



## Ruminations on the Tax Code

Ideally, taxes should exist solely to raise revenue to fund appropriate functions of government. When the code is used to reward or penalize particular behavior or groups, it becomes the tangled mess we have today. I am sure others, much smarter than I, have come up with approaches to how the code should be structured, but I have been thinking about this and thought you might find my thoughts useful.

Adam Smith in the *Wealth of Nations* gave four principles for taxation (emphasis mine):

- I. **The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state.** The expense of government to the individuals of a great nation is like the expense of management to the joint tenants of a great estate, who are all obliged to contribute in proportion to their respective interests in the estate. In the observation or neglect of this maxim consists what is called the equality or inequality of taxation. Every tax, it must be observed once for all, which falls finally upon one only of the three sorts of revenue above mentioned, is necessarily unequal in so far as it does not affect the other two. In the following examination of different taxes I shall seldom take much further notice of this sort of inequality, but shall, in most cases, confine my observations to that inequality which is occasioned by a particular tax falling unequally even upon that particular sort of private revenue which is affected by it.
- II. **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 all 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-gathered, 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 favours 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.
- 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.** A tax upon the rent of land or of houses, payable at the same term at which such rents are usually paid, is levied at the time when it is most likely to be convenient for the contributor to pay; or, when he is most likely to have wherewithal to pay. Taxes upon such consumable goods as are articles of luxury are all finally paid by the consumer, and generally in a manner that is very convenient for him. He pays them by little and little, as he has occasion to buy the goods. As he is at liberty, too, either to buy, or not to buy, as he pleases, it must be his own fault if he ever suffers any considerable inconveniency from such taxes.

IV. **Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the state.** A tax may either take out or keep out of the pockets of the people a great deal more than it brings into the public treasury, in the four following ways. First, the levying of it may require a great number of officers, whose salaries may eat up the greater part of the produce of the tax, and whose perquisites may impose another additional tax upon the people. Secondly, it may obstruct the industry the people, and discourage them from applying to certain branches of business which might give maintenance and unemployment to great multitudes. While it obliges the people to pay, it may thus diminish, or perhaps destroy, some of the funds which might enable them more easily to do so. Thirdly, by the forfeitures and other penalties which those unfortunate individuals incur who attempt unsuccessfully to evade the tax, it may frequently ruin them, and thereby put an end to the benefit which the community might have received from the employment of their capitals. An injudicious tax offers a great temptation to smuggling. But the penalties of smuggling must rise in proportion to the temptation. The law, contrary to all the ordinary principles of justice, first creates the temptation, and then punishes those who yield to it; and it commonly enhances the punishment, too, in proportion to the very circumstance which ought certainly to alleviate it, the temptation to commit the crime. Fourthly, by subjecting the people to the frequent visits and the odious examination of the tax-gatherers, it may expose them to much unnecessary trouble, vexation, and oppression; and though vexation is not, strictly speaking, expense, it is certainly equivalent to the expense at which every man would be willing to redeem himself from it. It is in some one or other of these four different ways that taxes are frequently so much more burdensome to the people than they are beneficial to the sovereign.

Similarly, the American Society of CPAs has promulgated ten guiding principles of good tax policy:

**Equity and fairness.** Similarly situated taxpayers should be taxed similarly. This includes horizontal equity (taxpayers with equal ability to pay should pay the same amount of taxes) and vertical equity (taxpayers with a greater ability to pay should pay more taxes).

**Certainty.** Tax rules should clearly specify when and how a tax is to be paid and how the amount will be determined. Certainty may be viewed as the level of confidence a person has that a tax is being calculated correctly.

**Convenience of payment.** A tax should be due at a time or in a manner most likely to be convenient to the taxpayer. Convenience helps ensure compliance. The appropriate payment mechanism depends on the amount of the liability, and how easy (or difficult) it is to collect. Those applying this principle should focus on whether to collect the tax from a manufacturer, wholesaler, retailer or customer.

**Economy of calculation.** The costs to collect a tax should be kept to a minimum for both the government and the taxpayer.

**Simplicity.** Taxpayers should be able to understand the rules and comply with them correctly and in a cost-efficient manner. A simple tax system better enables taxpayers to understand the tax consequences of their actual and planned transactions, reduces errors and increases respect for that system.

**Neutrality.** The tax law's effect on a taxpayer's decision whether or how to carry out a particular transaction should be kept to a minimum. A tax system's primary purpose is to raise revenue, not change behavior.

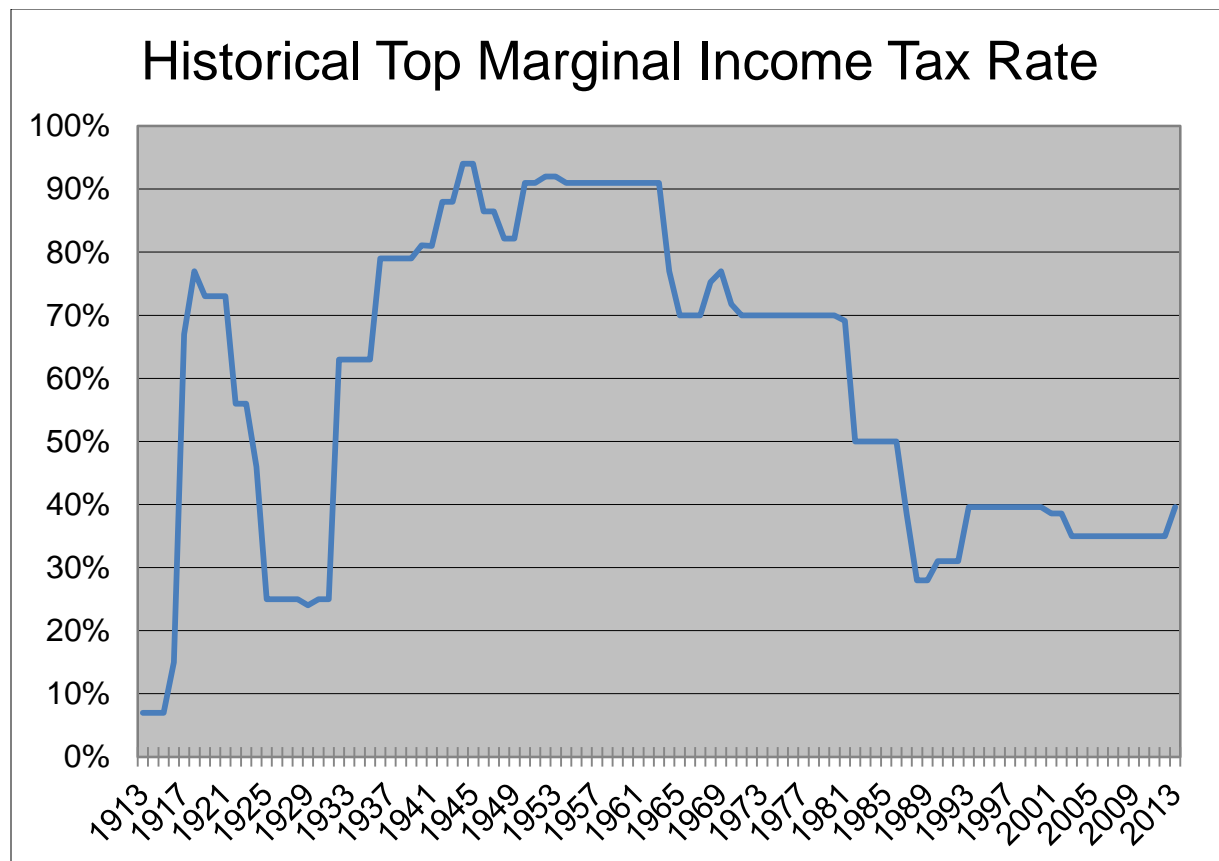
**Economic growth and efficiency.** A tax system should not impede productivity but should be aligned with the taxing jurisdiction's economic goals. The system should not favor one industry or type of investment at the expense of others.

**Transparency and visibility.** Taxpayers should know that a tax exists, and how and when it is imposed on them and others. Taxpayers should be able to easily determine the true cost of transactions and when a tax is being assessed or paid, and on whom.

**Minimum tax gap.** A tax should be structured to minimize noncompliance. The tax gap is the amount of tax owed less the amount collected. To gain an acceptable level of compliance, rules are needed. However, a balance must be struck between the desired level of compliance and the tax system's costs of enforcement and level of intrusiveness.

**Appropriate government revenues.** A tax system should enable the government to determine how much tax revenue it likely will collect and when—that is, the system should have some level of predictability and reliability.

Obviously our current tax code bears little resemblance to one that would be ideal, but in some respects it has gotten better. A lower tax rate on a broader base (i.e. few "loopholes") is a better tax system and we have been doing that to some respect over time:



Following are my thoughts on the current tax code and how it might be improved:

- 1) All taxes should be paid directly by each individual so that each person is aware of his true tax burden. Tariffs, Value Added Taxes (VAT), corporate taxes, etc. all obfuscate the actual burden of the tax. For example, when a corporation is taxed, there are only three possible sources for those funds: a stockholder receives lower dividends, an employee receives lower wages, or a consumer pays higher prices. Further, the current code encourages debt by making it tax deductible to corporations when dividends are not. Eliminating corporate taxes removes this disparity in treatment.
- 2) Taxes on expatriates should be simplified. The U.S. is the only developed country that taxes its citizens on worldwide income even if they are not residing in the U.S. This is done through a complicated system that forces people to plan so they don't spend "too many" days in the U.S. in a particular year. This should be replaced with a simple calculation:  $(\text{worldwide income for the year}) \times (\# \text{ of days in the U.S. or its territories during the year}) / 365 = \text{U.S. taxable income}$ .
- 3) Personal exemptions should be eliminated. Additional people are a drain on government resources and shouldn't be subsidized. Family size isn't a proper area of concern for Congress to attempt to influence through the tax code, and child tax and adoption credits should be eliminated as well. It is unfair to force the childless to subsidize those who choose to have children.
- 4) Mortgage interest deductions should be eliminated. The current system of allowing mortgage interest to be deducted is confused for three reasons: 1) why should the government favor buying over renting? This simply makes no sense, especially since renting is more advantageous for lower income people. 2) Since the mortgage interest is a deduction, the subsidy is greater for high income people. Indeed, the subsidy is non-existent for people who don't itemize (largely the poor, again). 3) The deduction is only available for those who incur debt. Again, the tax code irrationally encourages leverage.
- 5) Deductions for state and local taxes (sales taxes, income taxes, property taxes, etc.) should be eliminated. Allowing deductions for these taxes effectively shifts those taxes to taxpayers in other states.
- 6) Social Security taxes should be eliminated. This would remove the fiction that people somehow have a pension in Social Security. In reality, Social Security is a socially acceptable welfare system in which money is taken from people who are working and given to people who aren't working. Folding it into the regular tax system would clarify that. To alleviate the concern that people would be unprepared for retirement, they could be required to save a certain portion of their income in a designated account and those accounts could be restricted to investing in treasury bonds. This has the added advantage of funding the transition from traditional Social Security if older participants are kept in the old system.
- 7) Medicare taxes should be eliminated. Taxing earned income to fund Medicare gives those with unearned income a free ride and again complicates the tax code. In addition, the "sharing" of Medicare (and Social Security) taxes with the employer leads to concealing the true cost.

- 8) Deductions, in general, should be eliminated in favor of tax credits. If a person in a 40% bracket wants to donate (net) \$300 to what he considers a worthy cause, the charity can get \$500. (The individual donates \$500 and gets 40% or \$200 back on his taxes). If a person in a 20% bracket wants to donate \$300 (again net) to a charity, the charity would get \$375. (The individual donates \$375 and gets 20% or \$75 back on his taxes.) Why should higher income individuals' charitable choices get a larger subsidy than lower income individuals' choices? This holds true for other deductions as well. Assuming the taxpayer has high enough medical expenses to claim them at all, each additional dollar of expense is more subsidized by the tax code for high income (tax bracket) people than it is for lower income (and tax bracket) people.
- 9) Almost everyone should have "skin in the game" and be paying something in taxes. Allowing approximately half the population to avoid all income taxes (though not FICA taxes) and yet still vote will eventually cause societal breakdown.
- 10) Graduated tax rates cause inequities, and should be eliminated. Absent a flat tax or taxation of individuals instead of families, there is no way to arrange the tax code to not penalize some group for decisions about marriage.
- 11) Capital gains taxes at different rates from ordinary income cause gaming of the system and should be eliminated. A business owner can do three things with profit: 1) take it out in salary, 2) take it out in dividends, or 3) allow it to increase the value of the company and sell it later taking the profits out as a capital gain. Having disparate tax treatments for those three items leads to incentives to structure things in different ways which, in turn, leads the IRS to try to combat that restructuring giving rise to costs and tax disputes. Having the same rates for everything removes the incentives completely. It then doesn't matter *how* the individual is paid. (This is another reason to remove the payroll taxes as mentioned above.)
- 12) Estate taxes should be eliminated, however recipients of large gifts or inheritances should have to include them on their income tax returns as ordinary taxable income if it is not a capital asset and have a basis set to zero if it is.

So, in light of the above, following is my modest proposal for a complete overhaul of the tax code. It has the advantages of being simple, fair, transparent, etc. The percentages given below are what seem roughly appropriate to me.

- 1) Taxpayers are taxed on "all income from whatever source derived" on a cash basis. This is what we have now. In addition, there should be 100% expensing for capital investments and no limit on recognizing capital losses (which also may be carried forward if necessary).
- 2) Taxes are assessed on that net income at a flat 20% rate.
- 3) Non-refundable credits against that tax are given for a very few items:
  - a. 50% credit for medical expenses paid (for anyone). This gets the government out of the healthcare business while helping those with legitimate needs. This seems reasonable if we consider Rawls' "veil of ignorance" approach (i.e. you don't know whether you will be the unfortunate one with high medical expenses).
  - b. 50% credit for charitable contributions made. This is to enable private charities to supplant the government assistance that exists now. Charity would become directed by private individuals to what they perceive to be the real needs.

- c. 20% credit for education expenses paid (for anyone at any level). Education has societal benefits that “spill over” and is thus an externality that should be subsidized.
  - d. 20% credit for savings in accounts for retirement. However, these would be fully taxed upon withdrawal (essentially like the IRAs of today). These accounts could also be used for medical expenses or education expenses, but those expenses would not get the additional credit mentioned above.
- 4) Unused credits may be carried back 5 years and forward indefinitely.

That’s it. Simple and straightforward. The definitions of medical expenses, charitable contributions, educational expenses, etc. would be the same as they are currently. Many families at lower income levels still wouldn’t pay taxes and no one would pay more than 20%. Education, healthcare, charity, and retirement savings are all privatized enabling the government to easily fulfill its proper functions with the remaining revenue.

**Notes:**

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