

My 'Tax Reform Wish List' for the 110th Congress

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The following commentary appears on the tax blog, A Taxing Matter, run by my colleague, Professor Linda Beale. It was prepared in response to her request to me and several other academic tax specialists for our thoughts on what Congress should do to improve the tax system.

Introduction

Before setting forth specific reform suggestions, I discuss some political parameters and state my general philosophy of tax reform. Then I give a short list of reforms that have at least some possibility of achieving some bipartisan support or at least of avoiding a veto by President Bush. I have not put items on my list, such as an end to the capital gains preference, which would improve fairness and economic efficiency hugely but which have little political support in either party.

Political Parameters for Tax Reform

Tax reform of a major nature has typically been a bipartisan deal. Therefore, major tax reform is always difficult and especially difficult in the current political climate. In general, the Republicans tend to favor measures that enhance economic growth, whereas the Democrats favor measures that enhance the fairness of the system. Both parties are beholden to a considerable extent to various vested interests, so there are significant limits on what is politically feasible even with good will. And good will has been a rare commodity in Washington over the past decade, due in large measure to the slash-and-burn politics of the Republicans in Congress, particularly in the House. However, the Republicans have proven over the past decade to be far more subservient to the special interests than the Democrats ever were, so the shift in political control of Congress to the Democrats gives some cause for optimism that tax reform can occur in 2007-08. The past decade has been a period of almost unmitigated tax deform.

Even with good faith on all sides, compromise on the goals of economic efficiency and fairness are difficult to attain. Part of the reason is that whereas the Democrats do favor features of the tax system that encourage growth, many Republicans positively dislike tax measures that reduce inequalities in society – the

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central benchmark for fairness in the eyes of many Democrats. The Republicans contend that redistributive measures are unfair – resulting in double taxation of the rich or unfair burdens on the rich. Thus, they are disinclined to reach a compromise acceptable to the Democrats. Moreover, the Bush Administration has refused to produce the statistics that show the huge increase in inequality in our society over the past two decades and has released highly misleading numbers in an attempt to show that the rich are over-taxed.

The landmark 1986 tax act achieved a reasonable balance of fairness and economic efficiency by reducing marginal tax rates, which allegedly promoted economic growth, and by expanding the tax base to raise the average or effective tax rates on the rich. The tax base was expanded by eliminating many preferences, including the preference for capital gains, which enhanced fairness in the eyes of the Democrats. That type of compromise is unthinkable in the current political environment because President Bush would veto any tax bill that significantly reduced the preference for capital gains. Moreover, the Democrats probably would not support any further reduction in the marginal tax rates for high earners.

General Tax-Reform Philosophy

A few words on my own tax philosophy. I would not support any tax change that did not promote fairness or at least did not maintain the features of the current system that tend to promote fairness. In the current economic conditions, production of goods and services has become relatively easy, whereas the fair distribution of the rewards of production has become increasingly difficult. In the 19th century, it probably was a good tradeoff for the working classes to accept some of the harsh aspects of the industrial revolution to improve production. Such a tradeoff would be nonsensical in the 21st century. There is simply no good reason for average people to be made worse off in order to enhance production unless it is clear that they receive most of the benefits of that increased production.

In the current social and economic environment, measures that tend to increase inequalities in favor of the rich are decidedly anti-social. Moreover, I think it is extremely difficult to argue that the very rich in any significant way deserve their great wealth. There are, of course, exceptions to Dorothy Parker's assertion that "behind every great fortune lies a great crime." But incomes over \$1 million a year cannot be explained solely or primarily in terms of hard work. Hard work may be a pre-condition for such favorable outcomes. But without some combination of inherited talents and/or wealth, exceptionally good luck, or some inefficient exploitation of the economic system (rent-seeking or illegal activities), such great wealth would be impossible.

A final word on my tax philosophy. In my view, a major goal of a tax system is to fund the costs of government. People can legitimately disagree about the proper size of government. But once Congress has decided on the amount of expenditures the government will make, it should design the tax system to raise the money needed to fund those expenditures. I recognize the need on occasion for short-term deficits and surpluses to stimulate or cool the economy. But there is no justification for systemic surpluses or, much more likely, systemic deficits. We harm the economy and undermine fairness when we run chronic federal deficits. We currently have huge structural deficits, so I would oppose just about any reform that reduced revenues, notwithstanding its merits under different circumstances.

My Tax-reform Wish List

So here is my “practical” wish list of tax reforms for 2007 and 2008.

1. Revitalize the IRS by:

(a) Adding substantially (my guess is 25%) to its audit budget;

(b) Improving its technology;

(c) Reducing some of the impediments to fair and efficient auditing that were introduced in the past decade – including some bad stuff in the so-called taxpayer bill of rights. In particular, we need to make clear that the lawyer/client privilege does not apply to corporations or to accountants. I would also adopt reasonable measures to enhance auditing; and

(d). Requiring stock brokers to report to their clients and to the IRS their clients' net capital gains (gross proceeds from stock sales minus basis), not just the gross proceeds of stock sales, as they now report. Mutual funds already provide their clients (mostly small investors) and the IRS with such information, and the same reporting rule should apply to other investors. Better reporting would help honest taxpayers report their gains properly and would help the IRS catch some well-heeled tax cheats.

2. Adopt legislative measures to reduce tax fraud and aggressive tax avoidance, especially offshore tax fraud. The stuff passed by the Senate last year and rejected by the House would be a good start, although even the Senate stuff needs some strengthening.

A major goal should be a provision giving statutory authority for the “substance over form” rule that some conservative courts have refused to apply (in cases such as Compaq). Indeed, that rule needs to be strengthened significantly. I would go so far

as to say that for purely financial transactions, the form can be restructured to enhance the tax unless the transaction made good economic sense. We cannot impose such a harsh rule on non-financial transactions, like oil wildcatting. People are entitled to take “unreasonable” steps to enhance their incomes. But I do think it is reasonable to assume that a purely financial transaction have a profit motive that makes good economic sense.

I also would improve transparency by requiring greater disclosure of tax matters, especially by corporations. I think the secrecy associated with settlement decision is misguided, as is the secrecy for advanced pricing agreements (APAs) entered into by taxpayers and the IRS on transfer-pricing methods. I think corporations should be required to disclose on a country-by-country basis the amounts of taxes paid and tax credits claimed. Tax reform requires public pressure for reform, and that pressure is more likely to be generated if the voters know about the abuses of the system in appropriate detail.

3. Fix the AMT for moderate-income taxpayers. The Republicans intentionally created the AMT mess because they did not want to have to scale back their tax cuts for the rich by the amount needed to prevent it. Given the huge budget deficits, I am not prepared to endorse AMT reform unless the reform is revenue neutral. And I am not willing to increase taxes on the lower- and middle-middle classes to give tax relief to the upper-middle class. So AMT relief, to get my endorsement, has to come from increased effective rates on the rich. I am not at all confident that such relief would escape a Bush veto, but I think Congress should put the matter to him in as stark a form as possible – making it clear that he is vetoing a measure that simply readjusts his own tax changes to reduce a problem that those tax changes created. Now, my preference would be to use higher taxes for the rich for purposes other than tax relief for the upper-middle class. But such a step would get an automatic veto and would harm the Democrats in the next election, so it is not politically possible.

4. Increase taxes on capital gains whenever possible. I do not think a flat-out increase in the capital gains tax rates would escape a presidential veto, and surely the Congress could not override a veto on such an issue. But I do think that it is possible to restrict the preference at the edges, for stuff that clearly does not provide an economic benefit to the economy. It was possible, for example, to prevent collectibles from getting the low 15% rate for “normal” capital gains. In particular, I think it should be possible to move towards a definition of capital gains that is basically limited to unimproved real property, business capital assets, and corporate stock. The immediate goal should be to prevent a capital gains preference for disguised compensation. I'd want to roll back that foolish preference for song writers enacted in 2006. But I would also want to be sure that a sale of a partnership interest in any form does not produce a capital gain. The way to proceed in my view is to define a capital gain positively rather than as the residual of stuff not explicitly excluded.

5. Increase taxes on the “filthy rich” – defined as people earning over \$1 million a year or having a huge estate. I favor retention of the estate tax, of course. The estate tax is scheduled to return in full force in 2010, so retaining that tax is veto-proof. I’d be very content with that outcome – retention of the current estate tax. I would not give up any estate tax revenue to give relief to so-called small estates. I would be happy to give relief to those small estates if the revenue for that reduction came from higher taxes on the larger estates, especially the mega-estates. I’d prefer that the higher taxes on the mega estates came from substantive reforms of the tax base, but I’d be willing to see the rates increase as well if the increase is needed to make the reform package revenue neutral.

As the baby-boom generation dies off over the next 40 years, we can expect huge increases in estate tax revenues under current law. Those revenues are sorely needed to fund the government and should not be given away for any reason. But I am happy to improve the progressivity of the system by shifting more of the burden to the larger estates. Such a shift is consistent with one of the main purposes of the tax – to prevent the rich from gaining fuller control of the US political system.

I have no specific recommendations for explicitly raising the income tax on the filthy rich because I view any such reforms as fodder for a presidential veto. But I expect that most of the administrative and fraud reforms I’ve supported would have a disproportionate impact on that group.

6. Improve the international tax rules. In particular, I would want to:

- (a) Reduce the deferral privilege by strengthening subpart F;
- (b) Repeal the check-the-box mistake;
- (c) Cooperate with our trading partners to get effective withholding at source on interest (and interest equivalents) and other lightly taxed income items;
- (d) Revise the OECD Model Treaty to provide for taxation of business income whenever a company has a major economic presence in a country, whether or not it has a permanent establishment (PE) under current treaty rules; and
- (e) Work to reduce tax competition, including all of the forms of “harmful” tax competition identified by the OECD in its 1998 report (written before it lost its nerve after the 2000 election in the US).

7. Improve the legal framework for state taxation, especially the state corporate income tax and the state sales tax. For the sales tax, I would severely limit or overrule the Quill rule that the Supreme Court invented to prevent state taxation of cross-border mail-order sales. I also would want to work with the states to limit the tax competition that is undermining the state corporate income tax. For example, I would consider a revenue-neutral package that increased the federal tax rate on corporations but matched that increase with a credit for state corporate income taxes actually paid.

Concluding Note

I'm sure I could go on and will think of additional measures that I'd like to see enacted. But adoption of the listed measures would be a decent start on meaningful reform. I have not mentioned reforms to reduce the complexity of the system because I do not think there is any constituency for simplification in the abstract. In general, most of the measures I've suggested above would reduce some of the complexity by reducing avoidance opportunities. As one wag noted, "Paying taxes is simple – it is avoiding taxes that is complex."