TAX TALK

CPAS ADDRESS PRESIDENT CLINTON'S REVENUE PROPOSALS

Representatives of the accounting profession submitted written comments to the House Ways and Means Committee in April 1993 on President Clinton's Revenue Proposals. They also commented on the need for Congress to heed the analyses of groups that are directly affected by the tax law. The comments pointed out that accountants practice in all sizes of firms and represent all types of clients in planning their business transactions and in calculating their tax liabilities. As a result, accountants are able to provide enormous insight into the likely behavior of business and individual taxpayers in response to proposed changes in the tax law.

The Clinton Proposals

The accountants made observations on the specifics of the proposals.

Simplification of the Tax Law. The accountants made a plea for simplicity. Any tax law changes that are enacted this year should be drafted to be as simple as possible. Unless people understand the tax law and feel that it is reasonable and fair, many may begin to perceive that fully complying with it is not worth the effort.

Every time there have been tax law changes enacted in recent years, these changes have been referred to as "Accountants' and Lawyers' Relief Acts." While this generates chuckles and more than a few nods of agreement from the clients of tax professionals who are forced to pay increased fees, the reality is that the increased complexity of the tax law and the pace of the change have enormously eroded the profitability of most tax practices. The accountants noted that each tax law change requires many hours of tax staff training and of revising tax practice procedures. Additionally, in recent years many tax changes have not necessarily been grounded in sound tax policy. Rather they have been the means of achieving revenue neutrality without government's being forced into admitting a tax rate increase was necessary.

Complexity takes its toll at the IRS level as well. Given the limited resources of the IRS to audit returns, the government's interests are served by less complexity. In short, complexity carries a real cost to the tax system through lower levels of compliance by taxpayers (inadvertent and illegal) combined with the inability of government (through lack of resources) to provide adequate monitoring.

"Back-Door" Revenue Raising. Agreement was expressed with the Administration's objectives of fostering public investment and achieving deficit reduction, which may require tax rate increases. The maximum tax rates were probably reduced too much in 1986, since spending was not correspondingly reduced, resulting in the mushrooming of the deficit.

However, Congress was urged to keep in mind that many deductions were eliminated or capped in 1986, thereby substantially diminishing the benefit of the tax rate cuts for many middle income Americans in particular. Eliminating deductions generally serves to simplify the tax code, an end which is commendable. However, eliminating deductions for taxpayers who have made investment decisions, at least partly hinging on the tax law, serves to erode taxpayers' trust in the tax law and their respect for it. Thus, the imposition of the passive loss rules (albeit on a phased-in basis) on taxpayers who were able to afford the investment in certain pieces of real estate only because of the tax benefits these properties provided, permanently harmed many of these Americans economically. There have been numerous personal bankruptcies, as well as business failures, as a result of the 1986 tax law changes. The goal of eliminating tax shelters was a laudable one, but it should have been achieved in a more gradual fashion, in order to cause less economic pain. In the future, any tax legislation should seek to avoid such economic disruption by only applying to prospective transactions.

Furthermore, said the accountants, rather than putting limits on deductions that are otherwise allowable under the tax code, Congress should be more honest with the American people and, if more revenue is really a necessity, raise the tax rates. For example, rather than imposing a 10% surtax on individual taxable incomes grater than $250,000, put a 40% (or 39.6%) bracket in Section 1 of the Code. Instead of making permanent the personal exemption phaseout and the 3% limitation on itemized deductions, recognize that this is a back-door marginal tax increase on individuals at particular levels of income, and translate that into a direct increase that would affect that approximate group.

This makes the tax code much easier to work with and it gives taxpayers a clearer picture of the true rate of tax they are paying.

A Value Added Tax. As for considering some type of value added tax, Congress should recognize that while it may be a relatively painless way to raise vast amounts of money while leaving income tax rates untouched, it becomes an easy way to hide the tax bite being taken. Congress would be able to point with pride to the fact that it had not fiddled with the income tax rates—or was perhaps even able to lower them. However, imposition of such a new and regressive tax would create a vast new bureaucracy which would be expensive to establish and maintain. Furthermore, once such a taxing scheme is in place, it would become as easy to raise its rates as it was in the early days of the income tax, so that soon the U.S. VAT rate could approach that of Great Britain. Instead of providing a new form of temptation for increasing spending, Congress should start making hard choices under our current system as to where spending cuts can be made and programs curtailed.

Geographical Discrepancies. The accountants reminded Congress that different geographical areas in the United States mandate very different income levels to maintain a comparable standard of living. There are at least two ways the tax law could address this problem. Income cutoffs for imposing maximum tax rates could be set at a relatively high level so that residents of New York City, Los Angeles, and San Francisco, who are truly no more than middle income when the cost of living in those cities is taken into account, do not end up paying the highest tax rates that are intended to apply to the truly wealthy. On the other hand, cost of living differentials could be built into the tax rate structure for certain high cost urban areas. The IRS currently manages to accomplish this result in the travel expense per diem allowances it provides. Such a solution does not seem overly complex since the taxpayer would only be required to look at one rate table, even if several existed, and the one to be used could be determined by where the State and City return, if any, were filed.

Fostering Small Manufacturers. Many of President Clinton's proposals seem designed to foster a segment of the American economy which may not be the most fruitful target for stimulation. They seem to be geared primarily at encouraging small manufacturing enterprises. Once upon a time America had a number of small, "mom and pop" manufacturing concerns. They were located throughout many American communities.

However, in recent years, service businesses and large manufacturing conglomerates have dominated the economy. Many international competitors are huge undertakings benefiting from government subsidies and the economies of scale of large conglomerates—as well as benefiting from the cost savings available to multi-national operations. It may well be impractical for a primary target of stimulation of the American tax law to be new small manufacturing enterprises, which, in today's global economy, can be inefficient and noncompetitive. Small manufacturing should be encouraged, but it is unrealistic to think that this stimulus alone can reverse the decline in the country's economic fortunes.

Other Provisions. The accountants also commented on the effective dates of the proposals. Some call for retroactive dates that may create unnecessary administrative and compliance burdens for the IRS, taxpayers, and tax professionals. For example, extension of the research and experimentation credit is proposed to be retroactive to June 30, 1992. Implementing this provision will require many businesses to file amended returns and the IRS to process refund claims.

Another problem the accountants foresee relates to implementation of rate changes as of January 1, 1993, without a corresponding change in withholding tables. A negative impression of the tax system may result when taxpayers in April of 1994 see the full impact of higher rates without a corresponding increase in amounts that have been withheld. This becomes especially important as the legislative process moves further into the year. At some point the accountants felt that prospective application of rate increases should be seriously considered.

The accountants also expressed concern about proposals that raise the standard for accuracy-related and preparer penalties and grant capital gains incentives to small business.

History—the 1986 Tax Reform Act

In a similar role in 1985, accountants in commenting on President Reagan's tax proposals for "Fairness, Growth and Simplicity", expressed the fear, "Average taxpayers will be bombarded with stories of the large tax savings of the wealthy, compared with their minor savings under the President's plan." They went on to state, "The use of the Tax Code to achieve economic and social aims has strongly influenced the structures of business and of investment patterns in this country....Repeal of current incentives will disturb these structures, perhaps seriously." The analysis listed those individuals and entities whose activities would face at least some disruption. Included in this list were—

- Real estate syndicators, mortgage bankers, builders and others aided by various real estate incentives;
- State and local governments forced to find new sources of revenue or make hard choices concerning decreased services;
- Capital intensive industries dependent on ACRS and the investment credit; and
- Banks, insurance companies, and other entities whose operations could be profoundly affected by the proposals.

The profession is justified in feeling that its comments concerning the 1985 tax proposals were on the mark in many instances and that much of the negative effect of the 1985 proposals might have been avoided had they been recrafted to take into consideration analyses such as this. Many believe the decline in the real estate market can be attributed in large measure to the changes in the passive loss rules enacted in 1986. In turn, this decline in real estate seems to have led to financial difficulties in the savings and loan and insurance industries. It is possible that much of our economic slump over the last few years may be traceable to the 1986 tax law changes.

A Word to the Wise

Members of accounting organizations have extensive experience in working with tax laws and grappling with their complexities. Hopefully testimony before Congressional committees on the proposals will be taken into account when the final legislation is drafted. Both the U.S. Treasury and taxpayers will benefit. ❑

IRS IMPROVES ITS IMAGE

The IRS has 30 tons of microfilm files, important to providing lost or incomplete information for taxpayers. Each year 22,000 new rolls are added to the files containing eight billion records.

Managing this amount of information is no easy task. The IRS's Wage Information Retrieval System (WIRS) in Latham, NY, can now locate a single form in the eight billion using "Imagelink," a digital imaging system developed by Kodak. WIRS retrieves information from 26 million records each year.

Imagelink scans the microfilm, converts the file to a digital image, and from there, the user has a number of options. According to Terence K. Neary, chief of resources management for the IRS, "You can send that image to a local or remote laser printer, to a fax machine, to a floppy disk, or to a networked PC."

The IRS created WIRS in an effort to provide taxpayers with copies of W-2 and W-3 forms. Today the system does much more. It can match unpostable records, reconcile IRS master files with returns filed by employers, and provide needed information to government agencies.

The quality of the reproduced documents has improved as well. With an image of a document, a user can electronically "clean" the document. Carol Gagliardi, head of WIRS said, "Print quality is superior to anything we've had before...when you request a copy of your Form W-2, you want to be able to read it." ❑