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The President's Advisory Panel on Federal Tax Reform
1440 New York Avenue NW, Suite 2100
Washington, DC 20220

Dear Panel Members:

1. This is a comment from an individual, responding to the panel's second request for comments, which proposes a simplification of the current individual income tax system. Similar concepts could be applied to the corporate income tax system but are not addressed here.

2. I recommend simplifying the present income tax, rather than switching to a consumption, wealth, or property tax because, for almost all people, income best reflects the ability to pay to support the government. Because people in all economic brackets have many types of income, there is a minimum amount of "necessary complexity" involved. However, it should be possible to eliminate "unnecessary complexity," which I define as computations or reporting beyond what is needed to competently perform an economic activity, and interactions (such as phaseouts) between categories of income or expenses.

3. The two basic changes I propose to the federal income tax are evenly spaced integer tax bracket percentages, and applying a fixed rate of 20 percent to standard deductions, itemized deductions, and personal exemptions. These do not appear to be a simplification at all, but allow other changes that could reduce the complexity of the income tax system by half or more:

a. First, a 20 percent deduction and exemption rate exceeds the income tax rate for low income people. With appropriate adjustments of amounts and thresholds, this could replace or greatly simplify provisions such as the earned income credit, assorted child tax credits including the credit for child care expenses, and the tax credit for the elderly and disabled.

b. Similarly, the income tax rate for high income people exceeds the 20 percent deduction and exemption rate. This would eliminate the perceived need to phase out many tax breaks, and can even eliminate the Alternative Minimum Tax.

4. In addition, there are hundreds of provisions where tax computations are unnecessarily complex, or where the full complexity should not be imposed on small amounts of money. The Internal Revenue Service should be able to suggest reasonable simplifications. The underlying principle is that tax accounting should be no more complex than (and preferably not different from) the accounting needed to competently perform an activity.

Respectfully,

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Proposed Federal Individual Income Tax Simplification

Summary of proposed changes

A broad-based personal income tax is the fairest way to collect most of the money needed to fund federal government operations because it is based on ability to pay. Most current tax breaks appear to fulfill legitimate social and economic goals, and have wide political and public support. So, it is more reasonable to simplify the current income tax rather than to replace it with a tax on consumption, wealth, or property. Two basic changes would allow significant simplification:

(1) Tax rates should be evenly-spaced integer percentages, such as (for example) 10, 14, 18, 22, 26, 30, and 34 percent. Having more brackets than in the current system does not have to add complexity because, when the second recommendation is implemented, worksheets will not need to deal with each tax rate separately. Tax provisions will be more smoothly progressive at higher incomes than with current unevenly-spaced brackets. Appropriate income thresholds for each bracket could eliminate the marriage penalty for almost all couples with nearly equal incomes.

(2) A fixed rate of 20 percent should be applied to standard deductions, itemized deductions, and personal exemptions. While this does not appear to be a simplification at all, a deduction or exemption is then worth the same number of dollars in all tax brackets. This permits many other simplifications that can reduce the complexity of the income tax system by half or more.

An additional general recommendation is for the Internal Revenue Service to evaluate the tax code (and all future proposed changes) for simpler ways to accomplish tax goals. When the IRS evaluates proposals from both parties impartially, this is not improper political involvement.

Most thresholds, rates, and other tax provisions should not not be greatly changed, so transition effects and costs do not need to be large. Few specific numbers are given here (and the numbers which are stated are subject to change) because analysis beyond the scope of this summary is needed to set specific initial thresholds and rates which are approximately revenue neutral.

"Necessary complexity" versus "unnecessary complexity"

First, the bad news is that "necessary complexity" arises because ordinary people have some complex financial dealings that are relevant for a federal income tax. This is the main reason why a "postcard" return is not feasible. Here are a few examples of "necessary complexity," for which there are only limited opportunities for simplified tax treatment: (1) A person who has rental property or a business must keep track of income and expenses, and appropriately allow for capital expenses and depreciation. (2) An investor must monitor the cost, income produced, and sale proceeds of each security. Frequent trading results in many transactions which must be accounted for and reported. (3) To deduct charitable contributions, medical expenses, or other relevant expenses, appropriate records and receipts must be kept for each transaction.

"Unnecessary complexity" includes computations or reporting beyond what is needed to competently perform an economic activity, and interactions (such as phaseouts) between income or expense categories. Most "unnecessary complexity" in the tax code results from attempts to prevent abuse or side effects of an intended tax provision. A few examples are as follows:

(1) Many tax forms attempt to accommodate too many different circumstances. For example, Form 4562 (Depreciation and Amortization) covers deductible business capital expenses, all kinds of depreciation, business use of a vehicle, and certain business policies.

(2) Because of "one size fits all" forms, the IRS sometimes asks for irrelevant information, such as the annual number of nonbusiness miles when business mileage is claimed at the standard rate.

(3) If there is a simplified procedure or form, the threshold for imposing the full complexity is often too low. For example, the threshold for allowing use of the simplified Schedule C-EZ should be much higher than the current $2500 of annual receipts.

(4) It is appropriate to offer favorable tax treatment for certain types of income or expenses, but provisions are enacted piecemeal without regard for the system as a whole. So, the number of programs or categories with separate tax treatment is excessive in areas such as long-term capital gains, retirement accounts, education expenses, and medical and insurance expenses.

(5) Most provisions are implemented in a more complex way than needed. For example, to give favorable treatment to certain investment income, complicated worksheets are needed to treat each tax rate separately and to deal with interactions where one category affects the taxation of another category. It is simpler to exclude a portion of such income, as was done until 1986.

(6) The biggest area of complication is that many tax provisions have phaseouts (or phaseins) at certain income levels, including the Alternative Minimum Tax in case the other provisions do not provide enough progressivity. Establishing a phaseout or phasein usually causes a chain reaction of other provisions to attempt to avoid undesired effects. The perverse result is that the highest marginal tax rates are not imposed on the richest people.

Results of replacing deductions and exemptions with a fixed-percentage credit

The main reason for enacting phaseouts in the current tax system is that a deduction or exemption is worth much more in dollars to a person in the 35 percent bracket than in the 10 percent bracket. There are four categories of adjustments to income and taxes on Form 1040 ("above the line" adjustments to income, standard or itemized deductions, personal exemptions, and other credits or taxes). This recommendation proposes that a fixed rate of 20 percent should be applied to standard deductions, itemized deductions, and personal exemptions (but not to the other categories). Because of the fixed rate, these are renamed standard credits, itemized credits, and personal credits in the following discussion.

Some considerations in attaining the desired result of simplification in an approximately revenue-neutral way are as follows:

(1) Because (for example) a $5000 credit applied at a 20 percent rate is a tax reduction of $1000, credits can be expressed directly as dollar amounts, except for the itemized credit and the dollar threshold where it is more appropriate to itemize rather than taking the standard credit.

(2) Some tax provisions are "refundable," meaning that they can reduce the final tax to below zero. To properly replace the earned income credit and several other similar provisions, the standard or itemized credit should not be refundable, but the personal credit should be refundable. The standard credit should be a fixed amount according to filing status (If a taxpayer exceeds that threshold, it is best to itemize, as at present). Some items should be shifted to the personal credit category. The personal credit would be an amount per person, plus an amount per qualifying child (this replaces child tax credits), plus an amount for each elderly taxpayer, plus an amount for each blind taxpayer (politicians should decide if this or any other disability should be tax-favored), plus a percent of earned income up to some limit (to replace the earned income credit), plus a percent of Social Security income (this compensates for gradual taxation of Social Security income), plus a percent of child care expense, plus a percent of qualified education expense, and so on. This does not seem simple, but each amount or computation replaces what is now several paragraphs (or up to over a dozen pages) of instructions, worksheets, and tables.

(3) For a low-income taxpayer, credits at a 20 percent rate exceed the income tax rate. This is how tax provisions aimed at low-income people can be structured to reduce tax.

(4) As income rises into tax brackets above 20 percent, the effect of provisions aimed at people with low or moderate income phase out automatically. Some provisions such as a credit for a "percent of Social Security income" would still be limited. Allowing an itemized credit for home mortgage interest on mortgages totaling no more than $1 million, and limiting credits for charitable contributions, could remain as in the present law. Note that specifying limits in this way does not cause spikes in the marginal tax rate above the stated tax rate.

(5) For an extremely high-income taxpayer (millions of dollars taxed at 35 percent), if itemized deduction expenses are 25 percent of adjusted gross income (AGI), the itemized credit offsets 5 percent of AGI, reducing the final tax to 30 percent of AGI (minus a few thousand dollars for personal credits). Even a taxpayer with itemized deduction expenses equal to 100 percent of AGI would pay a tax of about 15 percent of AGI (minus personal credits). This may permit the elimination of the Alternative Minimum Tax. It is possible that a 20 percent tax credit rate may allow the top tax bracket to be lower than 35 percent.

Summary and final comments

This recommendation proposes keeping the current broad-based personal income tax, with two major simplifications that eliminate unnecessary tax complications. First, tax brackets should be evenly-spaced integer percentages. This allows smoother progressivity as income rises. Second, standard deductions, itemized deductions, and personal exemptions should be applied at a fixed rate of 20 percent. A large number of current tax provisions could be simplified, with no need for phaseouts which cause spikes in marginal tax rates, and it is possible that the Alternative Minimum Tax could be eliminated. Tax complexity could probably be reduced by about half for taxpayers with typical middle-class finances.

After a one-time restructuring, all provisions (such as thresholds) should be indexed, but the index does not always have to be the inflation rate. An index might be a salary percentile (such as the upper limit for Social Security taxation) or a percentage of taxpayers affected (such as the limit of business receipts for using Schedule C-EZ instead of Schedule C). Of course, these thresholds or limits would be expressed as dollar amounts. The decision process for setting a threshold could be complex but the complexity would not affect the taxpayer.

The additional general suggestion of searching for other areas which can be simplified will not be discussed in detail, but three areas will be mentioned which illustrate possible side effects and other political considerations:

(1) To maintain the fiction that employees pay only half of their Social Security tax, treatment of Social Security tax is scattered throughout the tax code to equalize treatment of employees and the self-employed. It would be simpler to have an employee pay the entire tax, out of an income that is correspondingly increased (The tax would be about 14.3 instead of 15.3 percent of the total income). The earned income credit could be simplified even further from the suggestion above, by allowing a credit for the first certain amount of Social Security tax paid, according to filing status (Amounts should be set to compensate for the increase in taxable income because the employer share becomes taxable). Two politically-related side effects are that the minimum wage would need to be increased, and provisions may need to be made to prevent a state income tax windfall on the increased taxable income.

(2) Also, up to 85 percent of Social Security income is taxed, with a complicated phase-in worksheet. The Social Security Administration should be able to report how much Social Security is subject to tax (approximately, the amount of income above the return of the employee share of Social Security taxes, which came from taxable income). The credit for Social Security recipients mentioned above would offset the tax for low-income people.

(3) Tax treatment of medical care and insurance expenses is excessively complex, involving employer-provided insurance, privately-obtained insurance, Medicare, Medicaid, charity, various kinds of medical accounts, and itemized deductions. Simplified tax treatment would need to be discussed as part of a more comprehensive overhaul of the insurance system, and obviously all complications, exceptions, and transition provisions cannot be discussed here.

Finally, because the proposed income tax is still broad-based and a structure for deductions and credits remains, politicians still would continue to make the final decisions about tax treatment of income and expenses. Continued caution would be needed to ensure that the overall complexity of the system does not increase, possibly by requiring that if something is made more complex, some other area needs to be simplified.