

RADICAL TAX REFORM MEASURES

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I. INTRODUCTION

A. The Call for Radical Tax Reform

1. THE NATIONAL MOOD

- a) With the Republican takeover of Congress, national headlines have carried a host of proposals intended at radically altering the method in which the federal government collects taxes.
- b) Tapping into the public's disgust with the current tax system, each proposal promises a quick and efficient way to collect taxes, an elimination of the double-taxation on corporate dividends, and tax breaks for certain types of investments.
- c) There is also an anti-spending hue to the debate, since the leading tax proposal, the flat tax, greatly reduces the federal government's tax take and makes it nearly impossible for Congress to raise taxes.

2. THE PROPOSALS

- a) Congressman Richard Armey's flat tax proposal has received the most national attention. Simply put, it would levy a single "flat tax" on individual and business income, but not on interest, dividends or capital gains (and possibly rents). This is the proposal with grassroots appeal.
- b) Senators Nunn and Domenici have floated their Unlimited Savings Allowance ("USA") tax proposal, a complicated regime that gives a deduction for annual increases in an individual's savings. This proposal is considered the "inside the Beltway" approach and has little appeal outside Washington, D.C.
- c) Finally, there is an approach sponsored by Cato Institute and supported by Senator Lugar and Congressman Archer to replace the current income tax system entirely and replace it with a national sales tax of 18% on all consumption of goods and services. This proposal is considered a direct assault on the IRS, since it would eliminate that bureaucracy entirely.

3. COMMON GROUND

- a) Each proposal attempts to increase the savings and investment in the U.S. and to discourage consumption. The Nunn and Domenici proposal is directly targeted at increasing the national pool of savings, but it retains the current progressive tax rates for individuals.
- b) The flat tax and national sales tax proposals eliminate the current progressive tax rates, thereby shifting the tax burden from the "wealthy" (defined below) to the "middle class" (defined below). Both these proposals eliminate the tax on investment income which further benefits the wealthy, since as a group, they have more dollars to invest.

- (1) These proposals also carry a distinct anti-tax, anti-IRS bias to them.

4. THE EXAMPLES

- a) The analysis of the various proposals is taken from a New York Times dated September 3, 1995 and entitled "The Tax Code Heads Into the Operating Room." The table in the article is attached hereto as Exhibit "A."
 - (1) Those in Washington, D. C. define the "wealthy" taxpayers as individuals (with or without families to support), with annual adjusted gross incomes ("AGI") of more than \$200,000.
 - (a) The reality that many who earn this amount — after payment of mortgage interest, private school tuition or college education expenses, day care, retirement contributions and heavy federal, state and local tax burdens — may have little or no money remaining to save or invest is not taken into account.
 - (2) The "middle-class" is usually defined as those with AGI's of between \$40,000 to \$80,000.
 - (3) Those who are supporting families with AGI's of \$25,000 or less are considered "poor."
 - (4) Most proposals are scrutinized as either benefiting the wealthy at the expense of the middle-class or the poor, or vice-versa.

II. THE TAX REFORM PROPOSALS

A. The Nunn-Dominici Proposal

1. THE BASICS

- a) The USA tax proposal stresses savings, but retains the progressive tax rate structure for individuals. There is a new and potentially complex "value added" business tax as well.
- b) While the proposal is a radical departure from the current code, it has a full set of its own complexities running through its 95 single-space pages.
 - (1) Since Senator Nunn has announced his retirement from the Senate, it is doubtful this proposal will receive much serious consideration.
- c) The USA proposal permits an individuals to save their earned income, rather than spend it, by permitting a deduction against income for the amount of their net saving increase per year.
 - (1) For instance, if an individual earns \$50,000 and saves \$10,000, he or she would receive a tax deduction of \$10,000. The tax, however, is merely deferred since once the funds are spent, a tax is levied on the individual.

- d) Senator Nunn believes that an increase in the national savings pool will help cure the economic ills of our society. He would tax income from investments at ordinary tax rates which means the USA proposal will not provide investment incentives such as the reduction or elimination of capital gains.
- e) The current deduction for mortgage interest on a qualified residence would remain.
 - (1) There would also be a maximum deduction of \$2,000 for qualified educational expenses for each eligible student, and a charitable deduction.
 - (2) The USA tax contains an interesting feature that might be incorporated into a future tax reform measure: Both the employer and the employee are permitted to deduct their respective share of payroll taxes, thereby merging the payroll and income tax systems into a single, integrated structure.
- f) Businesses would pay a “value-added” tax of 11% collected at each stage of production.
 - (1) No deductions would be permitted for wages, salaries or interest paid on indebtedness.
 - (2) The value-added tax would be rebated for exports.
 - (3) The taxes paid for payroll would be deductible to avoid a double-tax on that amount.
 - (4) Depreciation deductions would be grandfathered in as part of the bill.

2. ANALYSIS

- a) The USA proposal retains the progressive rate structure of the current system, but bestows no breaks for investment income or gains. There is nothing compelling about the measure, except a deferral on savings.
- b) The proposal’s underlying assumption is that savings deferral is the tonic needed for our economy, but there is not much empirical evidence that an increase in savings, at the expense of consumption, will benefit our economy.
 - (1) Consumer spending accounts for 60% of all economic activity and disincentives for such spending may cause negative reverberations throughout the economy.
 - (2) If an increase in savings is desirable, a simple change in the current tax code would suffice.
 - (a) If every individual could deduct a contribution to an Individual Retirement Plan of \$5,000 per year, that would dramatically increase the national savings pool.

(b) Another alternative could be a special savings account that permitted the receipt of tax-free interest. There could be an up-front deduction to such an account, if Congress believed additional incentives were needed.

c) USA proposal, to some extent, penalizes working families who need their incomes for consumption, and favors the elderly, wealthy and single taxpayers who would have greater discretionary income that could be used for the savings deduction.

d) By taxing savings when it is used, the plan actually discourages taxpayers from saving to purchase a house or other big-ticket items.

(1) Apparently, the income earned from the savings is taxable, so the savings plan works like an IRA except without the benefits of a tax-free build-up of earnings.

3. COMPARISON WITH THE ALTERNATIVES

a) According to Exhibit "A," the USA tax is higher than the current income tax for those with higher AGI's. Its payroll tax credit causes the tax to be lower for those with AGI's of \$20,000 and \$50,000.

b) The USA tax produces a significantly higher tax for those with a higher AGI than either the flat tax or the national sales tax.

B. The National Sales Tax

1. THE BASICS

a) Several Congressmen, including Senator Lugar and Representative William Archer, are backing the Cato Institute's national sales tax proposal which would tax purchases of goods and services at 18%.

b) Those who support this proposal claims it is simple, easy to administer and will eliminate the intrusive IRS from the lives of taxpayers.

(1) In fact, taxpayers will pay no income tax whatsoever, so they will not even have to file tax returns.

(2) The states would collect the taxes and would be compensated by the federal government for that task.

(3) There would be some type of tax credit card given to the poor to prevent them having to pay the national sales tax. How this would work in the real world is unclear.

2. ANALYSIS

a) Even the most cursory inspection of this proposal reveals a abundance of fatal flaws.

- (1) The proposal shifts the tax burden to the lower and middle class since they, as a group, consume a much larger portion of their income than the wealthy.
- (2) The tax would require a constitutional amendment since the 16th amendment to the constitution empowered Congress “to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.”
 - (a) A national sales tax is not a tax on income and would not meet the 16th amendment’s requirements.
- (3) The national sales tax of 18% would be added on top of state and local sales tax. In most states, the combined sales tax would be between 25% and 32%.
 - (a) At rates of 25-30%, an enormous underground economy would emerge to circumvent the tax.
 - (i) Farmers would be tempted to sell their produce directly to the public, or people would begin backyard gardens.
 - (ii) Bartering would become prevalent and swap meets, farmer’s markets or other informal gatherings could replace the retail store as the marketplace of choice.
 - (iii) The federal government would be totally dependent on the quality, honesty and tenacity of the local sales tax collectors.
 - (b) Another drawback to the national sales tax is that it would penalize those who have saved their money for a future purchase of goods and services. Those funds have already been taxed once. Upon the purchase of goods and services, the taxpayer will pay another 18% tax.
- (4) Stephen Moore, the architect of the national sales tax, pointed out the fatal flaw to his approach in a speech to the National Press Club in Washington, D.C., on May 11, 1995. In his speech, he stated as follows:

“A sales tax would be paid by consumers every time they purchased goods or services at the cash register. The tax would appear on the receipt.”

 - (a) How many attorneys, accountants, therapists and other professionals have cash registers?
 - (b) Mr. Moore’s thinking reflects the 1960’s, not the 1990’s.
 - (i) What about mail-order purchases?, purchases across the border?, over the Internet?, barter transactions? — and a host of other economic

activities that are not recorded through a cash register?

(ii) Many of our consumer goods are manufactured overseas. How difficult would it be for a company to begin a mail order business from Hong Kong for the items that would otherwise appear at Safeway, Macy's or the Good Guys?

(5) How would the state sales tax collectors police these types of transactions without a massive intrusion into the privacy of citizens?

(6) In reality, a national sales tax would mean no tax at all since it would be so easily defeated by creative taxpayers and businesses alike.

(a) Without an income tax the need for tax accounting systems would disappear because income and deductions would be irrelevant to the payment of tax.

(b) Without current accounting systems in place, there would be no incentive to record transactions through a cash register, especially cash transactions.

(i) The temptation to not record business transactions will be enhanced if competitors are engaging in this practice and the difference amounts to a 30% discount on the ultimate purchase price paid for an item.

(ii) Once the problems with a national sales tax surface, it would be difficult, if not impossible, to resurrect an income tax system since both the IRS and the accounting records necessary for an income tax will no longer exist.

(7) The problem with the national sales tax affects each of the other proposals as well. All their assumptions are based on "static revenue analysis."

(a) This is an outdated concept that does not take into account that people change their behavior, and tax advisors change the structure of investments, based on changes in the tax law.

3. COMPARISON WITH OTHER PROPOSALS

a) The national sales tax compares favorably with the current income tax for those with an AGI of \$100,000 and \$300,000.

b) Taxpayer's earning less than \$50,000 will suffer significant harm under this proposal.

c) The national sales tax also favors those with an AGI of \$100,000 and \$300,000, when compared to the USA tax, but those with an

AGI of \$300,000 and \$100,000 (with no children) fare better under the flat tax.

III. THE FLAT TAX PROPOSAL

Of all the three proposals, the flat tax is the one that should be taken seriously. As Americans struggled with completing their tax returns and with the exasperating effort to find the "correct" tax form, the call for a simple "flat tax" has garnered support across the country.

A. The Current Version

1. ARMEY'S FLAT TAX

a) The most recent version of the flat tax, sponsored by Republican Representative Richard ArmeY of Texas, has the following features:

(1) Americans would be taxed at the flat rate of 20% on all wage and salary income for 3 years; thereafter, the percentage would drop 17%.

(2) No tax would be paid on capital gains, dividends or interest.

B. The Tax on Individuals

1. THE BASICS

a) Taxable income for individuals means the excess of wages, retirement distributions and unemployment benefits over the standard deduction.

(1) There would be no deductions from gross income.

(a) Deductions for mortgage interest, retirement accounts, medical payments, state income taxes, charitable contributions, moving expenses, union dues, and the credits for earned income and child care would be eliminated entirely.

b) Taxpayers would deduct from gross income a personal exemption of \$13,100 for each adult and \$5,300 for each dependent. This means that a family with two adults and two children would pay no tax on an income less than \$36,800.

c) The tax return could be completed on the back of a postcard in four steps: (1) gross income listed on the first line; (2) personal and dependency exemptions calculated and listed on the next line; (3) taxable income computed by subtracting line 2 from line 1; and (4) the tax computed by multiplying line 3 by 20% (17% after 3 years). See Exhibit "B" attached to this outline.

d) Example: Assume a husband and wife with two dependent children had combined wages of \$120,000. In addition, they earned \$5,000 in interest and had a \$10,000 capital gain.

- (1) Line 1 (income - limited to wages and salary only) \$120,000
- (2) Line 2 (personal and dependency exemptions) \$36,800
- (3) Line 3 (taxable income, line 2 minus line 1) \$83,200
- (4) Line 4 (taxes owed, line 3 x 20%) \$16,640
- (5) After tax amount: \$118,160 (wages, interest, capital gains, less taxes paid)

e) All estate and gift taxes would be eliminated.

2. ANALYSIS

a) The virtue of the flat tax is its simplicity. However, much of its clarity comes at the expense of eliminating itemized deductions.

(1) The loss of the mortgage deduction could cause severe problems in the housing market (discussed below).

(2) The elimination of the alimony deduction will produce chaos in the family law field and could severely disrupt the economics of many families.

(3) Clearly, the winners under a flat tax are the wealthy and those who live off of investments, rather than those who must work to support their families.

(a) The combination of no tax on investments and capital gains, coupled with the elimination of estate and gift taxes, could produce an entire generation that will never pay income tax.

(b) Also, the tax advisors should be extremely busy restructuring investments, making gifts, and converting ordinary income situations into tax-free capital gains transactions.

3. BENEFITS OF THE FLAT TAX

a) The flat tax would, however, eliminate the current spending on record keeping, IRS audits, and tax preparation fees paid to tax preparers and accountants.

b) Under some estimates, tens of billion of dollars are spent in complying with the present tax system.

c) Armev does not dispute that the wealthy would prosper under his proposal, but he claims that so much income would be freed-up for investment that the wealthy could end up paying more tax than they currently pay.

4. COMPARISON WITH OTHER ALTERNATIVES

- a) The flat tax results in a higher tax for those with an AGI of \$20,000 and \$100,000 with children (since the itemized deductions are lost). The greatest benefits fall to those with an AGI of \$300,000 who will experience a 64% decrease in their tax obligation.
- b) The flat tax is much lower than the USA tax for those with an AGI of \$300,000 and \$100,000 without children, but the USA proposal results in lower taxes for the other groups.
- c) When compared to the national sales tax proposal, the flat tax is lower for those with an AGI of \$50,000, \$100,000 (with no children) and \$300,000, but causes a higher tax for the other groups.

C. The Tax on Business Activities

1. THE BASICS

- a) A tax of 20% will be imposed on every person (defined as an individual, partnership, corporation or otherwise) engaged in a business activity.
 - (1) Business taxable income means gross active income, reduced by deductions.
- b) Gross active income means receipts from the sale or exchange of property or services in the U.S. by any person in connection with a business activity.
- c) Deductions include wages and the cost of business inputs and retirement contributions.
 - (1) Business inputs mean the amount paid for property sold or used in connection with business activities, including land, structures, services and any sales tax, customs duty or other stated levy.
 - (2) Although the literature discussing the flat tax states that rents are taxable as a business activity, rents have not been expressly included in the definition of gross active income.
- d) Deductions are carried forward indefinitely and also earn interest at the 3-month Treasury rate. The combination of these factors could mean that some businesses will enjoy a tax-free existence for a long time, as explained below.

2. ANALYSIS

- a) The business tax changes will wreak havoc in the business community, but will provide a wealth of work for their tax advisors.
 - (1) For instance, partnerships will be taxed as corporations. How will partnerships with detailed and complicated special allocations be treated? What about those partners with negative capital accounts? Will all of them be let "off-the-hook" since the partnership will become the tax-paying entity?

- (2) What about the rules relating to depreciation recapture, sales of property in which the debt is excess of basis? Will taxpayers get a free ride on these types of deferral tax obligations?
- b) Service industries that do not have large capital costs will pay a greater tax than industries that invest in capital equipment because such investments are fully deductible in the year they are made.
- c) Those companies with large debt loads will not be permitted to deduct their interest payments.
- d) Business entities will no longer receive a deduction for providing fringe benefits to their employees, such as health care, and this change could have a far-reaching impact on the financing of medical care in our country.

D. The Consequences of a Flat Tax

1. THE EFFECT ON CURRENT INVESTMENTS

- a) With the creation of many tax-free investments, the price of municipal bonds should drop precipitously, which could cause many municipalities and possibly some states to become insolvent.
 - (1) As described below, the housing market could experience a drastic loss in value.
- b) The stock market should be the primary beneficiary from an elimination of the capital gains tax — those who live off of investments, rather than earn wages, will be the true winners under the flat tax.

2. VIEWS OF MILTON FRIEDMAN

- a) While everyone agrees the current tax system is a convoluted mess, no one really knows what to do about it. Theories abound as to why the tax code is so complicated.
- b) Noble prize economist, Milton Friedman, believes the current tax system permits members of Congress to raise campaign funds from lobbyists and this causes the nearly-annual changes in the tax code.
 - (1) Under Friedman's theory, changes in the tax code affect the lobbyists' members, consequently, lobbyists must contribute heavily to political campaigns to gain special privileges for their constituents.
 - (2) Friedman believes that the logic of a flat tax is compelling, but the political reality of campaign fund raising will prevent Congress from enacting such a sweeping change in our tax laws.

3. THE TAX CODE AS AN INSTRUMENT FOR SOCIAL BEHAVIOR

- a) Friedman's view is a little too cynical. Congress has used the tax code to motivate and encourage people to spend money to benefit the economy or society.
- b) The tax code had been used in this manner long before the issues involving campaign financing arose.
 - (1) Consequently, there are breaks for low-income housing and charitable giving.
 - (2) The deduction for home mortgages involves the judgment that Americans should own their own homes.
 - (a) Child care exemptions provide a benefit to dual-income households.
 - (3) By eliminating deductions and tax credits, Congress loses its ability to channel investments into what it believes are socially desirable activities.

4. DUELING OBJECTIVES

- a) There are two irreconcilable forces within any tax system: fairness and simplicity.
- b) The flat tax embodies simplicity. Our tax system is complex because of fairness concerns and past abuses.
 - (1) The tax code has eliminated many of the loopholes and tax shelters that wealthy taxpayers have previously enjoyed.
 - (2) Provisions such as the passive loss limitations, elimination of the capital gains deduction of 50% and the alternative minimum tax, were designed to make the wealthy pay their fair share of taxes.
 - (a) Under the proposed flat tax, wealthy taxpayers would obtain the largest tax breaks while middle income taxpayers who currently itemize their deductions would see their taxes rise.

E. The Future of the Flat Tax

1. WHO IS BURDENED BY THE PRESENT SYSTEM?

- a) Before adopting any radical tax reform solution, one must remember that the present complexity affects only 20% of all individual taxpayers. That being said, those who must with deal the present tax system have a legitimate argument that it is too complex and often unworkable.
- b) Most individuals, however, receive wages and salaries, and take the standard deduction.

- (1) Also, most taxpayers who currently itemize their deductions enjoy their home mortgage interest deduction, and the ability to deduct state income taxes and charitable donations.
- (2) The high-tax states, real estate industry and charitable lobby will scream long and hard over the elimination of these deductions.

2. RECALL THE SAVINGS AND LOAN CRISIS

- a) The savings and loan debacle in the late 1980's can be traced, in large part, to the elimination of the tax shelters for real estate under the Tax Reform Act of 1986.
 - (1) Taxpayers were encouraged to invest in real estate and the savings and loan industry financed those real estate projects.
 - (2) The Tax Reform Act of 1986 suddenly eliminated any incentive for purchasing those investments. With no buyers, the developers of those projects went broke and the savings and loan industry was stuck with billions of dollars of bad loans.
- b) This same type of calamity could happen to the home real estate market if the mortgage deduction is eliminated. A homeowner who might barely be able to afford tax-deductible mortgage payments might now default on his or her loan, if the law took away this tax advantage.
- c) Also, housing prices might drop (or crash!), and rentals might skyrocket, if the mortgage deduction is eliminated since there would be no tax advantage to owning real estate.
 - (1) One study commissioned by the real estate industry predicts that the elimination of \$80 billion in current deductions for real estate taxes and mortgage interest will reduce the nation's housing equity by \$1.7 trillion and cause a drop in housing prices by 15%.
 - (2) The lesson from the Tax Reform Act of 1986 is clear: Abrupt changes to the tax code often cause unexpected and catastrophic results.

F. A Boon to Tax Advisors and Tax Attorneys

1. RESTRUCTURING TRANSACTIONS IN GENERAL

- a) There will be a window of opportunity to use a panoply of devices such as reciprocal sales, installment sales, related party transactions, formation of new entities, gifts and estate planning, to vastly restructure the way in which America does its business and investing — in response to the flat tax.
 - (1) The lethal defect involved in all radical tax approaches is their inability to predict how taxpayers will change their behavior in response to the proposed changes.

(2) Also, Congress tends to focus on large corporations when evaluating tax changes. Smaller companies and individuals have the flexibility to restructure their business operations quickly and, if well advised, can often take advantage of opportunities that Congress never considered.

(a) For example, the portfolio interest rules under IRC Sec 871(h) were intended to assist large corporations with their debt offerings in Europe. This law says that foreign persons holding such debt are not subject to U.S. tax on the interest payments received.

(i) This law, however, was not limited to large corporations with the result that, with careful planning, foreign individuals and family members can often structure their investments in the U.S. to earn tax-free interest.

(b) This example illustrates how the tax law can and often does have unintended or unforeseen consequences.

2. RESTRUCTURING OPPORTUNITIES UNDER THE FLAT TAX PROPOSAL

a) The flat tax will apply to wages and rents, but not to sales of investment property (“capital gains” transactions), dividends and interest.

b) This disparity will create a huge incentive to restructure transactions (“recharacterize” income) to fall within the non-tax provisions of the flat tax.

c) The battle over what constitutes capital gains has been fought throughout the history of the tax code and both the taxpayers and the IRS have had their share of victories.

(1) One of the main reasons for enacting the Tax Reform Act of 1986 was to eliminate the distinction between capital gains and ordinary income and thereby avoid this confrontation.

(2) Under the flat tax, this issue will once again take center stage. Winning this battle will mean the difference between a 20% flat tax and no tax; consequently, tax attorneys and accountants will be extremely busy and creative — pulling out all the old techniques for converting ordinary income into capital gains — so their clients will pay no tax.

d) While capital gains conversions would be the primary target of opportunity, restructuring payments to workers in closely held companies from wages to tax-free dividends or interest will also occur.

(1) We will also see complicated arrangements to convert rental income into tax-free dividends and interest.

- (a) For instance, owners of rental property will transfer title to corporations to take advantage of the tax-free provisions for dividends paid to shareholders.
 - (b) **Example:** Assume a rental property has a fair market value of \$1,000,000, a tax basis of \$500,000 and produces \$100,000 in rents. Assume there is \$20,000 in direct expenses so the net profit is \$80,000. This transaction can be structured to eliminate tax indefinitely:
 - (i) Currently, the owner is taxed on \$80,000 as ordinary income. Assume there is a flat tax in which the rental income will be taxed at 20%. The owner can convert the income into tax-free income as follows:
 - (ii) The owner forms a corporation and “sells” the property to the corporation. The transaction will produce gain, but the gain would no longer be a taxable transaction.
 - (iii) The corporation receives a net of \$80,000 in profits, but it will be able to write-off the entire capital investment in the year of purchase.
 - (a) Moreover, the portion of the deduction not currently used is carried over to the following years indefinitely, and earns interest at the 3-month Treasury bill rate!
 - (iv) Assuming a net income of \$80,000 and a T-bill rate of 5.5%, no tax will be paid on this investment for 20 years and the taxpayer will receive \$1.6 million of tax-free income when the deduction (with interest on the unused portion thereof) is factored into the equation. See Exhibit “C” attached hereto.
 - (v) Once the investment becomes taxable, the property can be resold at no gain and the process can begin anew.
- (2) Of course, this example can be replicated or modified to meet all types of transactions.
- (a) The basic technique to accomplish the conversion involves triggering a tax-free capital gain and then converting the proceeds into a tax-free stream of income.
 - (b) Use of installment sales, where a highly-appreciated asset (such as real estate) is sold for a promissory note which pays principal and interest over a long period of time, will now be a completely tax-free event.
 - (i) Therefore, taxpayers could sell such assets to entities in which they control and receive a tax-free income stream.

- (a) If Congress prevents the sale to a related entity, then the taxpayer will have to sell the property to an unrelated third party, but there will be no tax on the transaction.
- e) Under the flat tax, the incentive to recharacterize income as tax-free will be irresistible and the flat tax will be quickly overwhelmed by creative and aggressive taxpayers and their advisors.

G. Audits are Still Necessary

1. AUDITS INVOLVING CHARACTERIZATION OF INCOME

- a) The flat tax's promise of a "post-card" sized tax return will not eliminate the IRS or record keeping.
 - (1) The IRS will continue to ensure compliance with the tax law, and that means audits.
 - (2) The focus of IRS audits will shift from verifying the deductions to characterization of income issues, such as the conversion from taxable income into tax-free income.
 - (3) If someone is paid \$1.00, the economic substance of the transaction is that one person received a dollar and one person paid a dollar. If the transaction can be restructured so that the person receiving the dollar receives it tax-free, then the parties will have a direct economic incentive to restructure the transaction.
- b) The government must continue to audit transactions to prevent massive fraud and a loss of tax revenue to the government.
 - (1) Wishful thinking aside, it is clear that the government will do whatever is necessary to secure its proper share of revenues under a flat tax, our revenue-hungry politicians will demand it.

H. The Flat Tax Could Cause an Economic Disaster

1. THE FLAT TAX MUST OPERATE IN THE REAL WORLD

- a) If one were forming a new country and devising an ideal tax system, the flat tax might merit consideration.
 - (1) Unfortunately, in the real world we are dealing with a \$6 trillion economy that is a tightly-woven and inter-related set of billions of on-going transactions. Changing the rules in the middle of such an economy will invite disaster.
- b) The flat tax will eliminate the mortgage interest deduction for the family home. This alone will cause the interest portion of mortgage payments to increase by 25%.
 - (1) At a 20% flat tax, an interest payment of \$1,000 would require earning \$1,250; a tax of 20% on \$1,250 = \$250, leaving \$1,000 for the interest payment.

- (a) That, in turn, will decrease the value of housing since the cost of maintaining a home will have increased 25%.
- (b) While some would argue that a decrease in the housing market will enable first-time home buyers to purchase a house, their monthly payments now will be 25% higher which might make it harder (or impossible) for them to qualify for a loan.
- (c) Also, with the tax incentive for owning a home gone, rents will increase and could drive those renters who cannot afford the higher rents onto the streets.
 - (i) Higher monthly mortgage payments could also trigger numerous defaults on mortgage loans and a collapse in the housing market.
 - (ii) Banks and Savings and Loans that have loaned large amounts to the housing market could fail if their borrowers default in large numbers — and so on.

2. REMEMBER THE TAX REFORM ACT OF 1986

- a) Actually, this scenario occurred after the Tax Reform Act of 1986. The collapse of the Savings and Loan industry occurred, in large part, because many of the major construction projects they were financing could not be sold.
 - (1) The target purchasers for many projects were limited partnerships which took advantage of the tax breaks offered for real estate investments.
 - (2) But the Tax Reform Act eliminated those tax breaks and, all of a sudden, there were no buyers for these real estate projects. The lesson is clear, massive tax reform can have sudden, unforeseen and ruinous consequences.

3. NO DEDUCTION FOR HEALTH CARE AND OTHER EMPLOYEE BENEFITS

- a) Under the flat tax, corporations would not be able to deduct health care payments or any other non-taxable fringe benefits now provided to their workers.
- b) Corporations would probably eliminate fringe benefit payments and, instantly, workers will have to scramble to pay for their own health care and other fringe benefits — with after-tax dollars.
 - (1) This is another example of a hidden tax lurking within the flat tax proposal.

I. The Flat Tax is an Absolute Gift to Investors

1. THE ULTIMATE REWARD FOR POLITICAL CONTRIBUTIONS

- a) Stripped of all its pretense, the flat tax is really a reward to the very wealthy; those people to whom the Washington politicians plead for campaign financing.
 - (1) Consider this example provided to me by one of our members: In 1994, a taxpayer received salary, dividends, interest and sold some assets for a profit. His income was \$1,100,000 and his federal income tax was approximately \$300,000.
 - (2) Under the flat tax, his income tax will fall to \$17,000! This example makes it obvious the real beneficiaries of the flat tax.
- b) Another example: Assume Bill Gates has \$5 billion of Microsoft stock and receives dividend payments of 5% on that stock.
 - (1) Under the flat tax, he will receive \$250,000,000 in tax-free dividend income and will pay less tax than a family of four earning \$50,000!

2. IT'S BETTER TO CLIP COUPONS THAN WORK

- a) The flat tax rewards those who clip interest coupons and receive dividends from their investments, and punishes those who work to support themselves and their families.
 - (1) Under a flat tax, one is far better off inheriting wealth rather than working for a living.
 - (a) Instead of surgeons performing operations and paying tax on their earnings, many will decide to become estate speculators or stock pickers, and engage in tax-free capital gain transactions.
 - (b) This happened when capital gains were taxed at a maximum of 20% compared to a 50% tax for personal service income.
 - (c) These priorities are perverse and certainly go directly against the very "work ethic" that its anti-government promoters constantly espouse.

J. You Can't Fix the System Until You Know Why It's Broken

1. THE CURRENT TAX CODE

- a) While everyone agrees that our current tax system is a convoluted mess, the flat tax or any other quick fix will never work until we deal with the causes of the tax system's complexity.
 - (1) The code is complex because the economy itself is complicated, diverse and complex.
 - (a) The same tax code taxes an individual with \$10,000 of income and General Motors with over a \$150,000,000,000 of income.

(b) There is no reason why a single tax code should attempt to tax every transaction in our economy.

(2) The current code attempts to apportion the tax burden in a fair manner — those with large incomes should pay their fair share of taxes and should not be able to subvert their duty through clever, abet legal, manipulations of the code.

(a) Consequently, there are many “defensive” provisions in the code to close loopholes and ensure that people pay their fair share of taxes.

2. THE PERVERSION OF THE LEGISLATIVE PROCESS

a) The tax code has been usurped by the Washington politicians as a tool to finance their re-election campaigns.

b) They have rewarded their special interest contributors with loopholes and tax breaks.

c) The relationship between the special interests and the legislators is symbiotic: the politicians threaten tax reform and the elimination of loopholes in order to garner campaign contributions from the special interests in return for preserving the status quo, just as the special interests lobby for increased tax breaks in the first place.

(1) The end result: campaign funds for the politicians, tax breaks for special interests, and a tax code that is incomprehensible.

(a) The influence of special interests works two ways:

(i) First, they want loopholes and are willing to contribute heavily to the campaign coffers of politicians on the tax-writing committees to get those favors.

(ii) Secondly, Congress has decreed that for each tax decrease, there must be an offsetting tax increase.

(iii) The combination of these two facts means that special interests are adding complexity to the code by first giving themselves loopholes, and then raising taxes to off-set the loophole created.

(iv) Since Congress will not raise taxes directly, the special interests tinker with the accounting provisions or penalty provisions in the code to raise the funds for their tax breaks.

(v) But those provisions burden all taxpayers and the cumulative effect of this procedure has made the tax code unworkable.

d) The failure of Congress to level with the American people when it raises tax indirectly also contributes to the current level of complexity.

- (1) Congress relies on the Treasury Department and the IRS to issue regulations and rulings that protect the tax revenue base, rather than raise taxes directly.
 - (a) So instead of a straight-forward tax increase which the American people see, the Treasury Department and the IRS crank out thousands of pages of complex regulations and rulings which accomplish the same task; confusing the public with complexity, then punishing them with tax penalties for “misinterpreting” the tax law.
 - (b) Also, the tax-writing committee staff members have jobs to protect — and complexity is a bureaucrat’s security blanket.
- e) Until campaign reform is enacted, special interests will continue to rule the day in Washington.
- f) Their efforts to secure tax breaks, while simultaneously skewering the rest of the taxpaying public by providing complex tax provisions that raise taxes to off-set their tax breaks will continue, despite passing a flat tax or any other tax measure.
 - (1) Just wait. Next year, the special interests will be back in force, undermining whatever tax proposal passed the year before.

And so it goes....

3. FIXING THE FLAT TAX PROPOSAL

- a) The fairness issue can be addressed by creating another tax bracket of 25% for incomes over \$100,000.
 - (1) By using a two-bracket approach, the fairness issue can be addressed without sacrificing simplicity to any great extent.
 - (2) All income, from whatever source, should be taxed equally. If Congress believes there is a need for a capital gains break, there should be a tax on capital gains of 15%.
- b) The mortgage interest deduction must be preserved to prevent a collapse in the housing market, even if that means adjusting the flat tax rate upwards to compensate for it. Likewise, deductions for state taxes and alimony should be retained to prevent severe disruptions and hardships in the economy.
- c) The estate and gift tax should be kept to prevent wholesale wealth transfers and the further concentration of political power and wealth by the top one percent of the population, but the tax rate might be reduced to a maximum of 25% and the unified estate and gift tax credit might be raised to \$750,000 as proposed in the current Congressional session.
- d) With these changes to the current flat tax proposal, the incentive to restructure investments to produce tax-free income and capital gains would be substantially reduced, and a flat tax might be

workable, although it will deliver far less than the politicians have promised.

Exhibits