A TAX PROFESSIONAL FOR TAX REFORM

BY ROBERT D FLACH
THE INTERNET'S "WANDERING TAX PRO"

I am a tax professional who has been preparing Form 1040s for individuals in all walks of life since February of 1972. I know full well that the United States Tax Code has grown into a complicated and convoluted "mucking fess". The major reason for tax return errors, by both paid tax preparers and taxpayers who "self-prepare", is the excessive complexity of the Tax Code.

MY PRINCIPLES OF TAX REFORM

I believe -

- The current US Tax Code should be totally rewritten.

- The one and only purpose of the Tax Code is to raise the money necessary to fund the government.

The new Tax Code must –

(1) Be simple – easy for everyone to understand. Simplicity for simplicity's sake.

(2) Be fair and equitable - treat all taxpayers equally.

(3) Be consistent – treat specific conditions, situations, and activities, and maintain specific definitions and descriptions, the same in all instances.

(4) Encourage savings, investment, and growth.

(5) Index for inflation all allowable deductions and credits.

The new Tax Code must **not** –

(1) Be used for social engineering, to redistribute income or wealth, or to deliver social welfare and other government benefits.

(2) Encourage or discourage certain economic decisions (other than savings, investment, and growth), or provide exclusive benefits for specific industries, business activities, or classes of taxpayers.

(3) Contain any refundable credits, or any phase-outs, exclusions or adjustments based on Adjusted Gross Income or Modified Adjusted Gross Income.

(4) Contain any "alternative" tax calculation systems (such as the current "Alternative Minimum Tax").

(5) Contain any temporary deductions, credits, benefits, or provisions.

THE TAX FOUNDATION'S PRINCIPLES OF SOUND TAX POLICY

As a nonpartisan, educational organization, the **Tax Foundation** has earned a reputation for independence and credibility. All Tax Foundation research is guided by the principles of sound tax policy, which should serve as touchstones for policymakers and taxpayers everywhere.

The FOUNDATION has identified 6 components of a sound tax policy, which I support-

1. **Simplicity**: Administrative costs are a loss to society, and complicated taxation undermines voluntary compliance by creating incentives to shelter and disguise income.

2. **Transparency**: Tax legislation should be based on sound legislative procedures and careful analysis. A good tax system requires that taxpayers be informed and understand how tax assessment, collection, and compliance works. There should be open hearings, and revenue estimates should be fully explained and replicable.

3. **Neutrality**: Taxes should not encourage or discourage certain economic decisions. The purpose of taxes is to raise needed revenue, not to favor or punish specific industries, activities, and products.

4. **Stability**: When tax laws are in constant flux, long-range financial planning is difficult. Lawmakers should avoid enacting temporary tax laws, including tax holidays and amnesties.

5. **No Retroactivity**: As a corollary to the principle of stability, taxpayers should be able to rely with confidence on the law as it exists when contracts are signed and transactions are completed.

6. **Broad Bases and Low Rates**: As a corollary to the principle of neutrality, lawmakers should avoid enacting targeted deductions, credits, and exclusions. If tax preferences are kept to a minimum, substantial revenue can be raised with low tax rates. Broad-based taxes also produce relatively stable tax revenues from year to year.

Put simply, good tax policy promotes economic growth by focusing on raising revenue in the least distortive manner possible.

A BETTER WAY

One of the biggest problems with the current system, and a large source of its complexity, is the erroneous use of the tax return to deliver government benefits. The Internal Revenue Service, and the tax professional community, should not be required to act as Social Workers and administer and verify government program benefit payments. This practice is not only inappropriate, but it also invites and encourages tax fraud.

I am not saying the government shouldn’t provide financial assistance to the working poor and college students, provide encouragements for purchasing health insurance, making energy-saving purchases and improvements and other ‘worthy’ actions. What I am saying is that such assistance and encouragements should not be distributed via the Form 1040.

The benefits provided by the Earned Income Tax Credit and the refundable Child Tax Credit should be distributed via existing federal welfare programs for Aid to Families with Dependent Children. The benefits provided by the education tax credits and deduction for tuition and fees should be distributed via existing federal programs for providing direct student financial aid. The benefits provided by the Premium Tax

Credit, the energy credits, and other such personal and business credits should be distributed via direct discount payments to the appropriate vendors or direct rebate programs, similar to the successful Cash for Clunkers program of a few years ago, funded by the budget of the appropriate Cabinet departments.

Distributing the benefits in this manner is much better than the current method for many reasons:

1. It would be easier for the government to verify that the recipient of the subsidy, discount or rebate actually qualified for the money, greatly reducing fraud. And tax preparers, and the IRS, would no longer need to take on the added responsibility of having to verify that a person qualifies for government benefits.

2. The qualifying individuals would get the money at the "point of purchase," when it is really needed, and not have to go "out of pocket" up front and wait to be reimbursed when they file their tax return.

3. We would be able to calculate the true income tax burden of individuals. Many of the current "47 percent" would still be receiving government benefits, but it would not be done through the income tax system, so they would actually be paying federal income tax.

4. We could measure the true cost of education, housing, health, energy and welfare programs in the federal budget because benefit payments would be properly allocated to the appropriate departments.

GEOGRAPHIC EQUALITY

I support keeping the itemized tax deductions for state and local income taxes and real estate taxes and "acquisition debt" mortgage interest on the primary personal residence.

The Internal Revenue Code taxes Americans based on income measured in pure dollars. However it is a fact that the "value" of one's level of income differs, sometimes greatly, based on one's geographical location. A family living in the northeast or California that has an income of $150,000 may be just getting by, while a similar family that resides in "middle America" lives like royalty on $150,000. Many components of the Tax Code are indexed for inflation, but nothing is indexed for geography. To be honest I have no idea how one would even begin to index for geography.

It costs an awful lot to live in states like California, Connecticut, Massachusetts, New Jersey and New York. State and local income and property taxes are the highest in the country in these states. The cost of real estate is also excessively high. As a result one must earn a lot more money to be able to live in these states – and salaries are arbitrarily increased to reflect the increased cost of living. Yet $150,000 in income is taxed by the federal government at the same rate in New York City as it is in Hope, Arkansas.

State and local income taxes, local property taxes, and the cost of a primary residence, and therefore also the amount of "acquisition debt" mortgage interest paid on the property, are higher in the Northeast, and California. Since we pay taxes on “net income” after deductions, allowing an itemized deduction for these items would help to somewhat geographically “equalize” the tax burden.

DEPRECIATION OF REAL PROPERTY

I would do away with the deduction for depreciation of real estate, including capital improvements to real estate, on individual and business income tax returns. The Tax Code should not permit a deduction for the depreciation of real property or capital improvements thereto on Schedule C, Schedule E, or Schedule F of Form 1040, Form 1041, Form 1065, Form 1120, or Form 1120-S.

According to the IRS, depreciation is “*an income tax deduction that allows a taxpayer to recover the cost or other basis of certain property. It is an annual allowance for the wear and tear, deterioration, or obsolescence of the property*”.

Let us look at depreciation from the point of view of the Income Statement of a business or rental activity. Basically, if you purchase an asset (i.e. equipment, a vehicle, or real estate) that will last more than one year you spread the cost of the asset over its “useful life”. You purchase a new computer. You certainly do not purchase a new computer each year – you expect that it will continue to provide service for several years. So you divide the cost of the computer over a period of years to reflect this fact, and to properly report the “economic reality” of the purchase.

If you deducted the full cost of the computer in the year of purchase this would distort the true cost of doing business. Since you generally purchase a new computer every five years, deducting the cost over a five year period “more better” represents the cost of operations. Thus depreciation is used to “*recover the cost or other basis of certain property*”.

Another way to look at depreciation is from the Balance Sheet perspective. When you purchase an asset that asset has value to you. You trade the asset of cash for the asset of a computer. If you sold your business the value of the computer would be included in the value of the business. As an asset ages its value drops. A two-year old computer does not have the same value in the market as a comparable brand new computer. Depreciation is used to reflect the drop in value of the asset. Thus depreciation is used to reflect the “*wear and tear, deterioration, or obsolescence of the property.*”

If we look at economic reality, a building has a life of much more than the 27.5 or 39 years over which depreciation is currently allowed. The building I lived in several years ago was 100 years old at the time, and is still going strong. And, for the most part, the value of real estate does not drop in value over the years. If properly maintained its value will generally increase. My parents purchased their first home for $13,000 and sold it many years later for $75,000 (and they were robbed).

Granted real estate values can go down due to market conditions. But this is the exception and not the rule.

For all intents and purposes, in most cases real estate does not “depreciate”. You do not replace a building every few years because it no longer provides the same service or function. And the value of real estate as a component of the value of a business does not drop as it ages. So why should we allow a tax deduction for the depreciation of real estate?

An added benefit - by doing away with the depreciation of real property taxpayers would no longer have to deal with the “recapture” depreciation when the property is sold, which would greatly simplify the process.

DEDUCTING BUSINESS USE OF A PERSONAL AUTO

I support a change to the rules for deducting business use of a personal automobile – which would apply to both employee business expenses and Schedules C, E and F – to more honestly reflect the true economic cost of business auto use.

For the most part taxpayers who use their car for business, other than commuting, would own a car whether or not one was needed for business. The business use, however extensive, is basically secondary to personal use.

I own a car. I have always owned a car. Although a large percentage of my current driving is business related (because since I work out of a home office I have no “commute”), I own the car primarily for personal and not business reasons, and would own a car whether it was needed for business or not.

Currently the standard mileage rate for business is calculated using an annual study of fixed and variable costs of operating an automobile - including depreciation, insurance, repairs and maintenance, tires, and gas and oil. The rate for medical and moving purposes is based only on the base variable costs, like gas and oil.

But because the main reason for purchasing a car is personal and not business, depreciating the cost of purchasing the car, based on business use, is not really a true business expense. Only the business use percentage of actual operating expenses should be allowed as a deduction – because the more miles you drive the more you spend for gas, oil, repairs and maintenance, tires, and probably insurance.

The 2016 business standard mileage rate of 54 cents per mile includes 24 cents allocated to depreciation. Under my change if you use your car for business, either as an employee or a self-employed individual, the standard mileage allowance for business miles would not include a component for depreciation. So, using the 2016 rate as an example, business standard mileage allowance would be 30 cents per mile and not 54 cents.

I also believe the standard mileage allowance for driving related to volunteer work for a church or charity should be the same as the rate for medical and moving driving, and adjusted up or down annually based on the study of actual costs. Currently the 14 cents per mile standard mileage allowance for charitable driving is set by Congress and hasn’t changed since 1998.

Taxpayers using their car for business would continue to have the option of using the appropriate business use percentage or actual expenses, but without depreciation. Those who lease a car and use it for business could also use the standard mileage allowance or actual expenses, but this deduction would not include the monthly lease payment.

In the case of motor vehicles used 100% in a business – trucks, vans, limos, cars that are leased out to others (including one's corporation) or used exclusively by couriers or for deliveries – a deduction will be allowed for 100% of the actual costs of maintaining and operating the vehicle, including depreciation. The standard mileage allowance would not be allowed.

FILING STATUS

I believe that the US Tax Code should create neither a "marriage tax penalty" nor a "marriage tax benefit".

Currently there are 5 choices for a return's filing status, each with its own rules and regulations and tax rate schedule –

1. Single
2. Married Filing Joint
3. Married Filing Separately
4. Head of Household
5. Qualifying Widow(er)

I would reduce this to 3 –

1. Single
2. Married Filing Joint
3. Married Filing Separately

The Married Filing Separately status would permit a married couple, whether living together or not, to elect to file as if they were two Single taxpayers. All of the exclusions from income, deductions and credits that are available to a Single filer would be available to the Married Filing Separate status in the same way. The Tax Rate Schedule (and Tax Table) for Married Filing Separately would be exactly the same as that for Single.

There would be a special 2-columned 1040 and 1040A form that would allow both spouses to file separately on one return. The couple would still choose to file separately on two separately filed returns.

The Married Filing Joint status would provide for double of everything available to the Single status. For example, if, as under current law, a Single filer can deduct up to $3,000 in net capital losses per year, a married couple filing jointly would be able to deduct up to $6,000. The standard deduction for Married Filing Joint would be twice that for Single, as it currently is. It would be as if the separate incomes and deductions allowed on the new 2-column 1040 for separate filers were combined in one column.

I like the idea of having only one Tax Rate Schedule (and Tax Table) for all taxpayers, regardless of filing status. In the case of a Married Filing Joint return the net taxable income could be divided in half, the tax determined from either table or rate schedule on this half of the combined income, and the tax multiplied by two.

John and Jane Q Taxpayer file a joint return. The net taxable income on the return is $100,000. The tax is taken from the tables is based on $50,000 of income. If the tax on $50,000 is $5,000, then the tax liability on the joint return is $10,000 (the 10% tax rate on this level of income is used only as an example for simplicity).

TAXING BUSINESS ACTIVITY

I would do away with all business tax "loopholes" and "preferences" for specific industries and activities, taxing business activity, regardless of how organized, on net book income. As discussed above, no deduction would be allowed for the depreciation of real property or capital improvements thereto.

I would allow a special "dividends paid" deduction for regular "C" corporations. If net book income was $1 Million and the corporation paid out $800,000 in dividends to shareholders tax would be assessed on only $200,000. This would do away with the "double-taxation" of corporate dividends.

The corporate dividends paid out to shareholders would be taxed at "ordinary income" rates on the recipients' Form 1040 (or 1040A) – there would be no special tax rate for "qualified" corporate dividends.

The top corporate income tax rate would be the same as the top individual income tax rate, which would certainly be mess, perhaps more so, than the current 39.6%.

WON'T TAX SIMPLIFICATION HURT MY BUSINESS?

Some people may wonder why a tax professional is calling for a simpler tax system. Does not each new tax law, and each complexity added to the code, put money in our pockets? Is not a more confusing Tax Code better for business?

I truly believe that a much simpler tax system would not hurt our business. I sincerely believe that if I did nothing but 1040As all day during the tax season I would make more money, experience less agita, and substantially reduce the number of GD extensions needed.

Most clients would not decide to do their own returns if the tax system was simplified; they would continue to come to us. Most taxpayers who use a tax professional simply don't want to be bothered with the task of preparing their tax return, and want to make sure they do not miss anything.

And even with a more simplified tax system there would still be a need to complete Schedules C, D, E, F, SE and related forms.

Your thoughts and comments on my tax reform proposals I have are welcomed and solicited. You can email me at **rdftaxpro@yahoo.com** with "Tax Reform Comments" in the subject line.

LET ME HELP YOU TO EXPERIENCE THE JOY OF AVOIDING TAXES

ROBERT D FLACH'S 1040 INSIGHTS

My name is Robert D Flach. I have been preparing 1040s for individuals in all walks of life since February of 1972, and writing the popular tax blog THE WANDERING TAX PRO since the summer of 2001.

This new newsletter, published 5 times a year - May, July, September, November, and January - will share in detail my insights on tax deductions, credits, strategies, and issues based on my 45 years in "the business".

A one-year subscription to ROBERT D FLACH'S 1040 INSIGHTS is **only $11.95** delivered as a pdf email attachment. A print edition sent via postal mail is available for **only $17.95**. One tip from an issue could return the cost of a subscription many times over.

This newsletter is not written for the "wealthy" – but for the average middle to upper-middle class taxpayer.

The first issue – May 2017 – discusses in detail **everything you need to know about deducting charitable contributions and taking a tax deductible vacation**, and explains **how long to keep tax records and when to contact your tax professional**.

I will send you a sample copy of the May 2017 issue for **only $1.00** - $2.00 for the print edition. If after reading the issue you decide to subscribe we will apply the $1.00 or $2.00 to the cost – so you pay only $10.95 or $15.95.

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