 1st Sess. (1983); S. 1421, 98th Cong., 1st Sess. (1983).

[37] See Michael J. Graetz, 100 MILLION UNNECESSARY RETURNS: A SIMPLE, FAIR, AND COMPETITIVE TAX PLAN FOR THE UNITED STATES. New Haven: Yale University Press, 2008. While income assessment of low-income families may remain necessary to continue delivering certain desirable tax benefits, such as variants of the refundable child tax credit and the earned income tax credit, the Graetz plan offers mechanisms that arguably resemble return-free filing.

Responses to Questions Submitted for the Record

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Regarding Testimony Before the United States Senate Committee on Finance
April 15, 2008

Senator Baucus

1. Congress has continually amended the Code, adding back in much of the complexity the 1986 reforms tried to eliminate. This question is for the entire panel.
    a. As Congress begins to consider tax reform, what principles should we keep in mind to help prevent a reoccurrence of what has happened post-1986 and help develop more stable tax reform that will not be undone soon after?

This is inherently a difficult problem, going beyond the design of a particular tax reform bill. Two principles that could help greatly are (1) eliminating the use of sunsets and other temporary legislation, other than when the policy is meant to be temporary (as in the case of counter-cyclical fiscal stimulus) and (2) requiring tax cuts to be fully financed by offsetting changes to taxes or spending (such as on entitlements), *both* within a short period, such as five or ten years, and over the long haul. "PAYGO"-type rules can at times be inconvenient, but over the long haul provide an important source of stability and fiscal discipline. For the taxation of individuals, if major simplification can be accomplished, thus making tax filing a lot simpler, the goal of keeping it simple might help constrain attempts to craft narrow tax preferences that would require making people's tax returns more complicated again.

b. How do we develop strong policy that will hold up to amendments?

Clear principles that are appealing and widely understood can help. Having a simple system with a broad base and low rates, and that permits most individuals to file very simple returns (if they must file at all) is a start. Another important key is finding principled common ground between the two parties. For example, differences in sympathy for comprehensive income taxation (rather than consumption taxation) as a basic approach can be addressed by having a broad income tax base subject to general savings incentives, rather than adopting consumption tax approaches (such as expensing) for one industry or another.

c. Are we destined to go through this process every 20 to 30 years?

This probably is inevitable. Back in 1986, leaders of the tax reform effort sometimes compared the process to scraping the barnacles off a ship that has been at sea

for decades. This inevitably will have to be done at periodic intervals. That said, however, one would certainly hope for a tax reform that proves more durable than the 1986 legislation.

2. You all point out different goals for tax reform.

    a. What should be the most important goal? What should Congress focus on?

I am reluctant to choose between the three goals of base-broadening, rationalizing business taxation, and dramatic simplification for individuals. The third of these goals is clearly the most salient, however, and can deliver dramatic benefits that the public could easily appreciate. The other two goals help it, however, since base-broadening promotes simplification via the curtailment of popular tax preferences for individuals, and since rationalizing business taxation could make life easier for people who currently need to report their investment income when they file.

    b. How should Congress prioritize these goals?

Simplification can be the leading wedge, helping to explain the need for the other changes, even if it is not literally prioritized as more important.

3. We're looking towards 2010 when the tax cuts expire, the alternative minimum tax has the potential to encompass 30 million taxpayers, and Congress is extending several expiring provisions a year.

    a. What is the biggest challenge to tax reform?

The biggest challenge is the need to mix the bitter with the sweet – to explain the need for base-broadening that pays for lower rates and makes simplification feasible. One of the hardest parts of this process is to explain that people aren't really being made worse off insofar as future adverse changes (in particular, from the growth of the alternative minimum tax) are already happening. The ongoing growth of the alternative minimum tax should help make this easier for people to see. In addition, bipartisanship was a big part of "making the sale" in 1986, and I imagine it would be needed again. This inevitably has to come from the leadership and the tax committees, rather than from the rank and file.

    b. How does Congress conquer that obstacle?

A broad agreement in principle to broaden the base, lower the rates, make filing by individuals much simpler, and fully finance all changes over both the short term and the long run can create an appealing structure for debate while leaving plenty of room for debate over the details.

    c. When does tax reform become unavoidable or an emergency? Have we gotten to that place?

Unfortunately (or perhaps fortunately), I don't believe there is any one point where the problems of the tax system suddenly switch into crisis mode. The analogy that comes to mind (although it may not be a true story) is that of the frog sitting in cool water that gradually heats up to the boiling point, without ever stimulating the frog to jump out.

The emergency that I foresee at some point in the future pertains to budget deficits and the fiscal gap. At some point, if the government continues to have no plan for establishing a sustainable long-term budgetary situation, the financial markets will punish us. This shock might be sudden, severe, and unpredictable, and might involve massive macroeconomic disruption. The income tax is part of the solution, insofar as we need to have a stable and well-functioning system in place, but the pending crisis has more to do with overall budget policy than the details of income tax design.

Senator Grassley

1. This question is for the panel. I read with interest the discussion in the report of the President's Advisory Panel on Federal Tax Reform about how our tax policies send a strong message in favor of debt financed investment as opposed to equity investments. To the point where the report concludes that the reward for debt-financed investment is greater than if there were no taxes at all – it is actually a negative tax.

   I'm also especially troubled by some research that suggests this policy encourages corporations to pile on debt. This preference may be increasing risks of bankruptcy and financial distress particularly when there is an economic downturn. Research also reveals that the different treatments between debt and equity also create opportunities for tax shelters.

   In these times, we've been disturbed by heavily leveraged entities in the financial services industry. I'd appreciate your expanding on these points and your suggestions for reform in this area.

Two core problems underlie these issues. The first is that a consistent income tax would include all returns to capital while allowing all interest to be deducted, while a consumption tax might do neither. The system gets into big trouble, leading to negative taxes, when it has consumption tax features on the inclusion side (such as through accelerated depreciation or deferral of unrealized gain) while acting like an income tax (through interest deductions) on the other side of the ledger. In general, the solution is not to allow this consistency, by denying interest deductions insofar as there is deferral or exclusion on the income side. However, present law rules that rely on approaches such as tracing interest deductions (via the underlying loans) to particular income items cannot work very well, given that money is fungible. Rules that provide first-dollar or pro rata disallowance of interest deductions, to the extent of departures from a pure Haig-Simons income tax on the inclusion side, can help to address the disparities.

The second core problem is the incoherence of our rules for distinguishing between different types of financial instruments, such as debt and equity along with various derivatives such as options, swaps, and notional principal contracts. Uniform rules for the cost of capital, applying to all financial positions, would be the most direct response to these problems. Two examples of such approaches, noted in my written testimony, are the comprehensive business income tax (CBIT) that the Treasury Department outlined in 1992, and the business enterprise income tax (BEIT) and associated cost of capital allowance (COCA) that Edward Kleinbard proposed in 2007.

2. The Chairman, Senator Conrad, myself, and others have talked about the tax gap. In testimony a few years ago, David Walker of the General Accountability Office ("GAO") analyzed the link between tax complexity and the tax gap. I'd like to revisit this linkage with the panel.

    a. Do you agree with the GAO that fundamentally reforming our tax system has the potential to improve compliance? That is, the complexity of, and frequent revisions to, the tax system make it more difficult and costly for taxpayers who want to comply to do so.

For two main reasons, I agree with the GAO. The first is that proper compliance can be costly and frustrating, discouraging taxpayers from engaging in it. The second is that taxpayers who feel that the system is unfair, in part because they suspect that others are exploiting the complexities, are much more likely to under-comply than taxpayers who believe that it is generally fair. That said, as long as there are potential financial gains to cheating (or taking aggressive and dubious tax return positions) without being caught, some people will do it. A healthy audit level is needed to keep such "rational cheating" (from a selfish standpoint) in check.

    b. First, wouldn't you agree that by reducing complexity, we should be able to reduce the amount of the tax gap attributable to unintentional noncompliance?

Yes. This is particularly so if we adopt a program like the pilot "Ready Return" system in California that I noted in my written testimony. People who had a tentative tax return, based purely on information that the government already gets under present law, would have to take affirmative steps to claim more favorable treatment. Greatly simplifying itemized deductions, and in some cases providing them through other mechanisms (such as payments to third parties), would also help.

    c. Second, do you know of any new data that have looked at how much of the tax gap is attributable to unintentional noncompliance due to the complexity of the tax code?

No.

d. And third, it has been said that the rate at which taxpayers voluntarily comply with our tax laws has changed little over the past three decades. What impact did the Tax Reform Act of 1986 have on the tax gap?

The 1986 Act's main contributions to voluntary compliance were twofold. First, through changes such as adoption of the passive loss rules, it effectively shut down the industry that was selling tax shelters (often of dubious legal merit) to individuals. Second, the two percent floor for miscellaneous itemized deductions closed down one motivation for wasteful record-keeping and what at times were legally dubious claims. The analogy today might involve addressing corporate tax shelters and creating further personal itemized deduction floors.

3. The landmark 1986 Tax Reform Act contained scores of transition rules. The Philadelphia Inquirer published a Pulitzer Prize winning series on the legislation. Much of that material focused on the transition rules. As a result of that controversy, Finance Committee Chairmen, from Senator Bentsen forward, on a bipartisan basis, implemented a practice prohibiting "rifle shots." Many practical observers of the process for the 1986 legislation would contend that the transition rules were necessary to secure political support for passage.

   The political imperative of transition relief is an issue we cannot ignore. Setting aside revenue neutrality for an instant, how do you recommend treating transitional items such as credit carryforwards and the loss of depreciation deductions, interest deductions, and deductions for the recovery of inventory?

Roughly speaking, the 1986 Tax Reform Act of 1986 had two types of transition rules. First were those of general import, such as effective date rules and phase-ins. These were generally accepted as necessary. The second were the taxpayer-specific or "rifle shot" rules that the Philadelphia Inquirer, and subsequently Senator Bentsen, addressed. Despite the rationales that proponents advanced for various of these rules during the process of lobbying for them, in general they deserved the advance commentary that they attracted. At the same time, it was genuinely true that they helped get the Tax Reform Act passed, and in that sense one could argue that they did more good than harm. One would certainly want to avoid them, however, if realistically possible.

In general, broad transition rules that apply across the board can be a sensible policy tool, preventing perverse results from changing the rules in midstream. The approach I would recommend is having effective dates that are as early as possible, along with some ability to be compensated for the loss of preexisting "tax assets" such as carryforwards. If revenue were not a concern, the best approach might be to compensate taxpayers directly for lost tax assets through refundable tax credits that functioned, in effect, as a buyout for no more than fair value (and perhaps for less, given that repeal was always known to be possible). While slower and less direct approaches might be necessary for political or revenue reasons, the theoretical merits of such a straightforward approach should be kept in mind when designing transition rules.

A final point worth noting here is that transition can play out to taxpayers' benefit, as well as their detriment. In illustration, suppose that a company deducted accelerated depreciation when the corporate tax rate was 35 percent, expecting to earn future income, and that the corporate rate was then lowered to 25 percent. Permitting companies to include at 25 percent income that they financed by earning deductions that were allowed against a 35 percent rate is no less an anomalous transitional result than, say, eliminating credit carryforwards, and equally ought to be addressed.

4. In general, U.S. citizens are taxed on their worldwide income. To avoid double taxation, the U.S. system employs a credit system that allows taxpayers a foreign tax credit to offset U.S. tax liability on foreign income.

   Another way to avoid double taxation would be to exclude foreign income from U.S. taxation altogether. This is the type of double tax relief provided by territorial tax systems. Under current law, the foreign earned income exclusion allows U.S. citizens to, in effect, elect territorial treatment with respect to a limited amount of foreign earned income.

   Many commentators have suggested adopting a territorial system for corporations. For instance, the President's tax reform panel recommended that approach. The most common reason given by supporters of a territorial system is that such a system is common to many industrialized countries and it would therefore enhance the competitiveness of U.S. businesses.

   Based on those same arguments, there have been recent proposals to enact a territorial regime for individuals by removing all restrictions on the foreign earned income exclusion. Yet, in its recommendations, the tax reform panel, for instance, retained worldwide taxation of U.S. citizens.

   Should we consider a territorial system for individuals?

I don't believe that the competitiveness arguments for moving towards a territorial tax system for companies comparably apply to individuals. The reason for the difference is that individuals are generally much less internationally mobile than capital or corporate investment. In addition, individuals are not really competing for financing in worldwide capital markets in the same manner as corporations do. Thus, for example, while I would personally benefit from a change that permitted me to teach summer classes abroad without owing any U.S. tax on the earnings, it is not as if taxing those earnings subjects me to a meaningful competitive disadvantage relative to, say, a German or Singaporean law professor. By contrast, a U.S. company may face competitive issues of this kind.

Senator Hatch

1. Professor Shaviro, you discussed in your written testimony the idea of adopting an adjustment to corporate taxable income of 50 percent of the difference between

taxable income and reported book income. Some have suggested simply using reported book income as the tax basis. Can you talk more about these two ideas?

The main problems I see with making book income the tax base are twofold. First, Congress is inevitably going to exercise discretion over the details of the income tax base, but the measurement of book income is best left to the independent experts at the Financial Accounting Standards Board. There is a broad consensus that this independence is good for the financial markets because it promotes transparency and fuller information. For example, while I tend to oppose most income tax preferences, it would be worse still to let them affect the income numbers reported to investors.

Second, in some respects the goals of tax and financial accounting diverge. For example, while exemption of foreign source active business income is a plausible (albeit controversial) tax policy idea, excluding such income for purposes of the financial accounting measure would clearly make no sense. Likewise, while consumption tax moves such as expensing for business investment (with consistent treatment of interest deductions) might make sense in the tax context, they clearly are not appropriate for financial accounting.

2. Professor Shaviro, you mentioned in your testimony that distributional concerns should be addressed through a progressive consumption tax, rather than through the capital income component of the current income tax. Could you please elaborate on this, and particularly what types of consumption taxes might be best for this purpose?

If a progressive consumption tax were politically feasible – which is a matter not just whether of Congress would have the votes to pass it, but of whether the broad general public would come to regard it as fair – two main approaches are probably best. The first is an X-tax, such as that designed by the late economist David Bradford. In 2005, the President's Tax Reform Panel sketched out a plan (the Growth and Investment Tax) that had X-tax features, although it also tacked on a poorly integrated 15 percent tax on investment income. The second is a consumed income tax – in effect, a system for individuals looking much like the present one, but with unlimited IRA accounts and inclusion of borrowing to the extent not deposited in such accounts. Taxing borrowing may look odd, but no one objects when a retail sales tax does this indirectly (since the tax applies even if you use borrowed funds to buy consumer goods). The Nunn-Domenici tax reform plan of the mid 1990s was a variant of the consumed income tax, but it had technical flaws that attracted widespread criticism. These flaws could have been eliminated by paying greater attention to the Blueprints plan that David Bradford and the U.S. Treasury Tax Policy Staff developed in the 1980s.

3. Professor Shaviro, you suggested in your testimony that Congress should consider repealing the step-up in basis of assets at death. How might this idea be integrated with an estate tax and what about the problems of record keeping and lost basis information?

Conceptually speaking, the question of what to do about the estate tax is distinct from that of whether to repeal the step-up in asset basis at death. The former is a tax on the value of assets in the estate, without regard to whether there is unrealized appreciation. The case for and against the estate tax (along with variants such as an inheritance tax) depends on what we think about the complex fairness issues, going to both donors and heirs, that are raised by bequests, and by questions of how people respond behaviorally to the tax. (If the estate tax is merely addressing gaps in the income tax, it is very poorly designed for that purpose.)

By contrast, the case for repealing the step-up in basis is compelling purely as a matter of income tax design. The only interaction between the two is that one might be reluctant to impose two large tax "hits" at the same time (such as from paying an estate tax plus an appreciation tax, if death were treated as a realization event). But any such timing overlap can be addressed through various means, such as having an inheritance tax in lieu of an estate tax and/or providing carryover basis in lieu of treating death as a realization event.

Congress in 1976 enacted a prospective repeal of the step-up in basis at death that it then repealed before the effective date. The repeal was largely rationalized on grounds relating to record-keeping problems and lost basis information. I believe, however, that this response to the problem was over-blown then and would be even less justified today. Information about past market values (which can be a proxy for cost) is far more available in today's Internet world than it was thirty years ago, in particular for any sort of asset that is publicly traded. There can also be default rules for addressing situations where heirs reasonably lack information about decedents' cost basis for assets. An example would be taking current market value (needed to establish basis under present law) and reducing it by a normal interest factor for the actual holding period when known, or otherwise for an assumed holding period. Even if some incentives remained under such a system to hold appreciated assets until death, the distortions would be less than under present law.

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16 April 2008

Senate Committee on Finance
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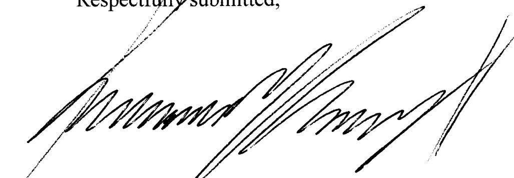
RE: Tax: Fundamentals in Advance of Reform hearing (15 April 2008)

Dear Sirs/Mesdames:

Anent to subject hearing, enclosed find an off-print of my article "Tax Simplification: So Necessary and So Elusive," which was published in the Pierce Law Review, volume 2, page 93 (2004).

The article is also freely available on the Internet at <http://www.piercelaw.edu/assets/pdf/pierce-law-review-vol02-no2-ryesky.pdf>.

Respectfully submitted,



Kenneth H. Ryesky, Esq.

Enclosure

Tax Simplification: So Necessary and So Elusive

KENNETH H. RYESKY*

> The tax which each individual is bound to pay ought to be certain and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought to be clear and plain to the contributor, and to every other person. Where it is otherwise every person subject to the tax is put more or less in the power of the tax-gatherer, who can either aggravate the tax upon any obnoxious contributor, or extort, by the terror of such aggravation, some present or perquisite to himself. The uncertainty of taxation encourages the insolence and favors the corruption of an order of men who are naturally unpopular, even where they are neither insolent nor corrupt. The certainty of what each individual ought to pay is, in taxation, a matter of so great importance, that a very considerable degree of inequality, it appears, I believe, from the experience of all nations, is not near so great an evil as a very small degree of uncertainty.[1]

I. INTRODUCTION

Cries for tax simplification have long been heard from presidents,[2] legislators,[3] current and former government officials[4] and the public. The

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Unless otherwise indicated, opinions expressed in this Article are those of the author, and do not necessarily represent the official position of any person, organization or entity with respect to which the author is or has been employed, associated or retained.

1. Adam Smith, *The Wealth of Nations* (Edwin Cannan, ed., Modern Amer. Lib., N.Y., 1937) (originally published in 1789), bk. V, ch. II, pt. II at 778 (Maxim II.).

2. *E.g.* President Ronald W. Reagan, *The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity* at 1 (May 1985) (SuDoc No. Pr 40.2:T19) ("The system is *too complicated* [emphasis in original]"); President Dwight D. Eisenhower, *Annual Budget Message to Congress: Fiscal Year 1960*, 1959 Pub. Papers 36, 41 ("As the budget permits, additional reforms should be undertaken . . . wherever feasible to simplify the [tax] laws.").

3. *See e.g.* 149 Cong. Rec. E851-01 (daily ed. May 1, 2003) (remarks of Rep. Neal); *see also* Dan Balz, *Kerry Blasts Bush's Tax Cuts, Offers Own Plan*, Washington Post A-4 (Dec. 4, 2002) (reporting Senator John F. Kerry's call for, *inter alia*, tax simplification).

judiciary has often expressed its frustrations in comprehending the tax statutes.[5] The Internal Revenue Service ("IRS") itself has had occasion to hesitate and waver in its interpretation and application of the tax statutes,[6] and indeed, several IRS officials have admitted to retaining professional assistance to prepare their personal income tax returns.[7]

Though nearly everyone seems to advocate tax simplification, the goal remains elusive. Tax litigation continues to abound, and sometimes, where

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4. *See e.g.* U.S. Gen. Acctg. Off., *Tax System: Issues in Tax Compliance Burden*, Pub. No. GAO/T-GGD-96-100, 4-5 (Apr. 3, 1996) (finding that of the Internal Revenue Code, coupled with frequent legislative changes, lead to taxpayer confusion, noncompliance, and impediment of IRS's ability to enforce the tax laws.); *Asides: Tax Revision* (Editorials), Wall St. J. 32, col. 1 (Mar. 3, 1987) (quoting Jerome Kurtz, former Internal Revenue Commissioner: "A taxpaying public that doesn't understand the law is a taxpaying public that can't comply with the law."); *Tax Report: Tax-Law Complexity and Poor IRS Service Draw Fire from an IRS Official*, Wall St. J. 1, col. 5 (Feb. 12, 1997) (reporting comments by IRS Taxpayer Advocate Lee R. Monks that tax law complexity is the cause of most taxpayer problems with the IRS); *Tax Schedule D for Dammit!*, Newsday (Long Island, NY) A4 (Feb. 13, 1998) (reporting that the new rules for Schedule D of Form 1040 concededly confused even Robert Kobel, an experienced senior Public Affairs Officer for IRS Brooklyn District).

5. *See e.g.* Judge Learned Hand, *Thomas Walter Swan*, 57 Yale L.J. 167, 169 (1947):

> [T]he words of such an act as the Income Tax, for example, merely dance before my eyes in a meaningless procession: cross-reference to cross-reference, exception upon exception—couched in abstract terms that offer no handle to seize hold of—leave in my mind only a confused sense of some vitally important, but successfully concealed purport, which it is my duty to extract, but which is within my power, if at all, only after the most inordinate expenditure of time. *Id.*

See Houston Textile Co. v. Commr., 173 F.2d 464, 464 (5th Cir. 1949) ("This petition brings up for solution one of those difficult jigsaw tax law puzzles all too common in the present deplorable crazy quilt patchwork state of the Internal Revenue."); *Cohen v. U.S.*, 995 F.2d 205, 209 (Fed. Cir. 1993) ("It is rare that tax law bears any recognizable relationship to common sense."); *Tkac v. U.S.*, 2002 U.S. Dist. LEXIS 16657 at *1-2 (Dist. Md. Aug. 1, 2002) ("Government counsel 'dumped' a collection of documents on the record and, in effect, left the Court to sort matters out on its own. Judges (and/or law clerks) unfamiliar with tax matters could find this a daunting task.").

6. *See e.g.* Priv. Ltr. Rul. 5811072330A (Nov. 7, 1958) (reversing prior telegraphic ruling that matches with "unstained wooden sticks, tips of various colors, and . . . contained in a barrel-shaped box" and "long matches with unstained wooden sticks, tips of various colors, and . . . contained in a long cylindrical box" were taxable at the higher 5.5 cents per 1,000 instead of the standard 2 cents per 1,000 under the then applicable I.R.C. § 4211 excise tax on matches (repealed June 21, 1965)).

7. Joy Vestal, *Newsmaker: Carol Landy*, Newsday (Long Island, NY) A22 (Apr. 11, 1995) (quoting Carol Landy, Director of the Internal Revenue Service Center, Brookhaven (Holtsville), NY: "I don't do my own tax return. I'm afraid to make a mistake."); Forbes 30 (Jan. 1, 1996) (reproduced in InfoTrac microfilm reel No. Bus. 84-E-2073 (Information Access Co.)) (reporting that then Internal Revenue Commissioner Fred Goldberg reportedly admitted to Rep. Christopher Cox (R. Calif.) to engaging an accountant to prepare his personal income tax returns); James Toedtman, *Mr. Fix-It to the Rescue: IRS Chief Takes on Agency, Taxpayers, Employees, Critics*, Newsday (Long Island, NY) F8 (Mar. 29, 1998) (reporting that then Internal Revenue Commissioner Charles O. Rossotti admitted to having his taxes prepared by professionals since 1970, when he started his own business); David Cay Johnston, *Need Tax Help? So Do the Experts in Washington*, N.Y. Times § 3, 8, col. 2 (Apr. 14, 1996) (reporting that then Internal Revenue Commissioner Margaret Milner Richardson, a tax lawyer, uses professional help to prepare her income tax return); *see also Daniel v. Commr.*, 74 T.C.M. (CCH) 151 (1997) (reciting that the taxpayer, an IRS collections supervisor, had enlisted the help of a subordinate (albeit a dysfunctional one) in preparing a personal income tax return which reported a casualty loss).

words alone do not suffice, judges augment textual opinions with graphic illustration in order to effectively elucidate their decisions.[8] The tax statutes and regulation books continue to grow ever more voluminous,[9] and the Internal Revenue Code ("IRC")[10] is replete with sections containing exceptions to the stated rule and to the listed exceptions.[11] Not included in the Code proper, however, are several uncodified revenue statutes of significant importance.[12] A single transaction often gives rise to liability for diverse types of taxes.[13]

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8. *See* Kenneth H. Ryesky, *From Pens to Pixels: Text-Media Issues in Promulgating, Archiving and Using Judicial Opinions*, 4 J. App. Prac. & Process 354, 360-361 (Fall 2002) and cases cited therein.

9. The familiar U.S.C.C.A.N. annual edition of the Internal Revenue Code (sometimes referred to as the "Red I.R.C.") has grown from a single volume of 1,930 pages in the 1976 edition to two volumes of 1,754 and 1,210 pages, respectively, for the 2003 edition. The U.S.C.C.A.N. companion Federal tax regulations publication ("Red Tax Regs") has grown even more dramatically over the same period, from two volumes totaling 4,508 pages in 1976 to five volumes of 1,964, 1,942, 1,978, 1,891 and 1,641 pages, respectively, in 2003. The foregoing figures do not include the Roman numeral prefatory pages or the index pages.

10. Unless noted otherwise, the statutory section references in this Article will be to the Internal Revenue Code (I.R.C.) of 1986, as amended. The Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2095 (1986), redesignated the Internal Revenue Code of 1954 as the Internal Revenue Code of 1986, retaining consistency in most of the section numbers and providing that except where inappropriate, official reference to one shall entail reference to the other. The 1986 Code was "not intended to change any substantive provision of the [1954 Code] not otherwise modified by [the Tax Reform Act of 1986]," H.R. Conf. Rep. No. 99-841at II-837 (reprinted in 1986 U.S.C.C.A.N. 4925).
Federal taxation is such a specialized area of the law that the Internal Revenue Code, codified at Title 26 of the United States Code, is among tax practitioners and courts widely cited as "I.R.C." instead of "26 U.S.C." *See The Bluebook: A Uniform System of Citation*, § P.5 at 16 and § 12.8.1 at 85 (Columbia L. Rev. Assn., et al., eds., 17th ed., 2000); Association of Legal Writing Directors & Darby Dickerson, *ALWD Citation Manual*, pt. 3, § 14.2(b)(3) at 103 (Aspen L. & Bus. 2000); *see also* Andrea I. Castro, *Overview of the Tax Treatment of Nonprofit Hospitals and Their For-Profit Subsidiaries: A Short-Sighted View Could Be Very Bad Medicine*, 15 Pace L. Rev. 501, 501 n. 1 (1995). By similar convention, regulations issued by the Treasury Department pursuant to the Internal Revenue Code are frequently cited as "Treas. Reg." instead of "26 C.F.R."

11. *See e.g.* I.R.C. § 2035. "Adjustments for certain gifts made within 3 years of decedent's death." *Id.* The general rule in § 2035(a) includes such transfers in a decedent's estate. Sections 2035(b) and 2035(d) are statutory exceptions to the general rule set forth in § 2035(a). Sections 2035(d)(2) and 2035(d)(3), however, set forth exceptions to the exceptions provided in sections 2035(b) and 2035(d); *see also* I.R.C. § 1031 (exception to the general rule that exchange of property is a taxable event, which has several exceptions and qualificatory subparagraphs).

12. *See e.g. In re Hickok*, 552 N.Y.S.2d 49 (N.Y. App. Div. 1990) (dealing with an uncodified tax statute, § 403(3) of Pub. L. 97-34, the Economic Recovery Tax Act of 1981 ("ERTA") relating to wills executed pre-ERTA), leave to appeal denied, 565 N.E.2d 516 (N.Y. 1990); *303 West 42nd St. Ent. Inc. v. IRS*, 181 F.3d 272, 274 (2d Cir. 1999) (determining issues relating to uncodified section of Revenue Act of 1978, Pub. L. No. 95-600 § 530, 92 Stat. 2763, 2885-86 (1978), relating to exemption from penalty for employers who, under certain circumstances, misclassify individuals as other than employees for tax purposes); *Smith v. Commr.*, 275 F.3d 912, 912 (10th Cir. 2001) (ruling on applicability of *Internal Revenue Service Restructuring and Reform Act of 1998*, Pub. L. 105-206, § 3463(a), 112 Stat. 685, 767 (1998), requiring last date to petition Tax Court be included in income tax deficiency notices sent by IRS). Statutes that have not been codified into the Internal Revenue Code nevertheless have the force of law if they appear in the United States Statutes at Large. *Smith*, 275 F.3d 912, 914 n. 1; *see also U.S. Natl. Bank v. Indep. Ins. Agents of Am., Inc.*, 508 U.S. 439, 448 (1993).

13. *See e.g. Lazarus v. Commr.*, 58 T.C. 854 (1972), *aff'd*, 513 F.2d 824 (9th Cir. 1975).

Several factors conjunctively operate to make and keep our tax system complex. By way of specific examples, this article will discuss some of the dynamics that impede and counteract the tax simplification efforts of the executive and the legislative branches. In doing so, the author does not purport that the cases, statutes, regulations or reports chosen for discussion are the only such examples. Nor does the author intend to woodenly impose any classification system, for the forces at work against tax simplification often appear in many guises and are susceptible to diverse analyses and classifications; moreover, they often interact synergistically with one another.[14] The author seeks here to advance the scholarly and practical understanding as to why taxation continues to resist simplification, by way of identifying and describing the actions of forces that complicate the taxation process.

II. LEGISLATIVE ENACTMENT OF TAX STATUTES

A. *Reaction to Judicial Construction of Statutes*

The United States Congress has taken pains to enact confusing, verbose and ambiguous tax statutes requiring complex logical and/or mathematical gymnastics to arrive at the correct tax. Many of these instances are modifications of statutes whose prior incarnations have been interpreted by the courts in a manner not consistent with legislative intent.

Such was the case of the Internal Revenue Code Amendments of 1949 on the heels of the Supreme Court's decision in *Estate of Spiegel v. Commissioner*.[15] There, Chicago merchant Sidney Spiegel placed approximately $1 million in trust for the benefit of his children and grandchildren.[16] There was no provision made for the disposition of the trust in the unlikely event that Spiegel survived all of his children and grandchildren, and so, the possibility of the trust reverting back to Spiegel was actuarially valued at approximately $70 dollars immediately before his death.[17] Nevertheless, because Mr. Spiegel had, by virtue of that remote possibility of reversion, not totally severed his ownership of the trust corpus for tax purposes, the entire amount was included in his estate when he died, increasing the estate tax due by over $450,000.[18] Congress, outraged by the result

14. *See* Edward J. McCaffery, *The Holy Grail of Tax Simplification*, 1990 Wis. L. Rev. 1267 (1990).
15. 335 U.S. 701, 701 (1949).
16. *Id.*; At the time the trust was settled, there was no gift tax applicable and Spiegel's grandchildren were yet to be born. *Id.* at 719-720.
17. *Id.* at 733.
18. *Id.* at 734.

in *Spiegel*, included a provision in that year's IRC amendments that reversionary interests in property must exceed 5% in order to be includible in a decedent's estate.[19] Such Congressional modification of the statute was, to be sure, specifically invited by Justice Burton's dissenting opinion in *Spiegel*.[20] The five percent rule was continued in the IRC's of 1954 and 1986.[21] A qualifying condition was imposed upon what had formerly been a simple rule (albeit a simple rule with a demonstrated potential for harsh draconian consequences). Desirable as it is to prevent situations such as that in *Spiegel* where, comparatively speaking, a miniscule reversionary value would cost the estate a king's ransom, the five percent rule appended to the statute by the 1949 amendment was in a sense a complication, and not a simplification, in the tax statute.

Congressional dissatisfaction with the *Spiegel* decision was easily articulable, but the rationality of Congress's reaction to *Edwards v. Slocum*[22] is not so clear. In 1924, the taxpayer in *Edwards* convinced the United States Supreme Court that Congress did not intend to require complex and reiterative interrelated mathematical calculations in computing the amount of the Federal estate tax.[23] Later that year, when Congress passed the Revenue Act of 1924, it rejected the reasoning in *Edwards* by explicitly requiring that a deductible interest be reduced by any death taxes payable out of it,[24] effectively requiring the reiterative interrelated calculation.[25] The Reve-

19. Pub. L. No. 81-378, § 7 (1949) (amending the Internal Revenue Code of 1939, § 811(c)). *See also* Sen. Rpt. No. 81-831 (reprinted in 1949 U.S.C.C.A.N. 2172, 2180-2181 (1940)). Also weighing in Congress's action to amend § 811 was the United States Supreme Court decision in *Commr. v. Church's Est.*, 335 U.S. 632 (1949); 1949 U.S.C.C.A.N. at 2179-2180.

20. *Spiegel*, 335 U.S. at 708-709 (Burton, J., dissenting):

> Today's decision adds to the difficulties in this troubled field of estate tax law. It may, however, serve a good purpose if it leads to a simultaneous consideration by Congress of the related fields of income, gift and estate taxation in connection with the creation or transfer of future interests. *Id.*

21. I.R.C. § 2037(a)(2). The subsection reads:

> § 2037(a)(2) the decedent has retained a reversionary interest in the property (but in the case of a transfer made before October 8, 1949, only if such reversionary interest arose by the express terms of the instrument of transfer), and the value of such reversionary interest immediately before the death of the decedent exceeds 5 percent of the value of such property. *Id.*

22. *Edwards v. Slocum*, 264 U.S. 61 (1924), *aff'g*, 287 F. 651, 654 (2d Cir. 1923).

23. *Id.* at 63.

24. Sen. Rpt. 68-398 (1924) (reprinted in 1939-1 C.B. 2, 266, 290 (1924)) (rejecting the *Edwards* case by explicitly requiring that a deductible interest be reduced by any death taxes payable therefrom).

25. *See* Treas. Reg. § 20.2055-3(a)(2); Rev. Rul. 71-232, 1971-1 C.B. 275; *see also Hartwick College v. U.S.*, 801 F.2d 608, 611 - 612 (2d Cir. 1986); *Martin v. U.S.*, 923 F.2d 504, 504 (7th Cir. 1991); *Chiles v. U.S.*, 1985 U.S. Dist. LEXIS 12704 **9-14 (Dist. Ore. 1985), *aff'd*, 843 F.2d 367, 367 (9th

nue Act of 1924 was enacted more than two decades before the invention of the automatic sequence electronic computer;[26] accordingly, the "squirrel cage" arithmetic calculations using mutually dependent variables mandated by Congress had to be done manually.

Legislative fixes for problem tax statutes, then, do not always make the taxes simpler.

B. *Political Influence*

This article leaves to others the tasks of setting forth detailed analyses of the political processes that affect tax legislation and/or listing the political artifacts to be found the Internal Revenue Code. There can be no denying, however, that foul or fair, much tax legislation is influenced by special interests.[27]

Some private tax legislation is never codified into the IRC, and thus, has little if any lasting effect upon the tax system. As an example, the Tax Reform Act of 1986 contains an obscure uncodified section known as the Jim Thompson Act.[28] James H. W. Thompson, the legendary American business entrepreneur who developed the silk industry in Thailand, mysteriously disappeared in 1967 while in Malaysia.[29] Thompson's property in Bangkok, initially bequeathed to a nephew, came into the hands of a charitable entity known as the Jim Thompson Foundation, which now operates a museum to preserve Thompson's house and chattels.[30] The indirect transfer to charity apparently did not comply with the requirements for a valid

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Cir. 1988); *Est. of Bush v. U.S.*, 618 F.2d 741, 741 (Ct. Cl. 1980); *Est. of Bradford v. Commr.*, 84 T.C.M. (CCH) 337 (2002).

26. In 1946, the United States Army took delivery from the University of Pennsylvania of the Electronic Numerical Integrator and Computer (ENIAC); *see e.g. Sperry Rand Corp. v. Bell Tel. Labs., Inc.*, 208 F. Supp. 598, 600-601 (S.D.N.Y. 1962), *appeal dismissed*, 317 F.2d 491, 491 (2d Cir. 1963); Alice R. Burks & Arthur W. Burks, *The First Electronic Computer: The Atanasoff Story* 105 (U. Mich. Press 1988); *see also* Martin H. Weik, "The ENIAC Story," Ordnance, J. of the Am. Ordnance Assn. (Jan-Feb. 1961) (republished at http://ftp.arl.army.mil/~mike/comphist/eniac-story.html) (accessed May 25, 2004).

27. *See e.g.* Philip M. Stern, *The Rape of the Taxpayer* (Random House, 1973); William Blatt, *The American Dream in Legislation: The Role of Popular Symbols in Wealth Tax Policy*, 51 Tax L. Rev. 287, 287 (1996); Richard L. Doernberg & Fred S. McChesney, *On the Accelerating Rate and Decreasing Durability of Tax Reform*, 71 Minn. L. Rev. 913 (1987); Ronald F. Wilson, *Federal Tax Policy: The Political Influence of American Small Business*, 37 S. Tex. L. Rev. 15 (1996).

28. *Tax Reform Act of 1986*, P.L. 99-514 § 1423, 100 Stat. 2717.

29. *A U.S. Millionaire Missing in Malaysia*, N.Y. Times 1 (Mar. 28, 1967); The Jim Thompson House, *The Jim Thompson Legacy*, http://www.jimthompsonhouse.org/museum/index.html (accessed May 25, 2004).

30. *Silk Man's Home to Keep His Art*, N.Y. Times 4 (July 8, 1968); The Jim Thompson House, *The James H. W. Thompson Foundation*, http://www.jimthompsonhouse.org/museum/index.html (accessed May 25, 2004).

charitable estate tax deduction,[31] and so, a steep estate tax bill was due to the IRS. With the obvious help of the Thompson family's political connections,[32] the Tax Reform Act of 1986 gave a private remedy to the financial problems of the Thompson's estate and foundation, providing that "[n]otwithstanding any other law or any rule of law (including res judicata, laches, or lapse of time)," the property which was Jim Thompson's and which was transferred to the Foundation would be eligible for the charitable deduction with respect to the Estate Tax. [33]

But some "private relief" tax provisions have actually achieved stealthy codification into the Internal Revenue Code. The old I.R.C. § 1240 is one such example. It read:

> Amounts received from the assignment or release by an employee, after more than 20 years' employment, of all his rights to receive, after termination of his employment and for a period of not less than 5 years (or for a period ending with his death), a percentage of future profits or receipts of his employer shall be considered an amount received from the sale or exchange of a capital asset held for more than 6 months if -
>
> (1) such rights were included in the terms of the employment of such employee for not less than 12 years,
> (2) such rights were included in the terms of the employment of such employee before the date of enactment of this title, and
> (3) the total of the amounts received in one taxable year and after the termination of such employment.[34]

It would seem that very few could fulfill of the conditions of this statutory section, but one person who was able to save approximately $2 million by having his lump sum severance payment taxed as a capital gain instead of ordinary income under the provision was the very person for whom the statute was specifically tailored, Hollywood mogul Louis B.

31. *Cf. e.g. Miss. Valley Trust Co. v. Commr.*, 72 F.2d 197 (8th Cir. 1934) (disallowing charitable deduction from estate for bequest to decedent's sons, subject to prior verbal understanding that sons would give the funds to charities), *cert. denied*, 293 U.S. 604 (1934).

32. Gary Klott, *How Special Breaks Got in the Tax Bill*, N.Y. Times 35 (June 14, 1986). Thompson's maternal grandfather, for whom he was named, was U.S. Civil War general cum diplomat James Harrison Wilson. Jim Thompson House, *Life and Legend, Key Influences on Thompson's Early Life*, http://www.jimthompsonhouse.org/life/index.html (accessed May 25, 2004).

33. *Tax Reform Act of 1986*, P.L. 99-514 § 1423, 100 Stat. 2717.

34. I.R.C. § 1240, *repealed by Tax Reform Act of 1976*, Pub. L. No. 94-455, § 1911(a)(139), 90 Stat. 1787 (1976).

Mayer.[35] Unlike the Jim Thompson Act, which directly mentions its beneficiary by name,[36] the former I.R.C. § 1240 was totally devoid of any mention of the name of its intended beneficiary.[37]

C. *Statutory Redesignations*

The Bankruptcy Tax Act of 1980[38] made several amendments to the I.R.C. One such amendment respectively redesignated I.R.C. §§ 6103(e)(5) and (e)(6) as I.R.C. §§ 6103(e)(6) and (e)(7).[39] Prior to 24 December 1980, I.R.C. § 6103(e)(6) was the statute that authorized the IRS to permit certain disclosures under the Freedom of Information Act if it were determined "that such disclosure would not seriously impair tax administration."[40] Since 24 December 1980, I.R.C. § 6103(e)(6) has referred to the statutory subsection that permits disclosure to a duly authorized representative of the taxpayer, a provision that had been designated as I.R.C. § 6103(e)(5) before Bankruptcy Tax Act.[41]

The Bankruptcy Tax Act redesignations have made tax research more difficult, confusing and subject to error. A key word search on databases such as LEXIS or Westlaw for I.R.C. § 6103(e)(6), if not properly date restricted, will hit cases that deal with the post-Bankruptcy Tax Act version of the statute[42] and cases that deal with the pre-Bankruptcy Tax Act version of the statute.[43]

Such redesignations can be especially complicative and confusing if they occur during the litigation.[44] As the Fifth Circuit noted in *Chamberlain*,[45]

35. *Stern, supra* n. 27, at 40-44; It has been reported that in 1966, Dow Jones CEO Bernard Kilgore fortuitously qualified under all of the conditions set forth in the statute that had been tailored specifically for Louis B. Mayer, and benefited accordingly. *Five-eight and Bald-Headed*, Forbes, June 1, 1987, p. 86.

36. *See supra* nn. 29-33 and accompanying text.

37. The Congressional report on the repeal of I.R.C. § 1240 did, however, mention Louis B. Mayer by name. H.R. Rep. No. 94-658 (1976) (reprinted in 1976 U.S.C.C.A.N. at 3291) ("This amendment repeals the so-called Louis B. Mayer provisions . . . . Since the provision contains narrow restrictions, including the requirement that the rights be created before August 16, 1954, it is believed that it has no applicability today.").

38. P.L. 96-589 (1980).

39. *Id.* at § 3(c)(1).

40. I.R.C. § 6103(e)(7) (2003) (formerly codified at I.R.C. § 6103(e)(6)).

41. I.R.C. § 6103(e)(6) (2003) (formerly codified at I.R.C. § 6103(e)(5)).

42. *Iacoe v. IRS*, 1999 U.S. Dist. LEXIS 12809 at *13 (E.D. Wis. 1999); *Sharer v. U.S.*, 1999 U.S. Dist. LEXIS 2439 at *6 (E.D. Cal. 1999).

43. *E.g. Chamberlain v. Kurtz*, 589 F.2d 827, 834 n. 17 (5th Cir. 1979), *cert. denied*, 444 U.S. 842 (1979); *Kanter v. IRS*, 433 F. Supp. 812, 824 n. 21 (N.D. Ill 1977).

44. *See e.g. Currie v. IRS*, 704 F.2d 523, 526 n. 4 (11th Cir. 1983).

45. *Chamberlain v. Kurtz*, 589 F.2d 827, 834 n. 17 (5th Cir. 1979), *cert. denied*, 444 U.S. 842 (1979).

> After the district court entered its orders herein, Congress substantially amended both the FOIA and the Internal Revenue Code in ways that directly affect this litigation. The Government in the Sunshine Act, enacted September 13, 1976, significantly narrowed the scope of Exemption 3 of the FOIA, while the Tax Reform Act of 1976 enacted October 4, 1976, completely revised section 6103 of the Internal Revenue Code and created a comprehensive scheme for regulating the release of tax returns and information collected to determine tax liability.[46]

Several other paragraphs of I.R.C. § 6103 have similarly been redesignated,[47] as have numerous other paragraphs and subsections of the Code.[48] Moreover, where it makes reference to statutory sections and paragraphs in other titles of the United States Code, the I.R.C's must be amended to reflect redesignations by Congress of such sections and/or paragraphs in the other titles.[49] On account of such Congressional tinkering with statutory redesignations, legal research of the Code for litigation and other purposes is akin to gunning for a moving target from a moving platform.

Diverse factors and forces thus motivate Congress to enact taxation statutes complex in their logic and/or requiring complexities in compliance and administration.

III. COMPLEX REGULATIONS BY THE TREASURY

> Owing to its interaction with more than 250 million taxpayers annually, the Internal Revenue Service . . . has a robust administrative practice, characterized by a panoply of multi-faceted and multi-purposed administrative pronouncements and positions. Among these are Treasury regulations (both interpretative and leg-

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46. *Id.*

47. P.L. 100-485, § 701(b)(1) (redesignating I.R.C. § 6103(l)(12) as I.R.C. § 6103(l)(11)); P.L. 98-369, § 453(b)(6) (redesignating I.R.C. § 6103(l)(7) as I.R.C. § 6103(l)(8)); P.L. 97-248, § 356(a) (redesignating I.R.C. § 6103(i)(6) as I.R.C. § 6103(i)(7)); P.L. 97-248, § 358(a) (redesignating I.R.C. § 6103(i)(7)(B) (as redesignated by § 356(a) of the Act) as I.R.C. § 6103(i)(7)(C)).

48. The author's keyword LEXIS search for "redesignated" in the "History" field of 26 U.S.C. cites yielded 588 hits (Jan. 4, 2004).

49. *See e.g.* Museum and Library Services Act of 2003, P.L. 108-81, § 503, 117 Stat. 991, 1003-1004 (Sept. 25, 2003) (amending I.R.C. § 170(e)(6)(b)(i)(III) to reflect the redesignation of 20 U.S.C. § 9122(2)(A) to 20 U.S.C. § 9122(1)(A)).

islative), revenue rulings, private letter rulings, technical advice memoranda and General Counsel Memoranda.[50]

Federal tax regulations are the product of a relatively complex rule-making process. This is so, in part, on account of the hierarchical structure of and between the IRS and the Treasury Department. The IRS is an organ of the Department of the Treasury, empowered as prescribed by the Secretary of the Treasury (though its chief executive officer, the Commissioner of Internal Revenue, is appointed by the President, subject to approval by the Senate).[51] Nevertheless, it is the Secretary of the Treasury who is ultimately responsible for enforcing and administering the federal tax laws[52] and indeed, many sections of the I.R.C. specifically permit or require "the Secretary" to promulgate regulations.[53]

The process of promulgating federal tax rules and regulations involves personnel from both the IRS and the Treasury Department.[54] Representatives from both the IRS and the Treasury itself collaborate to conduct the public hearings for proposed tax regulations.[55]

Critics have found the tax rulemaking process to be overly complex routine that produces overly complex rules.[56]

> It has now become disgustingly common for young lawyers to spend several years at Treasury working on complex regulations projects—creating obscurity for its own sake—in order to be able later to market their skills at interpreting their own work. The

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50. *Vons Companies, Inc. v. U.S.*, 51 Fed. Cl. 1, 3 (Fed. Cl. 2001), *modified*, 2001 U.S. Claims LEXIS 241 (Fed. Cl. 2001). The "panoply of multi-faceted and multi-purposed administrative pronouncements and positions" also includes Determination Letters, Opinion Letters, Information Letters and Closing Agreements. *See e.g.* Treas. Reg. § 601.201. Courts will even give due regard to IRS training materials, and to public or special audience speeches by high-ranking IRS or Treasury officials. *See Vinson & Elkins v. Commr.*, 99 T.C. 9, 58-59 (1992), *aff'd*, 7 F.3d 1235 (5th Cir. 1993).

51. I.R.C. § 7802.

52. I.R.C. § 7801.

53. *E.g.* I.R.C. § 1(f)(1) (mandating that "*the Secretary* shall prescribe" tax tables to phase-out the marriage penalty); I.R.C. §7872(h) ("*The Secretary* shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section") (emphasis added). The author's LEXIS keyword search of the Internal Revenue Code for the phrase "Secretary shall prescribe" yielded 273 hits (Jan. 5, 2004).

54. Treas. Reg. § 601.601; *see also* Carole C. Berry, *Sub S One Class of Stock Requirement: Rulemaking Gone Wrong*, 44 Cath. U.L. Rev. 11, 16–20 (1994).

55. *See e.g.* John E. Hembera, Jr., Witness *Suggests Changes to Proposed Estate Tax Filing Regs*, 90 Tax Notes 583 (Jan. 29, 2001) (reporting that government panel at the Jan. 24, 2001 hearing on proposed changes to Treas. Reg. 20.6081-1, at which the author of this article testified, "consisted of Katherine Mellody and Mary Berman from the IRS and Beth Kaufman from the Treasury Department").

56. *See e.g. Berry*, *supra* n. 54, at 19-20.

worse the Treasury product, the more valuable the draftsman becomes to private firms and others.[57]

Even a seemingly simple Code section can be made complex by the regulations and pronouncements of the IRS and the Treasury. One example is the 87-word I.R.C. § 107, quite laconic by I.R.C. standards, which reads in its entirety:

> I.R.C. § 107. Rental value of parsonages.
>
> In the case of a minister of the gospel, gross income does not include—
> (1) the rental value of a home furnished to him as part of his compensation; or
> (2) the rental allowance paid to him as part of his compensation, to the extent used by him to rent or provide a home and to the extent such allowance does not exceed the fair rental value of the home, including furnishings and appurtenances such as a garage, plus the cost of utilities.[58]

The noun "minister," when not used in the governmental or diplomatic sense, means "[a] person authorized by a *Christian* church to perform religious function."[59] Moreover, the word "gospel" refers collectively to the first four books of the Christian bible.[60] Accordingly, Constitutional issues notwithstanding, a facial reading of the statute would seem to exclude from its ambit a person whose employment consists of carrying out sacerdotal functions of a non-Christian religious denomination whose venerated writings do not include the books of Matthew, Mark, Luke and John.

Thus, a tax attorney who has been retained by a Jewish rabbi would, of course, look first to the applicable Treasury Regulations to determine whether his or her client might benefit from I.R.C. § 107, notwithstanding the language in which the statute has been couched by Congress. The attorney then turns to Treasury Regulation § 1.107-1, relatively wieldable at less than 600 words, which further clarifies that "[I]n order to qualify for the exclusion, the home or rental allowance must be provided as remunera-

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57. Erik M. Jensen, *Food for Thought and Thoughts About Food: Can Meals and Lodging Provided to Domestic Servants be for the Convenience of the Employer?*, 65 Ind. L.J. 639, 645 n. 34 (1990).

58. I.R.C. § 107.

59. *Black's Law Dictionary* 1011 (7th ed., West 1999) (emphasis added). The definition in the 5th and 6th edition reads "[a] person ordained according to the usages of some church or associated body of Christians for the preaching of the gospel and filling the pastoral office." *Black's Law Dictionary* 898-899 (5th ed., West 1979); *Id.* at 996 (6th ed., West 1990).

60. *Merriam-Webster's Collegiate Dictionary* 504 (10th ed., Merriam-Webster, Inc. 1997).

tion for services which are ordinarily the duties of a minister of the gospel. In general, the rules provided in § 1.1402(c)-5 will be applicable to such determination."[61] We are thus directed to Treasury Regulation § 1.1402(c)-5, whose verbosity score tops 1,700 words, and which sets forth various helpful but, by now, complex criteria, including "If a minister is performing service in the conduct of religious worship or the ministration of sacerdotal functions, such service is in the exercise of his ministry whether or not it is performed for a religious organization."[62]

In light of the well known Constitutional prohibitions against religious discrimination, the ambiguous phrase "minister of the gospel" and its elucidation in Treasury Regulation § 1.1402(c)-5(b)(2)(iii) should be construed as a religion-neutral provision allowing a Jewish rabbi and other clergy of other religions the benefit of the parsonage allowance provided in I.R.C. § 107.[63] All doubt on that score was removed in 1978, when the IRS specifically ruled that a Jewish congregational rabbi came within the ambit of I.R.C. § 107,[64] and the IRS subsequently ruled that a Jewish congregational cantor may, under certain circumstances, likewise find shelter in the shadow beneath the wings of § 107.[65] Accordingly, Jewish rabbis and cantors will be pleased to know that they are also considered to be ministers of the gospel, an appellation which would be considered well nigh insulting in any context other than that of I.R.C. § 107.

If the 87 words that comprise I.R.C. § 107 can spawn so much complexity in their supporting regulations, then the potential for trouble posed by Code sections of greater verbosity is as obvious as it is daunting.

IV. COMPLEXITIES IN ADMINISTRATION

In addition to the complexities in identifying taxable events and computing the correct tax, there is also much complexity to be found in tax administration. Even where the taxable event and the amount of the tax are clearly specified, complications can and do arise in the administration of the tax.

61. Treas Reg. § 1.107-1(a).
62. Treas Reg. § 1.1420(c)-5(b)(2)(iii).
63. *See U.S. v. Coombs*, 37 U.S. 72, 76-77 (1838).
64. Rev. Rul. 58-221, 1958-1 C.B. 53.
65. Rev. Rul. 78-301, 1978-2 C.B. 103. This Revenue Ruling was a reversal of the IRS's prior position taken in Rev. Rul. 61-213, 1961-2 C.B. 27, after losing more than once in the Tax Court on the issue. *See Silverman v. Commr.*, 1973 U.S. App. LEXIS 8851 (8th Cir. 1973), *aff'g* 57 T.C. 727 (1972); *Salkov v. Commr.*, 46 T.C. 190 (1966).

The annual half-shekel per capita tax levied while the Temple stood in Jerusalem is instructive. Though this tax was clearly specified as to incidence and amount – one half-shekel to be paid by every man over twenty years of age[66] – there were potentially complicating administrative matters that came into play. The entire amount was to be remitted in a single payment and not in partial payments.[67] A significant number of people paid their tax in coins other than the standard shekel used in the Temple, and provisions were thus necessary to address the exchange of coins.[68] The collected funds were often transmitted via an intermediary, and procedures for doing so were defined,[69] as were consequences for failure of the intermediary to properly pay over the tax.[70] And, of course, given the universal human distaste for paying taxes,[71] there needed to be a tax collection system which efficiently facilitated voluntary compliance but which was prepared to resort to force if necessary to ensure payment of the half-shekel.[72]

Even a conceptually simple tax such as the half-shekel can thus entwine itself in administrative considerations, which, given today's techno-

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66. *Exodus* 30:13–15.

67. *Maimonides, Mishneh Torah: Shekalim* ch. 1, ¶ 1 at 94 (Philip Birnbaum, trans., Hebrew Publg. Co., N.Y. 1967) (c. 1180). *Cf.* Ark. Atty. Gen. Op. No. 90-040, 1990 Ark. AG LEXIS 45 (Feb. 1, 1990) (ruling that county tax collectors are not required to accept partial payments of real property taxes); Mich. Atty. Gen. Op. No. 5777, 1979-80 Op. Atty. Gen. Mich. 983, 1980 Mich. AG LEXIS 60 (Sept. 10, 1980) (same).

68. *Talmud (Bab.),* ch. I, Mishnah 6 at 232 (Leo Jung, trans., I. Epstein, ed., Traditional Press, N.Y. 1983) ("The following are liable [to pay] a surcharge [to cover the costs of currency exchange] . . . If a man gave a sela' and received a shekel, he is liable to pay two surcharges."); *cf.* Treas. Reg. §§ 301.6316-1 through 301.6316-8 (setting forth regulations addressing particulars regarding payments, refunds and credits with respect to federal taxes paid in foreign currencies).

69. *See Talmud (Bab.), supra* n. 68, ch. II, Mishnah 1 at 233 ("Shekels may be changed into darics in order to [lighten] the load of the journey [to the Temple]."); *cf.* Treas. Reg. § 1.6302 (setting forth regulations for the use of government depositary banks in connection with certain tax payments).

70. *See Id.*, Mishnah 2 at 235 ("If a man gave his shekel to his fellow to pay it on his behalf, but [his fellow] paid it on behalf of himself . . . [his fellow] is guilty of sacrilege."). *Cf.* I.R.C. § 6672.

71. Ralph Waldo Emerson, *Ralph Waldo Emerson: Essays, Politics* (1844) (reprinted in *Ralph Waldo Emerson: Essays and Lectures* 567 (Joel Porte ed., The Library of America, N.Y. 1983)); *also* in 5 *The Harvard Classics: Essays and English Traits* at 247 (Chas. W. Eliot ed., Collier & Son, N.Y. 1909) ("Of all debts, men are least willing to pay the taxes.").

72. *See Maimonides, supra* n. 67, ch. 1, ¶ 9 at 94-95:

> On the first of Adar announcement is made concerning the payment of shekel dues, so that each individual may prepare his half-shekel and be ready to pay it. On the fifteenth of Adar, the money-changers sit down in each town and gently request everyone to pay. They accept from everyone who offers them the half-shekel, without using compulsion against anyone who does not. On the twenty-fifth of Adar, they sit down in the Temple to enforce collection. From then on, payment is obtained by force from those who have not yet paid. Anyone who refuses to pay is subjected to compulsion by levy; a pledge is taken from him forcibly, even the garment he is wearing. *Id.*

logical state of the art, can only further complicate the tax system.[73] Some of these considerations will now be discussed.

A. *Taxpayer Resistance to Taxation*

As previously mentioned, the taxpayer's disdain for the taxation process is nearly always a given.[74] Accordingly, there is normally some degree of resistance to taxation on the part of the payer. Against such a backdrop, fostering the American system of voluntary compliance[75] with the tax laws can be quite a challenge, for it necessarily entails the delicate balance of encouraging the taxpayer to come forward (albeit not necessarily with enthusiasm)[76] against the implicit threat of uncomfortable consequences if the taxpayer fails to discharge his or her duty.[77]

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73. Plastic credit cards as used in modern society were, of course, unknown in the days of the Temple, but one can easily imagine, at such time as the Temple is rebuilt and the half-shekel tax reinstituted, the payment of that tax via credit card. Provisions regulating credit card payments of the half-shekel tax will, no doubt, need to be promulgated. *Cf.* Treas. Reg. § 301.6311-2 (regulating the payment of federal taxes by credit card and debit card).

74. *See Maimonides, supra*, n. 72 and accompanying text.

75. *See e.g. Guide to the Internal Revenue Service for Congressional Staff*, I.R.S. Pub. No. 1273, at 4 (Jan. 1996), SuDoc No. T22.44/2: 1273/996 ("[Voluntary compliance] means that taxpayers are expected to comply with the law without being compelled to do so by action of a federal agent; it does not mean that the taxpayer is free to decide whether or not to comply with the law.").

76. *Belli v. Commr.*, 57 T.C.M. (CCH) 1172, 1181 (1989) ("Expressing one's feelings about the IRS . . . is not an element of tax fraud; if it were, our Federal prisons undoubtedly would be brimming with such 'tax convicts.' We fail to discern any requirement that taxpayers must enjoy or look forward to paying their taxes.").

77. *See* 1 Edward Gibbon, *History of the Decline and Fall of the Roman Empire*, 493 (John B. Bury, ed., Heritage Press 1946) (originally published 1788) (also available at http://www.earthops.org/gibbons/2dfre10.html (accessed May 25, 2004)):

> The secret wealth of commerce, and the precarious profits of art or labor, are susceptible only of a discretionary valuation, which is seldom disadvantageous to the interest of the treasury; and as the person of the trader supplies the want of a visible and permanent security, the payment of the imposition, which, in the case of a land-tax, may be obtained by the seizure of property, can rarely be extorted by any other means than those of corporal punishments. *Id*

Maimonides, supra n. 67, ch. 1, ¶ 9, at 94-95; Rita Zeidner, *From Grizzly to Cuddly*, Oct. 1992 Govt. Exec. Mag. 12, 17 (quoting Natwar Gandhi, Associate Director for Tax Policy, U.S. General Accounting Office: "Kind words can do a lot, but kind words and a gun can go a lot further."); *see also* Illinois Dept. of Revenue, Letter Ruling IT 92-0191 (GIL) (Oct. 8, 1992), (available at http://www.revenue.state.il.us/legalinformation/letter/rulings/it/1992/920191.pdf (accessed May 25, 2004) ("Penalties and interest are imposed to aid the Department in the timely collection of the proper amount of taxes due. Without the ability to enforce timely payment of tax obligations, the State of Illinois would incur an enormous financial detriment.").

Taxpayer resistance against taxation personnel takes on various forms. At worst, it amounts to physical violence[78] or murder.[79] Not quite reaching such extremes, many individuals known as "tax protesters"[80] engage in all sorts of frivolous and vexatious court actions.[81] Interestingly enough, many of the same frivolous arguments used by tax protesters in the United States have been put to analogous use by tax protesters in other countries.[82] Such tax protest actions do not expedite the taxation process, whether in the United States or elsewhere. Acts of tax resistance, such as refusal to

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78. *See e.g. Commonwealth v. Gearing*, 83 Mass. 595 (1861) (Conviction of assault upon deputy sheriff attempting to collect taxes); *Mendenhall v. U.S.*, 119 P. 594 (Okla. Crim. App. 1911) (defendant convicted of assaulting with intent to kill a city marshal in tax collection dispute); *see also Man Shot Official over Stadium Tax*, Pittsburgh Post-Gazette A5 (July 14, 1998) (reporting statements by defendant at sentencing hearing that he had shot a Maricopa County, AZ supervisor because of her support of a sales tax to fund construction of Arizona Diamondbacks baseball stadium).

79. *See e.g. People v. Brown*, 59 Cal. 345, 350-351 (1881) (affirming capital murder conviction in which defendant and other ex-convicts had conspired "to commit larceny, burglary, and robbery, and particularly, to rob the Tax Collector of [Mendocino] county, and to resist by force any who might attempt to interfere with them or to capture them"); *see also* David Lyons, *Trial is in Miami, But Law is Italy's*, Natl. L. J. A8 (May 11, 1998) (reporting trial testimony in Miami, in prosecution of Italian national by Italian judicial system, for murder of Miami sales tax collector who had attempted to collect from defendant's business).

80. *See e.g. Coleman v. Commr.*, 791 F.2d 68, 69 (7th Cir. 1986):

> 'Tax protesters' have convinced themselves that wages are not income, that only gold is money, that the Sixteenth Amendment is unconstitutional, and so on. These beliefs all lead -- so tax protesters think -- to the elimination of their obligation to pay taxes. The government may not prohibit the holding of these beliefs, but it may penalize people who act on them. *Id.*

81. *See e.g. Burnett v. Commr.*, 68 T.C.M. (CCH) 811, 813 (1994) ("Petitioner testified that he has not filed a tax return since 1980, and plans to litigate each and every notice of deficiency he receives with the same arguments."); *Harrell v. Commr.*, 75 T.C.M. (CCH), 2458, 2460 (1998) ("Petitioner has been before this and other courts on income tax matters on numerous occasions, as shown in table 1."), *aff'd*, 1999 U.S. App. LEXIS 19886 (7th Cir. 1999); *Webb v. Commr.*, 66 T.C.M. (CCH) 1273 (1993), *aff'd*, 95-1 U.S.T.C. (CCH) ¶ 50,127 (9th Cir. 1995); *see also* Marcus Farbenblum, *The IRS and the Freedom of Information and Privacy Acts of 1974* 43-56 (1991) ("The Tax Protest Movement").

82. *Cf. e.g. O'Toole v. Commr.*, 84 T.C.M. (CCH) 471 (2002) (rejecting petitioner's claim that the IRS assessment was invalid because it omitted the apostrophe in his name) with *Commr. of Inland Revenue v. Boyton*, 2001 NZDCR LEXIS 170, D.C. REG. 1126 (Dist. Ct. Upper Hutt, 2001) (rejecting defendant's argument that the New Zealand Inland Revenue assessment was invalid because it spelled his name "Craig Gordon Boyton" instead of "Craig-Gordon: Boyton"(with hyphen and colon as indicated)); *cf. e.g. Lister v. U.S.*, 2003 U.S. App. LEXIS 20430 (9th Cir. 2003) (rejecting tax protester's arguments that the Federal Income Tax is unconstitutional) *with Matchett v. Dep. Commr. of Taxn.*, [2000] NSWSC 975, 2000 NSW LEXIS 350 (rejecting Australian tax protester's arguments that the Australian Income Tax Act is unconstitutional); *cf. e.g. Marsh v. Commr.*, 79 T.C.M. (CCH) 1327 (2000) (rejecting tax protester argument that native Hawaiians are not obligated to pay taxes), *aff'd*, 2002 U.S. App. LEXIS 1354 (9th Cir. 2002); *Avery-Carter v. Commr.*, 66 T.C.M. (CCH) 1596 (1993) (same, African-American); *Hill v. Commr.*, 70 T.C.M. (CCH) 13 (1995) (same, Native-American) *with Kaihau v. New Zealand Inland Rev. Dept.* [1990] 3 NZLR 344 (Highcourt, Auckland, 1990) (rejecting tax protester's argument that he is exempt from New Zealand taxation because he is a Maori).

divulge a Social Security Number to a prospective employer,[83] or filing altered tax forms[84] obstruct the bureaucracy that administers the taxes. Accordingly, those who seek to simplify our taxes must reckon with resistance to taxation by the taxpayer (or non-payer).

B. *Management of Sociological Considerations*

The IRS (or, for that matter, a state or local taxation authority) is not only a fiscal system and a technical system, but is also a social system; and, as is the case with other business or governmental organizations, the social interactions of the taxation personnel, whether amongst themselves or with the public, cannot be ignored when implementing taxation policy.[85] Positive public perceptions are critical to the performance of the IRS's mission.[86] Thus, IRS employees, and employees of state taxation authorities, must be held to a higher standard in their personal compliance with the tax laws in order to foster tax compliance from the public at large,[87] and to maintain order within the ranks of the taxation authority itself.[88]

83. *See Seaworth v. Pearson*, 203 F.3d 1056 (8th Cir. 2000), *cert. denied*, 531 U.S. 895 (2000); *Baltgalvis v. Newport News Shipbuilding, Inc.*, 132 F. Supp. 2d 414 (E.D. Va. 2001).

84. *Williams v. Commr.*, 114 T.C. 136 (2000).

85. *See e.g.* John V. Murray & Frank A. Stickney, *The Human Factor in Matrix Management*, in *Matrix Mgt. Sys. Handbook* 231–254 (David I. Cleland, ed., Van Nostrand Reinhold Co. 1984).

86. *See e.g.* Pres. Harry S. Truman, *Annual Message to Congress: Fiscal Year 1953*, 1953 Pub. Papers 63, 112 ("The maintenance of public confidence in the tax collection process is essential to our tax system.").

87. *See* Kenneth H. Ryesky, *Of Taxes and Duties: Taxing the System with Public Employees' Tax Obligations*, 31 Akron L. Rev. 349, 357-365 (1998).

88. *See* Brief for Respondent at 55, *Kooi v. Chu*, 517 N.Y.S.2d 601 (N.Y. App. Div. 3d Dept. 1987) (No. 53842) ((microformed on Fiche No. 3-87-466, Micro Copy, Inc., Rochester, NY) (Affidavit of Roderick G. W. Chu, New York State Commissioner of Taxation & Finance, at 8)):

> All individuals employed by the Department [of Taxation & Finance] are either directly or indirectly charged with the responsibility of administering and enforcing the State's tax laws. It is vital to the integrity of the Department and to the equitable, fair, and effective administration of the State's tax laws that all officers and employees of the Department performing such duties be above reproach with respect to the requirement to file New York State personal income tax returns pursuant to Tax Law § 651. Toleration of violation by any such officer or employee carries with it *the risk of a creeping rot within the Department itself*, with a consequent serious adverse effect on the morale of those officers and employees within the Department who are in full compliance with the tax laws [emphasis added]. *Id.*

The disintegration of order and morale amongst taxation personnel has long been known to imperil the stability of any government, democratic or otherwise. *See* 2 M. Rostovtzeff, *The Social & Economic History of the Hellenistic World* 724-726 (Clarendon Press, Oxford, 1967) (discussing how conflict and chaos among tax collection hierarchy contributed to the decline and fall of the Ptolemaic dynasty in Egypt).

Confidentiality of tax return information is necessary "to facilitate tax enforcement by encouraging the taxpayer to make full and truthful declarations in his return, without fear that his statements will be revealed or used against him for other purposes."[89] This is especially so where the tax involved is the income tax as we know it in America, because the tax examiner is typically privy to, or else can readily deduce, certain personal information such as names of family members, employer, medical situation, the political, social and religious leanings of the taxpayer's favorite charities (and, by inference, such leanings of the taxpayer), and other personal data that would be unavailable and irrelevant to the administration of an impost such as an excise tax or a sales tax paid at a merchant's cash register. Accordingly, it is hardly surprising that I.R.C. § 6103, dealing with the confidentiality and disclosure of returns and return information, is a very verbose and complex statutory section whose legislative history is replete with frequent amendment and modification.[90] Even where taxpayer information is not disclosed outside the IRS, the widespread "tax snooping"[91] abuse by IRS personnel has so imperiled public confidence in the system that Congress enacted the Taxpayer Browsing Protection Act to criminalize the willful unauthorized access of taxpayer files by IRS employees and others, and to provide a cause of action for damages for taxpayers whose tax information is so accessed.[92]

The effectiveness of the IRS's control against abusive actions by its agents and employees against the taxpayer has oft been questioned.[93] A

89. *Webb v. Standard Oil Co. of Cal.*, 319 P.2d 621, 624 (Cal. 1957).

90. *See supra* nn. 39-46 and accompanying text. There were no confidentiality privileges for taxpayers under the first effective Federal income tax, instituted to help finance the Civil War, which in fact provided that "lists, valuations and enumerations . . . may be examined; and said lists shall remain open for examination for the space of fifteen days after notice shall have been given . . . ." *Act of July 1, 1862*, 12 Stat. 432, 437. From that time until the Tax Reform Act of 1976, the confidentiality of tax returns was subject to the prevailing winds of political and administrative forces and sentiments. For a detailed chronology of the tax return confidentiality practices and theories in force prior to the Tax Reform Act of 1976, see S. Doc. 94-266 at 821-1135 (1975).

91. 143 Cong. Rec. E693 (daily ed. Apr. 15, 1997) (remarks of Rep. Paxon).

92. I.R.C. §§ 7213(a)(2), 7213A and 7431 (enacted under the *Taxpayer Browsing Protection Act of 1997*, P.L. 105-35 (Aug. 5, 1997) 110 Stat. 1104).

93. *See e.g. Dixon v. Commr.*, 316 F.3d 1041, 1046, *opinion editorially corrected at* 2003 U.S. App. LEXIS 4843 (9th Cir. 2003) (noting that the secret settlement deals made by IRS trial attorneys, to the detriment of approximately 1,300 taxpayers "amounted to a fraud on both the taxpayers and the Tax Court"); *Siddiqui v. U.S.*, 359 F.3d 1200, 1201 (9th Cir. 2004) (reciting illegal disclosure of personal tax information by IRS agent at retirement luncheon attended by approximately 100 people); *Straight v. Commr.*, 74 T.C.M. (CCH) 1457, 1466-1467 (1997) (imposing sanctions on IRS for admitted alteration of document, and lying about it, by IRS agent); *Abernathy v. U.S.*, 150 B.R. 688 (Bankr. N.D. Ill. 1993); U.S. Gen. Acctg. Off., *Tax Administration: IRS Inspection Service and Taxpayer Advocate Roles for Ensuring that Taxpayers are Treated Properly*, Pub. No. T-GGD-98-63 (Feb. 5, 1998) (statement of Lynda D. Willis, Director, Tax Policy and Administration Issues, General Government Division).; 137 Cong. Rec. S11813 (Aug. 1, 1991) (statement of Sen. Symms) ("As the pressure on the IRS grows year after year to collect every last dollar due to the Treasury, the incidents of taxpayers abuse by the Service

tax administration agency such as the IRS, which by nature requires in its temperament some attributes of a bulldog in order to be effective,[94] has an indubitable need for statutory, regulatory and judicial leashes. Paradoxically, while such control mechanisms certainly serve to complicate the taxation process; not having such controls would also ultimately cause complications in the taxation process.

C. *Bureaucratic Dysfunction*

The IRS is a bureaucracy, and it functions (and malfunctions) accordingly. Many reported incidents of dysfunction within the IRS occur because it is a bureaucracy, and not because its mission is taxation. For example, there can be significant problems for the taxpayer where the cognizant bureaucrat, [95] such as an Appeals Officer, proposes a particular settlement with the taxpayer but lacks the authority to bind the IRS in such a settlement,[96] or when one office within the IRS refuses to give relevant information to another.[97] Even a conceptually simple matter can cause difficulties, as when a taxpayer timely delivers a payment or document to the IRS, but the cognizant bureaucrat does not actually receive it until after the filing or payment deadline.[98] There are also reported incidents of the IRS and other taxation authorities losing or misplacing tax returns and other documents,[99]

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grow as well."); 126 Cong. Rec. 14415 (1980) (remarks of Sen. Baucus) ("Numerous horror stories have been reported in Montana and elsewhere . . . Fear of the IRS is based . . . on its well-earned reputation for inconsistency and unpredictability"); U. S. Gen. Acctg. Off., *Tax Administration: IRS Can Strengthen Its Efforts to See That Taxpayers Are Treated Properly*, Pub. No. GAO/GGD-95-14 (Oct. 1994); *see generally* Shelley L. Davis, *Unbridled Power* 196 (HarperBusiness 1997).

94. *See supra* n. 77 and accompanying text.

95. The author, a former IRS bureaucrat, imputes no negative or disparaging connotations to the word "bureaucrat" or to public sector career choices.

96. *See e.g. Est. of Jones v. Commr.*, 795 F.2d 566 (6th Cir. 1986); *David v. Commr.*, 66 T.C.M. (CCH) 1774 (1993), *aff'd*, 43 F.3d 788 (2d Cir. 1995).

97. *Berg v. Commr.*, 65 T.C.M. (CCH) 2004 (1993) (finding that IRS did not mail the notice of deficiency to taxpayer's last known address where Special Agent in IRS Criminal Investigation Division knew taxpayer's latest address, but refused to divulge same to Examination Division).

98. *See e.g. Hull v. U.S.*, 146 F.3d 235, 240 (4th Cir. 1998) (ruling that receipt in the mailroom constitutes filing, regardless of the date the document is actually delivered to the cognizant IRS bureaucrat); U.S. Gen. Acctg. Off., *Multiple Collection Notices Sent to Individual Taxpayers*, Pub. No. GAO/GGD-00-55, 5 (Apr. 2000) (describing delays in recording a tax payment after receipt as one cause of multiple collection notices being sent to taxpayers).

99. *Andrew Crispo Gallery, Inc. v. Commr.*, 16 F.3d 1336, 1339 (2d Cir. 1994) (noting that IRS lost evidence, thereby prejudicing taxpayer); *In re Ashe*, 228 B.R. 457 (C.D. Cal. 1998) ("the IRS destroyed the file because the two year mandatory retention period had expired. Nor could IRS Appeals Officer Lee recall any dealings, conversations, or correspondence with Appellee about his case."); *Palihnich v. Commr.*, 86 T.C.M. 488 (CCH) (2003) (abating interest that accrued during the nearly 11 year period when the IRS Brookhaven Service Center lost the taxpayers' tax returns); *Cook v. U.S.*, 52 Fed. Cl. 62, 67 n. 5 (Fed. Cl. 2002), *appeal dismissed*, 2002 U.S. App. LEXIS 17804 (Fed. Cir. 2002); *Downing v. Commr.*, 118 T.C. 22 (2002); U.S. Gen. Acctg. Off., *Tax Administration: Information on IRS' Philadelphia Service Center*, Report B-221000 at 31-40 (Nov. 22, 1985) (reporting, *inter alia*, several sub-

and losing track of tax payments tendered by taxpayers.[100] While these types of incidents are not directly a function of any particular incomprehensible and verbose tax imposition statute, they nevertheless complicate the taxation process.

1. *Incompatibility of the tax bureaucracy with the tax statutes it administers*

Many of IRS's bureaucratic dysfunctions directly result from incompatibility between the bureaucracy and the statute it administers.[101] As an example, an Estate Tax return, filed at the IRS Service Center after its due date, is reviewed by a Service Center bureaucrat who, having inadequate expertise in Estate Tax matters, accepts the taxpayer's explanation and waives the lateness penalties. Later, after the return is sent to an IRS field office away from the Service Center, it again is reviewed by an Estate Tax Attorney who, being equipped with special expertise and training,[102] finds the taxpayer's explanation insufficient and reimposes the lateness penalties.[103] Were the bureaucracy better geared to Estate Tax returns, perhaps

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stantiated incidents of unprocessed tax returns and/or remittance checks being placed in trash receptacles); *see also Matter of Stephen Walter Kaminski*, N.Y.L.J. 33, col. 5 (Jan. 22, 1996) (Surrog. Ct. Suffolk Co.) (noting that New York State Department of Taxation and Finance twice lost tax refund submission, thus necessitating a third submission of the paperwork).

100. *E.g. Matter of Christian Lotterer*, N.Y.S. Div. of Tax Appeals, Determination DTA No. 819042 (Nov. 26, 2003) (available at http://www.nysdta.org/Determinations/819042.det.htm) (accessed May 25, 2004) (rejecting denial by New York State Dept. of Taxation and Finance that tax had been paid, in light of taxpayer's canceled check drawn to New York State Department of Taxation and Finance, and entry of same in bank statement).

101. *Cf.* U.S. Gen. Acctg. Off., *Tax Administration: Ways to Simplify the Estimated Tax Penalty Calculation*, Pub. No. GAO/T-GGD-98-96, 11 (1998) (concurring in the IRS Commissioner's position that Form 2210 should not be revised until recommended legislative action is implemented to amend the relevant statute).

102. *See Sack v. Bentsen*, 1995 U.S. App. LEXIS 5714, n. 12 (1st Cir. 1995) (upholding, *inter alia*, IRS practices calculated to recruit persons having "up-to-date knowledge of legal principles and agency practices" in Estate Tax Attorney positions); *Collins v. Commr.*, 32 T.C.M. (CCH) 890 (1973) (noting that the IRS had at one point upgraded its employment qualifications to require a law degree for new hires for examination of Estate and Gift Tax returns); *see also Bass v. Bragalini*, 207 Misc. 1055, 1057, 143 N.Y.S.2d 490, 493 (Sup. Ct. Albany Co. 1955) (noting specialized nature of Estate Tax Attorney position in the New York State Department of Taxation and Finance bureaucracy), *aff'd*, 286 App. Div. 944, 143 N.Y.S.2d 494 (3d Dept. 1955), *appeal denied* 309 N.Y. 1032 (1955); *Internal Revenue Service, Estate and Gift Tax Law for Attorneys, Student Text* Unit 1, ch. 1, Forward at page 1-1 (IRS Training Material 3129-22, TPDS 85576 (Jan. 1986)) ("You are about to embark on a career which deals with one of the most specialized areas of the tax law.").

103. *See e.g. Est. of Wilbanks v. Commr.*, 94 T.C. 306, 311-312 (1990) ("Wilbanks I") (denying summary judgment to the taxpayer), *reconsideration denied*, 59 T.C.M. (CCH) 896 (1990) ("Wilbanks II"), *judgment on merits for respondent*, 61 T.C.M. (CCH) 1779 (1991) ("Wilbanks III"), *aff'd*, 953 F.2d 651 (11th Cir. 1992); *Serv. Bolt & Nut Co. Trust v. Commr.*, 724 F.2d 519, 524-525 (6th Cir. 1984); *Reynolds v. Saadi*, 2003 Cal. App. Unpub. LEXIS 10489 at *4 (Cal. App. 2003) (reciting fact that IRS reimposed previously abated late payment penalty on estate tax return); Priv. Ltr. Rul. 9111005 (Dec. 6, 1990); Priv. Ltr. Rul. 83-11-004 (Nov. 18, 1982).

by having a more specifically trained bureaucrat review the Estate Tax Return for lateness penalties at the Service Center in the first place, then the bureaucrat might have imposed the penalty initially, thus avoiding the bureaucratic flip-flop.

The IRS's bureaucracy has had significant compatibility problems with the statute that provides for the filing of joint personal income tax returns by married couples.[104] Though there are two individual taxpayers involved in a joint income tax return filing, each with his or her own individual tax situation, the IRS bureaucracy treats each tax return as it would one individual taxpayer.

> The standard procedure of the IRS is to use the social security number of the first taxpayer listed on a return as the means of tracking information about that return and that taxpayer in the IRS computer system. Specifically, the standard procedure of the IRS is to use the social security number of the first taxpayer as the means for determining the last known address for a taxpayer that is available in the IRS computer system. The social security number of the second taxpayer listed on a joint return is generally not used by the IRS for tracking purposes in its computer system.[105]

In tracking only one "primary" taxpayer[106] when there actually are two taxpayers who filed the return, the IRS can and does easily malfunction if the marriage disintegrates. Refund checks have been issued to one ex (or soon-to-be ex) spouse when the income to which the refunded tax was at-

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During the author's service with the IRS as an Estate Tax Attorney, he had several occasions to reimpose lateness penalties that had previously been abated by another bureaucrat at the Service Center when the returns were initially filed. The particulars of those cases are not matters of public record, accordingly, identification here of the taxpayers involved would be highly inappropriate. *See* I.R.C. § 7213(a)(1) (prohibiting, *inter alia*, former IRS employees from disclosing taxpayer information, under pain of $5,000 fine and/or 5 years imprisonment, together with costs of prosecution).

104. I.R.C. § 6013. It is ironic that the joint spousal personal income tax return was initially intended to be a solution to another problem. Prior to its institution, married couples residing in community property states could evenly split their income between the two spouses and take advantage of the lower tax brackets. Accordingly, oil millionaires and other magnates in non-community property states such as Oklahoma were relocating to community property states such as Texas, causing political, social and economic turmoil. *See Stern, supra* n. 27, at 119-134. Moreover, the problems of a clueless spouse's joint liability with his or (usually) her wrongdoing mate (or ex-mate) in tax matters have prompted Congress to enact a statutory protection for innocent spouses, I.R.C. § 6015, which has spawned its own complicated regulations and litigation.

105. *U.S. v. Shafer*, 1996 U.S. Dist. LEXIS 5616, finding of fact no. 18 at *5 (E.D. Pa. 1996) (citations to transcript omitted).

106. The first taxpayer listed on the joint income tax return, whose Social Security Number is used to track the return through the IRS bureaucracy, is often referred to as the "primary" taxpayer. *See e.g. U.S. v. Nielsen*, 1 F.3d 855, 857 (9th Cir. 1993), *cert. denied*, 525 U.S. 827 (1998) *Wallin v. Commr.*, 744 F.2d 674, 677 (9th Cir. 1984). More often than not, the "primary" is the husband.

tributable was income of the other spouse or ex-spouse.[107] Interest paid by the IRS has been reflected on the Form 1099 issued to the inappropriate spouse.[108]

An IRS disclosure officer has admitted that disclosing whether a prospective juror in a criminal tax trial has been the subject of an IRS tax audit[109] may be more difficult for the IRS by "a change of name and the fact that a prospective juror may have filed joint returns, while the records reflect the other spouse's social security number as primary."[110] Yet, in another criminal tax case, an IRS disclosure officer testified that it was "*not* necessary that the name and social security number of the potential juror's spouse be provided in order for the IRS to accomplish a search of its records"[111] [emphasis added]. Reconciling the two incidents, one can deduce that while it the IRS may have trouble tracking the tax history of a non-primary spouse, the information nonetheless exists in its database and, through creative and diligent data searching techniques, it is *possible* to find the non-primary spouse information. Indeed, the Ninth Circuit found that

> [a] taxpayer's social security number appears in only one of two locations on the tax return—in the primary taxpayer's box or in the spousal taxpayer's box . . . . The IRS has the ability to perform a computer search of both sets of social security numbers in order to discover a subsequent return filed under a different name or in a different state.[112]

The IRS's collection system, "keyed exclusively to the name and Social Security number of the spouse who appears first on the joint return,"[113] has gotten the IRS into trouble for violating the automatic stay in a bankruptcy proceeding[114] by levying a debtor's wages.[115] And the bureaucracy is so fixated with the Social Security Numbers ("primary" or otherwise) that the IRS lost a Tax Court case in which it argued that a custodial par-

107. *U.S. v. MacPhail*, 2003 U.S. Dist. LEXIS 11545 (S.D. Ohio 2003); *Hathaway v. U.S.*, 1993 U.S. Dist. LEXIS 5791 (W.D. Wash. 1993); *Williamson v. U.S.*, 1979 U.S. Dist. LEXIS 11450 (D.N.J. 1979).

108. *Grimland v. Commr.*, 66 T.C.M. (CCH) 402 (1993).

109. I.R.C. § 6103(h)(5) formerly required that the IRS disclose whether a prospective juror in, *inter alia*, a criminal tax trial has been the subject of an IRS tax audit. That provision has since been repealed. P.L. 105-34, § 1238, 111 Stat. 788, 1038 (Aug. 5, 1997).

110. *U.S. v. Nielsen*, 1 F.3d 855, 857 (9th Cir. 1993), *cert. denied*, 525 U.S. 827 (1994).

111. *U.S. v. Howell*, 1996 U.S. Dist. LEXIS 10515 at *26 (D. Kans. 1996).

112. *Wallin v. Commr.*, 744 F.2d 674, 677 (9th Cir. 1984).

113. *In re Washington*, 172 B.R. 415, 419 (Bankr. S.D. Ga. 1994).

114. 11 U.S.C. § 362(a) (2000).

115. *In re Washington*, 172 B.R. at 418.

ent's written declaration releasing a claim to a dependency exemption [116] must have the Social Security Numbers of both parents.[117]

2. *Transactions between bureaucracies*

Bureaucratic dysfunction can also occur when two bureaucracies interface with one another. One bureaucracy with which the IRS has significant interface is the United States Postal Service, a bureaucracy that certainly is not immune to dysfunction. Postmarks applied by the Postal Service are relevant and often critical to facilitating a taxpayer's compliance with the tax laws,[118] but the Postal Service has applied illegible postmarks to mailpieces,[119] postmarks printed partially off the mailpiece,[120] and have delivered mailpieces with no postmark at all.[121] A postmaster has been known to change a taxpayer's mailing address twice in a thirteen month period.[122] Additionally, the detinue of mail to the IRS by the Postal Service has caused "potentially serious ramifications" for some taxpayers.[123]

In 1966, well before the Internet, Congress intended that the public would use the postal system to file tax returns and other documents with the IRS.[124] Three decades later, as new technologies became reality, Congress tasked the Treasury Department to develop a "return-free tax system" in which electronic filing became the norm.[125] But if electronic tax filing simplifies the return filing by circumventing the Postal Service and its dysfunctions, it has also created a whole new administrative necessity,

116. I.R.C. § 152(e)(2).

117. *Boltinghouse v. Commr.*, 85 T.C.M. (CCH) 1277 (2003).

118. I.R.C. § 7502. Proof of a postmark is further discussed *infra* at notes 187 through 197 and accompanying text.

119. *See e.g. Skolski v. Commr.*, 351 F.2d 485, 487 (3d Cir. 1965); *Berry v. Commr.*, 67 T.C.M. (CCH) 2983, 2983 (1994); *Dorsey v. Commr.*, 65 T.C.M. (CCH) 2474, 2476 (1993); *Minuto v. Commr.*, 66 T.C. 616, 617 (1976); *Augustin v. Gilot*, 606 N.Y.S.2d 514, 515 (N.Y. App. Term. 1993); *In re Joshua T.*, 2001 Cal. App. Unpub. LEXIS 553, n. 4 at *5 (Cal. App. 2001); *Migliore v. Migliore*, 717 So. 2d 1077, 1078 (Fla. App. 1998).

120. *See Selvaggi v. Dir. of Revenue*, Delaware Tax App. Bd., Docket No. 952 (July 12, 1991).

121. *See e.g. Fallen v. U.S.*, 378 U.S. 139 (1964); *Casqueira v. Commr.*, 42 T.C.M. (CCH) 656, 657 (1981); *Sylvan v. Commr.*, 65 T.C. 548 (1975); *Higby v. Commr.*, T.C. 1973-176, (1973); *Rappaport v. Commr.*, 55 T.C. 709, 710 (1971), *aff'd*, 456 F.2d 1335 (2d Cir. 1972).

122. *Sicari v. Commr.*, 136 F.3d 925 (2d Cir. 1998).

123. *See* Arnold Abrams, *A Taxing Situation; IRS Says Postal Service Held Up Its Mail*, Newsday (Long Island, N.Y.) 2 (July 28, 1990) (reporting the IRS District Director's protest that the Garden City, NY Post Office detained mail to the newly opened Garden City office of the IRS).

124. *See e.g.* Sen. Rpt. 89-1625 at 1-2 (1966) (reprinted in 1966 U.S.C.C.A.N. 3676, 3683-3684) (permitting Treasury Department to require tax returns to be mailed to service center).

125. Pub. L. No. 105-206, §§ 2001 et seq. (July 22, 1998). The term "return-free tax system" is a misnomer, inasmuch as taxpayers will continue to be required to provide the Government a report of computations for the taxes owed. A more accurate terminology for the Congressional ideal would be "paper-free tax return system."

namely, developing and enforcing qualification criteria for those who are authorized to offer electronic filing services to the public. Indeed, the IRS already has had occasion to suspend or exclude some vendors from its Electronic Filing Program.[126]

It is clear, then, that tax simplification means more than removing the excess verbiage associated with conjunctive logical operators such as "if", "and," "or," "subject to," and "except as provided" from the taxation statutes and regulations.[127] There can be no real tax simplification if the bureaucratic apparatus that administers the tax is not compatible and consonant with the statutory taxation scheme, and with the other bureaucracies with which it must interface in administering the tax.

D. *Administrative Discretion of the IRS*

1. *Discretion in collecting delinquent taxes*

Notwithstanding the dangers of reposing discretion in the tax collector as to the *amount* of the tax,[128] it is necessary that individuals in the taxation bureaucracy have discretion in certain administrative matters. Indeed, the much despised IRS tax audit is based upon the principle that the Secretary of the Treasury, able to personally accomplish only so much in a 24-hour day, has been given authority and discretion which, in turn, are delegated all the way down to the IRS agent in the field.[129]

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126. *Brenner Income Tax Ctrs., Inc. v. Dir. of Practice for the IRS*, 87 F. Supp. 2d 252 (S.D.N.Y. 2000) (upholding IRS suspension from Electronic Filing Program of a tax preparer); *Forehand v. IRS*, 877 F. Supp. 592 (M.D. Ala.1995) (same); *Ekanem v. IRS*, 98-1 U.S.T.C. (CCH) ¶ 50,257, 1998 U.S. Dist. LEXIS 2866 (D. Md.1998) (same); *Sabat v. IRS*, 2000 U.S. Dist. LEXIS 3974; 200-1 U.S.T.C. (CCH) ¶ 50,328 (W.D. Pa. 2000) (same); *Compro-Tax, Inc. v. IRS*, 2000 U.S. Dist. LEXIS 8155, 2000-1 U.S.T.C. (CCH) ¶ 50,406 (S.D. Tex. 2000), *aff'd*, 273 F.3d 1095; 2001 U.S. App. LEXIS 22621 (5th Cir. 2001), *cert. denied*, 535 U.S. 1053 (2002) (same).

127. The author's keyword LEXIS search of the Internal Revenue Code for the phrase "except as provided" yielded 624 hits (Jan. 12, 2004).

128. *See* epigraph to this article, *supra* n. 1 and accompanying text.

129. I.R.C. § 7601(a):

> The Secretary shall, to the extent he deems it practicable, cause officers or employees of the Treasury Department to proceed, from time to time, through each internal revenue district and inquire after and concerning all persons therein who may be liable to pay any internal revenue tax, and all persons owning or having the care and management of any objects with respect to which any tax is imposed. *Id.*

Treas. Reg. § 301.7601-1:

> Each district director shall, to the extent he deems it practicable, cause officers or employees under his supervision and control to proceed, from time to time, through his district and inquire after and concerning all persons therein who may be liable to pay

The federal budget's revenue is largely comprised of the all-too-familiar paycheck deductions that employers collect from America's workforce and, in turn, remit to the IRS.[130] In the event that the employer fails to remit such funds to the IRS, I.R.C. § 6672 provides that all persons who were responsible for collecting, accounting for, and paying over the "trust funds"[131] are liable for the amount of the taxes due,[132] and that liability is joint and several.[133]

The IRS has broad discretion as to which responsible party it may pursue, [134] and often directs its efforts without regard to relative degree of responsibility.[135] Thus, where even the most egregiously responsible person has disappeared or is insolvent, the IRS can and does go after the party who, like the low-hanging fruit in the orchard, is most conveniently available. [136] The broad collection discretion provided to the IRS through I.R.C. § 6672 often yields inequitable results, akin to forcing "a cabin boy on a sinking ship" to "follow it to the bottom of the sea while the admiral was

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any internal revenue tax, and all persons owning or having the care and management of any objects with respect to which any tax is imposed. *Id.*

130. *See* I.R.C. §§ 3401 et seq. One seldom discussed administrative consideration behind requiring employers to withhold income taxes from employees' pay, and in requiring merchants to add sales taxes to customer purchases, is that it keeps the government's taxation personnel out of the direct line of fire (often literally) from hostile and unwilling employees, customers, or other such unenthusiastic taxpayers. *See e.g.* Elizabeth Mehren, *Massachusetts Man Convicted of Office Massacre*, L.A. Times A1 (Apr. 25, 2002) (describing a workplace massacre that was the result of a tax withholding dispute between employer and the defendant employee); Michael Cooper, *Suspect Is Arrested in Threat to Store That Was Set Ablaze*, N.Y. Times B3 (Apr. 28, 1998) (reporting alleged threat to burn down store, made by firebombing suspect, in course of dispute with store owner over sales tax on purchase of a hat).

131. Taxes held by employers (and others) for the government are commonly known as "trust funds." *See e.g. Slodov v. U.S.*, 436 U.S. 238, 243 (1978); *Fran Corp. v. U.S.*, 164 F.3d 814, 817 (2d Cir. 1999).

132. I.R.C. § 6672. For more detailed discussions regarding parties who may be responsible under I.R.C. § 6672, see Corrie Lynn Lyle, *The Wrath of I.R.C. § 6672: The Renewed Call for Change – Is Anyone Listening? If You Are a Corporate Official, You had Better Be*, 74 S. Cal. L. Rev. 1133, 1140 - 1143 (2001); Mary A. Bedikian, *The Pernicious Reach of 26 U.S.C. § 6672*, 13 Va. Tax Rev. 225 (1993). Many states and localities have provisions similar if not verbatim to I.R.C. § 6672. *E.g.* Conn. Gen. Stat. § 12-736; Minn. Stat. § 270.101; NY Tax Law § 685(g); *see also* N.Y.C. Admin. Code §§ T46-65.0 (g) and U46-35.0 (g).

133. *See e.g. Thosteson v. U.S.*, 304 F.3d 1312, 1318, 1320 (11th Cir. 2002), *aff'g*, 182 F. Supp. 2d 1189 (M.D. Ala. 2001).

134. *U.S. v. Pomponio*, 635 F.2d 293 (4th Cir. 1980); *Kelly v. Lethert*, 362 F.2d 629, 635 (8th Cir. 1966); *Hornsby v. U.S.*, 588 F.2d 952, 954 (5th Cir. 1979); *see also Abramson v. U.S.*, 39 B.R. 237, 239 (Bankr. E.D.N.Y., 1984).

135. *Howard v. U.S.*, 711 F.2d 729, 737 (5th Cir. 1983) ("And section 6672(a) looks only to 'responsible persons,' not to 'the most responsible person,' for satisfaction.").

136. *See e.g. Thosteson, supra*, n. 133, at 1315; *Grizaffi v. U.S.*, 1987 U.S. Dist. LEXIS 6951 (N.D. Ill. 1987); *Unger v. U.S.*, 1999 U.S. Dist. LEXIS 10932, 84 A.F.T.R.2d (RIA) 6817 (S.D.N.Y. 1999), *on remand from U.S. v. Landau*, 155 F.3d 93 (2d Cir. 1998), *cert. denied*, 526 U.S. 1130 (1999).

picked up by helicopter and safely put ashore."[137] In one situation, the "cabin boy," Nathan Unger, "was twenty-eight years old when the tax delinquency occurred. Since then he has been stripped of all his assets (including a life insurance policy) and is faced with an undischargable debt of more than one million dollars."[138]

To partially remedy the inequities of the IRS's administration of § 6672, Congress included, as part of the Taxpayer Bill of Rights 2, a federal statutory right of contribution in favor of responsible persons who actually pay more than their proportionate share of trust fund penalties.[139] But a right of contribution is of limited value unless the persons against whom the right may be asserted are known, so Congress also had to amend its disclosure statute, I.R.C. § 6103, to enable persons pursued by the IRS to know the identity of, and collection efforts made against, other persons responsible for the same funds.[140] Thus, the discretion of the IRS to collect trust fund taxes from any available source has had a complicating effect upon the taxation system, and beyond.

The IRS also has the discretion to allocate payments from the taxpayer where the taxpayer has outstanding obligations to the IRS arising from more than one tax year or type of tax. A taxpayer may direct the allocation

137. *Unger v. U.S.*, 1997 U.S. Dist. LEXIS 190 *1 (S.D.N.Y. 1997).

138. *Unger v. U.S.*, 956 F. Supp. 1152, 1154 (S.D.N.Y. 1997). The *Unger* litigation would wend its way through the courts for many years, and included a remand after denial of certiorari by the United States Supreme Court on one issue; *see Unger v. U.S.*, 1999 U.S. Dist. LEXIS 10932, 84 A.F.T.R.2d (RIA) 6817 (S.D.N.Y. 1999), *on remand from U.S. v. Landau*, 155 F.3d 93 (2d Cir. 1998), *cert. denied*, 526 U.S. 1130 (1999). Mr. Unger's "cabin boy" position would also oblige him to the New York State Department of Taxation and Finance for trust fund penalties with respect to unremitted sales taxes. *Matter of Unger*, N.Y.S. Tax App. Tribunal, DTA Nos. 805351 and 805353 (Mar. 24, 1994) (available at http://www.nysdta.org/Decisions/805351.dec.pdf) (accessed May 25, 2004).

139. I.R.C. § 6672(d) (enacted under the Taxpayer Bill of Rights 2, Pub. L. No. 104-168, § 903, 110 Stat. 1452, 1466 (1996).

140. I.R.C. § 6103(e)(9) (enacted under the Taxpayer Bill of Rights 2, Pub. L. No. 104-168, § 902, 110 Stat. 1452, 1466 (1996).
The new subsection reads:

> (9) Disclosure of certain information where more than one person subject to penalty under section 6672. -- If the Secretary determines that a person is liable for a penalty under section 6672(a) with respect to any failure, upon request in writing of such person, the Secretary shall disclose in writing to such person--
> (A) the name of any other person whom the Secretary has determined to be liable for such penalty with respect to such failure, and
> (B) whether the Secretary has attempted to collect such penalty from such other person, the general nature of such collection activities, and the amount collected. *Id.*

TBOR2 also made other amendments to I.R.C. § 6672, largely irrelevant to the discussion in this Article, relating to preliminary notice requirements and to immunity for voluntary board members of tax-exempt organizations. TBOR2 § 901, 110 Stat. 1452, 1465-1466 (codified at I.R.C. § 6672(b)) & TBOR2 § 904, 110 Stat. 1452, 1467 (codified at I.R.C. § 6672(e)).

of payments made voluntarily, but the IRS has broad discretion to apply involuntary payments, or voluntary remittances without specific taxpayer directions, to such outstanding taxpayer obligations as the IRS deems appropriate.[141] Thus, one party responsible for "trust fund" penalties[142] can benefit or lose, depending upon whether the IRS allocates the payments made by another responsible party with respect to the same underlying taxes.[143] Additionally, IRS bureaucrats are given relatively broad discretion to enter into closing agreements with taxpayers,[144] compromise in civil or criminal liability of the taxpayer[145] and pay "snitch" bounties to informants who apprise the IRS of tax law violations by others.[146]

2. *Discretion in applying and interpreting the tax statutes*

Some administrative discretion most certainly facilitates the orderly function of the taxation system, but such breadth of discretionary powers can complicate taxes to the extent that similarly situated taxpayers are treated differently. The courts more strictly scrutinize decisions of administrative agencies where the agencies have inconsistently applied the statutes and their own regulations.[147] Thus, appeals of agency decisions not rooted in consistency are more uncertain, which, in the case of the IRS, does little to impart tax simplicity.

Private IRS rulings for particular taxpayers give the IRS great latitude to duck its duty to accord similar treatments to taxpayers in similar predicaments. Private rulings have no precedential value, and the IRS thus has no obligation to follow them with subsequent, similarly situated taxpayers.[148] They are now available to the public, albeit sanitized of specific

141. *See e.g.* Rev. Proc. 2002-26, 2002-1 C.B. 746; *Muntwyler v. U.S.*, 703 F.2d 1030, 1032 (7th Cir. 1983); *Liddon v. U.S.*, 448 F.2d 509, 513 (5th Cir. 1971), *cert. denied*, 406 U.S. 918 (1972).

142. *See supra* nn. 131-138 and accompanying text.

143. *See e.g. In re Energy Resources Co., Inc.*, 871 F.2d 223, 230 (1st Cir. 1989), *aff'd sub nom. U.S. v. Energy Resources Co., Inc.*, 495 U.S. 545 (1990). Suppose, for example, that certain third parties that included "responsible" individuals were willing to advance enough money to rehabilitate the corporation only if the court would assure them that the reorganized corporation would pay its "trust fund" tax debts first. That assurance would diminish the likelihood that the third parties would have to pay the debts personally; without it they might prefer immediate liquidation, which could mean total payment of all tax debt, and "a guarantee that no tax penalty will be assessed against them personally [internal citations omitted]." *Id.*

144. I.R.C. § 7121.

145. I.R.C. § 7122; Treas. Reg. § 301.7122-1.

146. *See e.g. Carelli v IRS*, 668 F.2d 902 (6th Cir. 1982); *Schein v U.S.* (E.D.N.Y. 1972) 352 F. Supp. 182 (E.D.N.Y. 1972).

147. *See U.S. v. Mead Corp.*, 533 U.S. 218, 228 (2001); *Skidmore v. Swift & Co.*, 323 U.S. 134, 140 (1944).

148. I.R.C. § 6110(k)(3).

identifying information,[149] thanks to the Tax Reform Act of 1976.[150] Prior to 1976, the IRS took zealous measures to resist disclosing its private rulings.[151]

The *Sklar* case[152] demonstrates how the IRS's inconsistent application of the allowability of charitable deductions for payments of tuition for religious education has led to uncertainty, litigation and complication. In *Sklar*, taxpayers allocated the tuition payments made to the religious private school in which their children were enrolled, and claimed a charitable deduction on their 1994 personal income tax return for the portion allocated to religious studies.[153] The IRS *had* allowed similar expenses with respect to the Church of Scientology,[154] and had in fact "obsoleted" a previous revenue ruling specifically determining that such deductions for Church of Scientology "audits" were *not* deductible.[155] Though critical of the IRS's special treatment of the Church of Scientology, the court held that the Sklars could not claim the deduction.[156] In a concurring opinion, Judge Silverman wrote:

> If the IRS does, in fact, give preferential treatment to members of the Church of Scientology—allowing them a special right to claim deductions that are contrary to law and rightly disallowed to everybody else—then the proper course of action is a lawsuit to stop to that policy. The remedy is not to require the IRS to let others claim the improper deduction, too.[157]

Well-wishers, many of whom foot the bill for private religious day school tuition, from diverse religious backgrounds were quite disappointed by the ruling against the Sklars.[158] The Sklars have resumed litigation

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149. I.R.C. § 6110(c).

150. *Tax Reform Act of 1976*, Pub. L. No. 94-455, § 1201(a) (codified at I.R.C. § 6110).

151. *See e.g. Tax Analysts & Advocates v. IRS*, 505 F.2d 350 (D.C. Cir. 1974); *see also Fruehauf Corp. v. IRS*, 522 F.2d 284 (6th Cir. 1975), *vacated* on other grounds, 429 U.S. 1085 (1977). The Supreme Court vacated *Fruehauf* subsequent to the Circuit Court's ruling to require disclosure based on 1976 legislation that added I.R.C. § 6110 to open private letter rulings and other written IRS determinations to public inspection. *IRS v. Fruehauf Corp.*, 429 U.S. 1085 (1977).

152. *See Sklar v. Commr.*, 282 F.3d 610 (9th Cir. 2002), *aff'g*, 79 T.C.M. (CCH) 1815 (2000)).

153. *Id.* at 612.

154. The IRS refused to disclose the details of its closing agreement with the Church of Scientology to the taxpayer, the Department of Justice, or the Court, claiming that it was confidential, and thus the court assumed that they had allowed the deductions. *Id.* at 614. Nevertheless, purported copies of the agreement had been published in unofficial sources. *See e.g. Scientologists and IRS Settle for $ 12.5 Million*, Wall St. J. A12 (Dec. 30, 1997).

155. Rev. Rul. 93-73, 1993-2 C.B. 75 (*obsoleting* Rev. Rul. 78-189, 1978-1 C.B. 68).

156. *Sklar*, 282 F.3d at 619, 622.

157. *Id.* at 623.

158. *See e.g.* Agudath Israel of America, Press Release, Feb. 1, 2002 (available at http://www.jlaw.com/Recent/religtuition.html) (accessed May 25, 2004); *see also* Christianity Today magazine, Weblog, (week of Aug. 21, 2000) (available at http://www.christianitytoday.com/ct/

against the IRS on the same issue, with respect to their 1995 tax year.[159] *Sklar* illustrates how secrecies and inconsistencies in the IRS's use and abuse of its broad discretion have complicated taxes in America.

V. MULTIPLE TAXATION AUTHORITIES

This article does not strive to set forth any detailed analysis of the interplay that occurs when an event or transaction is subject to the taxes imposed by multiple authorities. Such interplay, however, works contrary to tax simplification.

In an effort to simplify tax returns, many states conform their income tax schemes to the federal scheme.[160] Such coordination has simplified the lives of taxpayers who, already burdened with the distasteful task of preparing their federal income tax returns, can realize economies of labor in

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2000/134/32.0.html (accessed May 25, 2004) ("[The *Sklar*] case will be an interesting one to watch.")). The Agudath Israel of America, a religious Jewish organization, filed a brief *amicus curiae* in support of the Sklars in their appeal to the 9th Circuit.

159. David Cay Johnston, *Scientologists' Tax Break Cited in Suit Against I.R.S.*, N.Y. Times C-6, col. 5 (Mar. 24, 2004). Serious questions persist as to whether the Sklars are the ideal taxpayers to bring a test case against the IRS on the issue. Michael Sklar is a Certified Public Accountant who prepares personal income tax returns of others. *See* Michael Sklar, *Homepage of Michael Sklar, an Accountancy Corporation*, http://pages.prodigy.com/netcpa (accessed May 25, 2004). Sklar filed his own 1994 personal income tax return late, even after two extensions of time were granted, tendering the excuse "that he was simply too busy to file his Federal income tax return for 1994 by October 15, 1995." *Sklar*, 79 T.C.M. (CCH) 1815 at 1817, *aff'd*, 282 F.3d 610 (9th Cir. 2002). Just as IRS agents are held to a higher standard by the IRS and the courts to comply with their tax obligations, *see supra* notes 87 and 88 and accompanying text, so, too, do the IRS and the courts have special heightened expectations that accountants and others who prepare the tax returns for the public file their own returns in a timely manner and otherwise comply with the tax laws. *See e.g. Blocker v. Commr.*, 64 T.C.M. (CCH) 1586 (1992), *aff'd*, 25 F.3d 1043 (5th Cir. 1994); *Keene v. Commr.*, 44 T.C.M. (CCH) 1335 (1982), *aff'd*, 734 F.2d 21 (9th Cir. 1984); *Dustin v. Commr.*, 53 T.C. 491, 507 (1969), *aff'd*, 467 F.2d 47 (9th Cir. 1972); *see also U.S. v. Fritzson*, 979 F.2d 21 (2d Cir. 1992) (affirming upward adjustment of offense level due to defendant's use of his special skills as accountant to perpetuate a fraud upon the IRS); *Director, Off. Prof. Resp. v. Banister*, Complaint No. 2003-2, Dept. of Treasury (Dec. 29, 2003) (available at http://www.irs.gov/pub/irs-utl/banister.pdf (accessed May 25, 2004)) (disbarring respondent from practicing before IRS, and finding respondent's status as a C.P.A. and past position as an IRS agent to be aggravating factors).

Sklar's lateness may well have placed him and his wife at a disadvantage against the system's inherent biases against untimely tax return filers.

160. *See e.g.* 72 P.S. § 7330(a) (synchronizing the filing due date of the Pennsylvania personal income tax return with the due date for the federal return); Cal Rev & Tax Code § 17008.5 (2004) (applying the I.R.C. § 7704 provisions treating publicly traded partnerships as corporations under California tax law); Ohio Code § 5747.01 (2003) (providing that with respect to Ohio state income taxes, "[e]xcept as otherwise expressly provided or clearly appearing from the context, any term used in this chapter has the same meaning as when used in a comparable context in the Internal Revenue Code").

contemporaneously preparing and filing their state (and sometimes local) income tax returns using much of the same basic information.[161]

But when state statutes make adjustments to the federal numbers for state tax purposes, the process gets more complicated. For example, though New York generally follows the federal scheme for income,[162] it departs from it in several respects, including its treatment of interest income on state and local bonds issued by non-New York State entities.[163] Taxpayers thus need to make the appropriate calculations to the federal income entries to adjust them for the New York State Income Tax return.[164]

State tax authorities also complicate the administration of taxes when they apply different standards to the process than the IRS. For example, a state may impose a lateness penalty on a tardy state income tax return even when the IRS has waived the analogous federal penalty.[165] Indeed, to rebut the IRS's presumably correct findings, the taxpayer need only prove the tax auditor's findings incorrect by a preponderance of evidence,[166] but is held to the more stringent "clear and convincing evidence" standard when the same records are examined by the New York State Department of taxation and finance.[167] And the standards to which the New York City taxpayer is held are not necessarily the same as those imposed for analogous taxes at the state level.[168]

The I.R.C. § 2011 credit for state death taxes illustrates another complicating interplay between federal and state tax administration. Subject to a graduated table of limitations, when I.R.C. § 2011 was in full effect,[169] it

161. *Cf. Adam Smith, supra* n. 1 ("[Maxim number] III. Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it."). Most if not all of the commercially available tax return preparation software have provisions for generating both federal and state income tax returns. *See e.g.* Bruce V. Bigelow, *It May not be April, but it's Quite Taxing*, San Diego Union-Tribune C-1 (Dec. 2, 2003) ("In addition to the federal tax software, Intuit has developed different TurboTax versions for filing individual returns in 45 states.").

162. N.Y. CLS Tax § 612 (2003).

163. N.Y. CLS Tax § 612(b)(2) (2003).

164. N.Y. State Dept. of Taxation & Finance, Form 201 Resident Income Tax Return (2003), Line 19.

165. *See e.g. Hallmac Walls & Ceilings, Inc. v. St. of Wash.*, Dkt. No. 46828-24 (Wash. St. Bd. of Tax App. 1995), http://bta.state.wa.us/search.htm (accessed May 25, 2004).

166. *Brewster v. Commr.*, 607 F.2d 1369, 1374-1375 (D.C. Cir. 1979).

167. *Blodnick v. N.Y. State Tax Commn.*, 124 A.D.2d 437, 438 (N.Y. App. Div. 3d Dept. 1986), *appeal withdrawn* 514 N.E.2d 1375 (1987).

168. Carolyn J. Lee & Joseph Lipari, *Tax Departments, Tribunals Differ on Combined Reporting Cases*, 231 N.Y.L.J. 3, col. 1 (Mar. 5, 2004) (discussing inconsistent authorities used by New York State Tax Appeals Tribunal and New York City Tax Appeals Tribunal).

169. The state death tax credit will not be available to the estates of decedents dying after December 31, 2004. I.R.C. § 2011(f). This article will not detail the complexities and uncertainties associated with the possibly temporary phaseout/repeal of the federal estate tax as provided by the Economic Growth and Tax Relief Reconciliation Act ("EGTRRA") of 2001, Pub. L. No. 107-16, 115 Stat. 38. Suffice it to say that EGTRRA itself has contributed nothing at all towards the cause of tax simplifica-

allowed estates a dollar for dollar credit against the federal estate tax for taxes paid to states by reason of the decedent's death. "The state death tax credit was designed to preserve for states an historic source of revenue without incurring additional expense to their citizens."[170]

Many states simply fixed their death taxes at the I.R.C. § 2011 credit amount.[171] Such a tax is sometimes referred to as a "sponge tax" because it absorbs, for the state treasury, funds which otherwise would go to the IRS.[172] Where the state death tax exceeds the I.R.C. § 2011 credit amount, however, the state can no longer merely require the estate representative to inform the state taxation authority of any federal audit changes in the federal tax (and therefore the state tax), but must independently audit estate tax returns. Moreover, the additional state death taxes over and above the I.R.C. § 2011 credit pass to the state and not to a decedent's spouse of a charity (?); accordingly, the amount of the additional tax does not qualify for a federal marital or charitable deduction.[173]

Where a taxpayer relocates from one state to another during the year, or otherwise is not a full year resident of any one state, the taxpayer may have multiple state and/or local tax obligations in addition to the federal. The situation is all the more complex if the taxpayer or the transactions go international. Increased mobility of people and goods, together with its consequent expansion of businesses into or between multiple jurisdictions, can only complicate the taxes.[174]

It is clear, then, that merely overhauling the Internal Revenue Code is not going to win the battle to simplify America's taxes. The state and local tax statutes, and the taxation authorities that enforce those statutes, must also be given their due regard if not actually included in the effort.

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tion. *See generally,* Karen C. Burke & Grayson M. P. McCouch, *Estate Tax Repeal: Through the Looking Glass,* 22 Va. Tax Rev. 187 (2002).

170. *Second Natl. Bank of New Haven v. U.S.*, 297 F. Supp. 1080, 1083 (D. Conn. 1969).

171. *E.g.* 36 M.R.S. § 4063 (2003) (Maine tax on estate of resident); Idaho Code § 14-403 (2003) (same, Idaho).

172. *See e.g.* Sara R. Stadler, *A Cure for the Creeping Palm Tree Disease,* Conn. L. Tribune S4 (Feb. 12, 1996) (referring to Florida's tax, equal to the I.R.C. § 2011, as a "sponge tax"); *see also* Joshua S. Rubenstein & Eileen Caulfield Schwab, *Historic New York Estate and Gift Tax Reform,* 218 N.Y.L.J. 1 (Aug. 20, 1997) (referring to such tax as a "sop tax").

173. *Chiles v. U.S.*, 843 F.2d 367 (9th Cir. 1988).

174. *See e.g.* Tom Herman, *Tax Report: A Special Summary and Forecast of Federal and State Tax Developments,* Wall St. J. 1 (Sept. 29, 1999) (reporting that AT&T must file an estimated 39,912 state and local tax returns each year); *Alaska Dept. of Revenue v. Dyncorp & Subsidiaries,* 14 P.3d 981, 983 (Alaska 2000) (reciting that Dyncorp was required to file over 300 amended state tax returns on account of its business activities in most states).

VI. JUDICIARY'S TREATMENT OF TAX CASES

A. *The Unreported Opinion Controversy*

One great burning controversy among the bench and bar is the limitation, in many jurisdictions, of the precedential value of unreported judicial opinions.[175] "[U]nder a regime in which judges may choose *ex ante* whether to publish decisions, judges might bury hard questions in unpublished decisions. Judges might also seek to deviate from precedent in unpublished decisions, knowing that an unpublished decision will not draw as much attention as a published decision."[176] One appellate judge reportedly acknowledged the bar's "legitimate concern" that unreported opinions can be an abusive means for "sweeping tough decisions under the rug."[177]

Combined with the notoriously arcane complexity of American taxation, unreported opinions have had some curious effects upon the development and administration of American tax law. Generalist judges, often relatively unfamiliar with the particulars of the tax statutes and regulations, can be tempted to deliver an unreported opinion as a means of limiting the precedential value of, and therefore the potential damage and fallout from, a questionably reasoned decision.[178] Judge Patricia Wald, a Chief Judge of the U. S. Court of Appeals for District of Columbia Circuit before moving on to the International Criminal Tribunal for the Former Yugoslavia,[179] has noted that "[t]here is always risk in generalist judges construing the intricate interrelationships of words and phrases in specialized legislation, and that danger is heightened in the case of the Internal Revenue Code."[180] Judge

175. *See e.g. Anastasoff v. U. S.*, 223 F.3d 898 (8th Cir. 2000), *vacated en banc & remanded*, 235 F.3d 1054 (8th Cir. 2000); *Developments and Practice Notes: Anastasoff, Unpublished Opinions, and "No-Citation" Rules*, 3 J. App. Prac. & Process 169 (2001) (Mini-Symposium); Memo. from Hon. Samuel A. Alito, Jr., Chair, Advisory Committee on Appellate Rules, to Anthony J. Scirica, Chair, Standing Committee on Rules of Practice and Procedure, *Report of Advisory Committee on Appellate Rules* 30-39 (May 22, 2003) (available at http://www.uscourts.gov/rules/ Reports/AP5-2003.pdf (accessed May 25, 2004); Tony Mauro, *Difference of Opinion; Should Judges Make More Rulings Available as Precedent? How an Obscure Proposal is Dividing the Federal Bench*, Legal Times 1 (Apr. 12, 2004).

176. *RECENT CASES: Constitutional Law – Article III Judicial Power - Eighth Circuit Holds That Unpublished Opinions Must Be Accorded Precedential Effect*, 114 Harv. L. Rev. 940, 945 (2001).

177. Edward A. Adams, *Increased Use of Unpublished Rulings Faulted*, 212 N.Y.L.J. 1 (Aug. 2, 1994) (quoting Second Circuit Judge Wilfred Feinberg).

178. *See supra* nn.176-177 and accompanying text; *cf.* John J. Tigue, Jr. & Jeremy H. Temkin, *Second Circuit Tax Cases in 2003*, 231 N.Y.L.J. 3 (Jan. 15, 2004) ("All of these [tax law] decisions were issued in the form of summary orders, signaling some reluctance on the court's part to imbue them with application beyond the case at hand.").

179. Federal Judges Biographical Database, Patricia McGowan Wald, http://air.fjc.gov/servlet/ tGetInfo?jid=2475 (accessed May 25, 2004).

180. *Ryan v. Bureau of Alcohol, Tobacco & Firearms*, 715 F.2d 644, 651 (D.C. Cir. 1983) (Wald, J., dissenting).

Richard A. Posner, an accomplished academician and prolific author on legal, monetary and economic issues,[181] has opined that in technical areas of the tax laws, "we generalist judges should be loath to lay down the law on the question without the Treasury's view."[182] If jurists in the league of Posner or Wald tread with caution in adjudicating tax cases, then many judges of lesser caliber, reluctant to second-guess the IRS, are surely tempted to seek refuge in the unreported opinion when confronted with the task of applying the tax statutes.

Carrying the caution of such refugee a step further, a judge who is unsure of the tax laws may take the path of least resistance in a tax litigation situation by giving too much deference to the tax collector's views of the law, which can hardly be called objective.[183] Moreover, by keeping disproportionately large numbers of taxation opinions out of the mainstream, judges fail to facilitate the development of bodies of case law on the various sections of the Internal Revenue Code. As Justice Douglas has lamented, the United States Supreme Court seems "particularly ill-equipped to resolve income tax disputes between the Commissioner and the taxpayers [because it] . . . seldom see[s] enough of them to develop any expertise in the area."[184] Collectively and synergistically, the judiciary impacts the system by failing to objectively police the IRS or effectively create viable tax law precedent.

B. *Unreported Opinions and I.R.C. § 7502*

Judge Arnold's ruling in *Anastasoff*[185] has touched off renewed and intensified debate and interest in the unreported opinion controversy.[186] Though *Anastasoff* will likely be remembered for its considerable contribu-

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181. *See Judge Richard A. Posner Brief Biographical Sketch*, http://home.uchicago.edu/~rposner/biography (accessed May 25, 2004).

182. *Rebecca K. Crown Income Charitable Fund v. Commr.*, 8 F.3d 571, 576 (7th Cir. 1993).

183. *See e.g. Lykes v. U.S.*, 343 U.S. 118, 128-129 (1952) (Jackson, J., dissenting) ("The Treasury may feel that it is good public policy to discourage taxpayers from contesting its unjustified demands for taxes and thus justify penalizing resistance. It is hard to imagine any instance in which the Treasury could have a stronger self-interest in its regulation."). Justice Jackson's accomplished career included, prior to his ascension to the Supreme Court bench, a stint as General Counsel of the Bureau of Internal Revenue. Federal Judges Biographical Database, Robert Houghwout Jackson, http://air.fjc.gov/servlet/tGetInfo?jid=1160 (accessed May 25, 2004).

184. *Commr. v. Idaho Power Co.*, 418 U.S. 1, 19 (1974) (Douglas, J, dissenting).

185. *Anastasoff v. U.S.*, 223 F.3d 898 (8th Cir. 2000), *vacated en banc as moot*, 235 F.3d 1054 (8th Cir. 2000).

186. *See e.g. Developments and Practice Notes: Anastasoff, Unpublished Opinions, and "No-Citation" Rules*, *supra*, n. 175; Lance A. Wade, *Honda Meets Anastasoff: The Procedural Due Process Argument Against Rules Prohibiting Citation to Unpublished Judicial Decisions*, 42 B.C. L. Rev. 695 (2001); John P. Borger & Chad M. Oldfather, *Anastasoff v. United States and the Debate over Unpublished Opinions*, 36 Tort & Ins. L.J. 899 (2001); Bruce M. Wexler & F. Christopher Mizzo, *Unpublished Opinions Rising, But Do They Help?*, 227 N.Y.L.J. S8 (Feb. 11,2002).

tion to the unpublished opinion controversy, it was a tax case; specifically, a case about the timely postmark rule under §7502 of the Internal Revenue Code.[187] There is split authority among the Circuits in connection with I.R.C. § 7502.[188] As this author has previously observed,

> Consistent with its institutional bias to maximize tax assessments, the IRS, whenever possible, routinely takes the position that where the IRS does not note an actual postmark on the envelope, I.R.C. § 7502 only allows a taxpayer to prove a timely mailing by producing a receipt for registered or certified mail. Because federal taxation is such a complex, specialized, and esoteric area of the law, even the most learned judges have conceded difficulty in interpreting the taxation statutes. Therefore, the judiciary often finds adopting the IRS's position inherently simpler than overruling it. Under such circumstances, the IRS has throughout the years persuaded various courts to accept its interpretation of I.R.C. § 7502, creating, in effect, a "Big Lie" that Congress specifically intended to limit proof of a postmark to registered or certified mailings. Courts in circuits where the "Big Lie" has been accepted as truth now blindly follow circuit precedent and, indeed, with robotic predictability, go to great lengths to negate, deny and disregard any interpretation inconsistent with the IRS's position under section 7502.[189]

I.R.C. § 7502 is, at best, ambiguous as to whether a mailing via registered or certified mail is the sole means to prove a postmark on a tax return or other mailing to the IRS or to the Tax Court. The split among the Circuits on that issue is evidence of that ambiguity. Taxation statutes are to be strictly and narrowly construed, and "[i]n case of doubt they are construed most strongly against the government, and in favor of the citizen."[190] The legislative history of I.R.C. § 7502 is totally devoid of any language to indicate that Congress intended a registered or certified mailing to be the *exclusive* means of proving a postmark.[191] Indeed, the House and Senate Reports specifically state with respect to an amendment to I.R.C. § 7502 that "[t]he taxpayer, of course, could also establish the date of mailing by

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187. I.R.C. § 7502; *Anastasoff*, 223 F.3d at 899.

188. *Compare e.g. Surowka v. U.S.*, 909 F.2d 148, 150 (6th Cir. 1990) (disallowing evidence other than an official postal receipt to prove a postmark) *with Est. of Wood v. Commr.*, 909 F.2d 1155, 1161-1162 (8th Cir. 1990) (allowing other extrinsic evidence).

189. Kenneth H. Ryesky, *Analysis of the Split Authority on Proof of a Postmark under Internal Revenue Code § 7502*, 21 U. Dayton L. Rev. 379, 395-396 (1996) (citations omitted).

190. *Ocean Drilling & Exploration Co. v. U.S.*, 988 F.2d 1135, 1156 (Fed. Cir. 1993) (quoting *Gould v. Gould*, 245 U.S. 151, 153 (1917)).

191. *See Wood*, 909 F.2d at 1160.

other competent evidence [besides registered or certified mail receipts]."[192] Yet, in some Circuits, a judiciary intimidated by the Internal Revenue Code has abdicated its responsibility to prevent excesses on the part of the tax collector by blindly accepting the IRS party line, even though the IRS position flies in the face of explicit Congressional sentiment.[193]

Had the judiciary done its job, the IRS would be required to live by the provisions of I.R.C. § 7502, and by its own duly promulgated regulations. The IRS may well have the authority to prescribe, by regulation that the sole means of proving a postmark under I.R.C. § 7502 is by proof of a registered or certified mailing. The Federal Acquisitions Regulations had contained just such a provision (and indeed a more stringent one) to prove the timely mailing of a bid for a Federal procurement contract.[194] A Federal agency can thus be strict in its application of the statutes it must enforce, provided that it properly promulgates clear and explicit rules.

The IRS, however, has revised neither its own regulations nor its official instructions for its tax forms to explicitly limit the proof of a timely postmark to a registered or certified mailing. On the contrary, the IRS continues to successfully assert its "Big Lie" in most of the Federal Circuits,[195] where the judiciary, having swallowed, hook, line and sinker, the IRS's questionable interpretation of I.R.C. § 7502, lacks the will to depart from its own faulty rationale to contradict the tax collector.

The Federal judiciary has failed to provide effective checks and balances upon an Executive agency, and is ultimately responsible for the IRS's abuse of § 7502. In one egregious example, the Sixth Circuit in *BMC Bankcorp*[196] cowered behind unreported opinions while it all but conceded the righteousness of the taxpayer's position. Like the whining prisoner who holds the key to the jail cell in his or her very own pocket, it declared itself constrained by its own precedent to affirm the District Court

192. Sen. Rpt. 90-1014, at 19 (Mar. 15, 1968) (reprinted in 1968 U.S.C.C.A.N. 2354, 2373); H. R. Rpt. 90-1104, at 14 (Feb. 23, 1968) (reprinted in 1968 U.S.C.C.A.N. 2341, 2354).

193. *Chevron U.S.A. Inc. v. Nat. Resources Def. Council, Inc.*, 467 U.S. 837, 842-843 (1984).
When a court reviews an agency's construction of the statute which it administers, it is confronted with two questions. First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress. *Id.*

194. *See* former 48 C.F.R. § 14.304-1(b) (removed 64 Fed. Reg. 51837, 51838 (Sept. 24, 1999)). The old 48 C.F.R. § 14.304-1(b) was first promulgated in 48 Fed. Reg. 42171 (Sept. 19, 1983), and was derived from the old Defense Acquisition Regulation (DAR) (formerly known as the Armed Services Procurement Regulation (ASPR)) § 2-303.2 (formerly codified at 32 C.F.R. Subpart A).

195. *E.g. Moore v. IRS*, 2003 U.S. Dist. LEXIS 13446, 2003-2 U.S.T.C. (CCH) ¶ 50,599 (M.D. Fla. 2003); *Goldcorp v. U.S.*, 2002 U.S. Dist. LEXIS 6486, 2002-1 U.S.T.C. (CCH) ¶ 50,413 (E.D. Mich. 2002).

196. *BMC Bankcorp, Inc. v. U.S.*, 1994 U.S. Dist. LEXIS 8404, 94-2 U.S.T.C. (CCH) ¶ 50,335 (W.D. Ky. 1994), *aff'd*, 1995 U.S. App. LEXIS 15147, 2000-1 U.S.T.C. (CCH) ¶ 50,368 (6th Cir. 1995), *reh'g denied* 1995 U.S. App. LEXIS 32716 (6th Cir. 1995).

decision against the taxpayer.[197] We thus see how judicial proceedings can complicate the process of taxation.

VII. CONCLUSION

The Internal Revenue Code of 1954 was touted by Congress as a "long overdue reform measure . . . developed through extensive and lengthy study of ways and means of removing tax inequities and tax restraints" whose "passage will lead to increased employment and a higher standard of living."[198] The 1954 Code revision purportedly included "a rearrangement of the provisions to place them in a more logical sequence, the deletion of obsolete material, and an attempt to express the internal revenue laws in a more understandable manner,"[199] "to remove inequities, to end harassment of the taxpayer, and to reduce tax barriers to future expansion of production and employment."[200] *Plus ça change, plus c'est la même chose.*

Taxation is a dynamic process that interacts with the environment and the times. It not only is susceptible to political, social and economic events and practices, but also impacts itself upon those political, social and economic events and practices, often in a manner quite unrelated to the purpose behind imposing the tax in the first place.[201] It requires hands-on

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197. *BMC Bankcorp*, 1995 U.S. App. LEXIS 15147, 2000-1 U.S.T.C. (CCH) ¶ 50,368 (6th Cir. 1995).

> We must affirm the judgment of the district court. While we express no opinion on either the strength of the proof offered by BMC to show that the 1988 refund claim was timely mailed to the IRS or the soundness of the decisions of the Eighth and Ninth Circuits holding contrary to our decisions in *Miller* and Surowka, *we* are constrained to follow the clear precedent of *this* Circuit [emphasis added]. In both *Miller* and *Surowka*, we squarely rejected the plaintiffs' 'attempts to introduce extrinsic evidence other than the postmark or mail receipts to prove timely filing, and concluded that the only exceptions to the physical delivery rule available to taxpayers are the two set out in section 7502. *Miller*, 784 F.2d at 730-731; *Surowka*, 909 F.2d 148 at 150. That rule is dispositive of this case [footnotes omitted]. *Id.*

198. H.R. Rpt. 83-1337, at 1-2(Mar. 9, 1954) (reprinted in 1954 U.S.C.C.A.N. 4017, 4025); Sen. Rpt. 83-1622, 1-2 (Apr. 5, 1954), *Sen. Fin. Comm. Report on Internal Revenue Code of 1954* (1954) (reprinted in 1954 U.S.C.C.A.N. 4621, 4629). The introductory materials to the respective House and Senate documents were mostly verbatim to one another.

199. H.R. Rpt. 83-1337, at 1-2 (Mar. 9, 1954); Sen. Rpt. 83-1622, 1-2 (Apr. 5, 1954)

200. *Id.*

201. David Ricardo, *The Principles of Political Economy and Taxation*, ch. 16, 157 (Everyman's Library, no. 590, J. M. Dent & Sons, London, 1969) (orginally published 1817) ("[Taxation] frequently operates very differently from the intention of the legislature by its indirect effects."). Taxation statutes sometimes operate *diametrically opposite* from their legislative intent. *See e.g. In re Rockefeller*, 773 N.Y.S.2d 529, 555 (Surrog. Ct. N.Y. Co. 2003).

management, and oftentimes the tax administrators must focus special attention on particular types of taxes or taxpayers, issues, or problems.[202] Accordingly, any system of taxation will inevitably grow inefficient and dysfunctional over time, as artifacts from ongoing events accumulate in the statutes, regulations, administrative practices, the culture of the bureaucracy, and society as a whole.[203] Increased international trade and commerce, and the growing regulation of such commerce, by treaty or otherwise, inevitably accelerates the rate at which such artifacts accumulate. Changes in federal taxation, even if made in the name of tax simplification, cannot help but complicate state taxation schemes crafted in light of and geared toward the previous federal scheme.[204]

Much as houses periodically require painting, automobile engines brakes require servicing, pianos and other musical instruments recurrently require tuning, lawns must be mowed and hedges need pruning, a taxation scheme likewise requires a periodic overhaul. A half century after the basic Internal Revenue Code we use today made its debut,[205] those who now

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The income tax benefit obtainable by the substitution of [a non-New York resident trustee] is clearly in the interests of the beneficiaries. Indeed, the frequency with which such applications are made reflects an understandable eagerness on the part of persons interested in trusts to be rid of the high tax price payable where the fiduciary is a New Yorker. Although no formal tally has been made of the number of such applications, it is clear that their combined result — a loss of trust business by this State — is sufficiently serious to suggest that New York's high fiduciary income tax may be counterproductive to the State's overall economic interests. The New York legislature is urged to evaluate the present fiduciary income tax scheme in light of its negative repercussions, including the trend embodied by applications such as the one presently before the court. *Id.*

202. *See e.g. Kooi v. Chu*, 129 A.D.2d 393 (N.Y. App. Div. 3d Dept, 1987) (upholding an enforcement initiative by a new taxation administration against New York State Department of Taxation & Finance employees who failed to file their own income tax returns); *McGee v. Hester*, 815 F.2d 1193, 1194 (8th Cir. 1987) ("In 1979, [the Tennessee Alcoholic Beverage Commission] commenced a crackdown upon the illegal import of untaxed out-of-state liquor into the State of Tennessee. The object of the crackdown was to arrest Tennessee residents importing such liquor into the State."), *cert. denied*, 484 U.S. 963 (1987); *Lerman v. Commr.*, 939 F.2d 44 (3d Cir. 1991) ("This case involves the continuing saga of a crackdown by the Commissioner of Internal Revenue on a tax shelter device we will call the 'option-straddle transaction' and the divers[e] attempts of various taxpayers to avoid the consequences of this crackdown."), *cert. denied*, 502 U.S. 984 (1991); U.S. Dept. of Just., *Justice Department Files Suit To Stop Illegal Tax Scheme*, News Release No. 03-511 (Sept. 17, 2003), http://www.usdoj.gov/ tax/03_tax_511.htm (Sept. 17, 2003) ("The suit is part of the Justice Department's continuing nationwide effort to combat promoters of illegal tax schemes and scams."). Carlton Smith, *State is Planning a Sales-Tax Crackdown*, Seattle Times B-3 (Aug. 15, 1990) (reporting Washington State Department of Revenue's efforts to enforce sales tax compliance among merchants); *see also Mexico Plans Tax Crackdown*, Financial Times (London) 6 (Jan. 16, 1997) (reporting enforcement efforts of Mexican government to pursue tax evaders and their unpaid taxes).

203. *Cf.* 2 Ibn Khaldun, *Muqaddimah* 89 (F. Rosenthal, trans., Bollingen Ser. XLIII, Pantheon Books, 1958) (completed 1377) (pagination in original Arabic version: II, 79) ("It should be known that at the beginning of the dynasty, taxation yields a large revenue from small assessments. At the end of the dynasty, taxation yields a small revenue from large assessments.").

204. *See e.g.* Mark L. Silow, *The Decoupling of Pennsylvania's Estate Tax*, 229 Legal Intelligencer 5 (Nov. 25, 2003); Joshua S. Rubenstein, *Federal 'Repeal' of Estate Tax Puts Burden on States*, 228 N.Y.L.J. 9 (Sept. 9, 2002).

205. *See supra* n. 10.

call for its total revision have no trouble marshalling illustrative exhibits to buttress their arguments.