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H.R. 11 — R.I.P., REALLY!

H.R. 11 (The Revenue Act of 1992) illustrates the violence that so-called revenue neutrality does to tax policy. Top priority in tax policy should go to removing tax barriers to economic progress. The revenue raising provisions in both the House and Senate versions of H.R. 11 move in precisely the opposite direction.

The House and Senate versions of H.R. 11 (The Revenue Act of 1992) differ in their revenue raising provisions. The Senate bill is roughly twice as large, in terms of both its revenue raising and revenue losing features. The Joint Committee On Taxation (JCT) scores the tax hikes in the Senate version at $34 billion for the five year period 1993-1997 versus $17 billion for the House version over the same period.

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The only coherent theme running through the two versions' revenue raisers is that they seem either to be largely hidden from voters by their technical nature or else to target politically vulnerable groups of taxpayers. They would not simplify the tax code; most of them would add to its complexity. They would not lessen inefficiency-causing tax biases against various activities but, on the contrary, generally raise them. Instead of being in accord with principles of sound taxation, most of the proposed tax hikes seem arbitrary and capricious and would violate good tax principles. The proposed increases range across the tax code with no discernable connection to each other. The Senate bill has more objectionable provisions than the House plan because it is larger.

Why Tax Hikes Do Not Belong In H.R. 11

The Conference Committee appointed to reconcile the two versions of H.R. 11 will need to examine a long list of provisions. Although the legislation is often passed off as an urban aid tax bill, it is actually wide ranging and large; the overwhelming majority of H.R. 11 has nothing to do with urban aid.

Many of the provisions under consideration are revenue raisers. The Conference Committee should reject most of them. In general, the revenue raisers in both versions of H.R. 11 are complicated and arbitrary. Many of them would worsen tax biases against saving and investment. Some would discourage work effort. They are, in short, at odds with improving the tax system.

The revenue neutrality argument for the tax hikes is that they are needed to counterbalance H.R. 11's tax reductions and spending increases. It makes little sense, however, for the government to enact a beneficial set of tax changes with one hand and then hit taxpayers with a harmful collection of changes with the other hand. If either the House or Senate bill were presented on a take-it-or-leave-it basis, it might be better to leave it. It is not clear that present law is inferior to either package of proposed changes, and retaining present law avoids the confusion and other disruptions that occur when the tax code is altered.

Institute for Research on the Economics of Taxation

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Many taxpayers, dizzy from a seemingly endless stream of complicated tax changes, desperately want a few calm years.

Suppose H.R. 11 were passed without its tax hikes. Many of the remaining provisions would offer modest tax relief, allowing the economy to become stronger and grow more rapidly. That, surely, is a worthy objective. Although the Treasury would probably collect somewhat less revenue, the nation as a whole would be in better shape. Moreover, the actual revenue loss would be far smaller than the official estimates from the Joint Committee on Taxation would lead one to believe. All the official estimates are predicated on the patently unrealistic assumption that tax changes have no effect whatsoever on the economy's overall health and rate of growth. To rationalize harmful tax increases according to an alleged need for more revenue based on grossly misleading revenue estimates is very bad tax policy, indeed.

A Comparison Of The Two Versions' Revenue Raisers

Limitation On Itemized Deductions The largest revenue raiser in the Senate plan would extend permanently the limitation on itemized deductions for individuals with adjusted gross incomes (AGI) above $105,250 in 1992 (with the threshold indexed for inflation). This restriction was originally enacted as part of the 1990 budget agreement and had been scheduled to expire in 1995. The JCT estimates the extension would collect $6.5 billion in 1996 and 1997 alone. The House bill contains no comparable provision.

The itemized deduction limitation violates virtually all rules of sound taxation. Because of the restriction's relation to income, it would effectively increase the marginal tax rate of the individuals to whom it applies by nearly 1 percentage point (0.93%). The higher marginal rate would intensify existing tax biases against work, saving, and investment and be directed against the very people who tend to be most productive and have the greatest potential to save and invest. The proposal is also discriminatory because it would single out a group of people on the basis of income and arbitrarily deny them legitimate itemized deductions available to everyone else. The restriction also works against tax simplification because of the added calculations it entails. Furthermore, it is desirable for taxes to be as visible as possible, but this tax increase seems to be deliberately hidden.

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Phaseout of Personal Exemptions The Senate bill would also permanently extend the phaseout of personal exemptions for higher income individuals. This phaseout, which is slated to expire in 1996, was first introduced in a slightly different form as part of the 1986 Tax Act. In 1992, it applies to joint filers with AGIs above $157,900 and single filers with AGIs above $105,250 (the thresholds are indexed for inflation). The JCT estimates this extension would cost taxpayers $1.2 billion just in 1997. There is no comparable extension in the House version.

Like the itemized deduction limitation, this phaseout is harmful and without justification. It elevates marginal tax rates sharply for the taxpayers it affects and does so in a hidden manner. The marginal tax rate increase is about 0.57% per exemption. For a married couple who file jointly, have two dependent children, and are within the phaseout zone, the rate increase is approximately 2.3%. Together, the itemized deduction and personal exemption phaseouts would raise this family's marginal income tax rate to about 34.25%, compared to the statutory top rate of 31%. The higher marginal rate discourages growth-generating activities because it takes away more of the rewards via taxes. It discriminates against a group of

taxpayers, arbitrarily depriving them of exclusions that are available to everyone else and are a long-established part of the tax system. The personal exemption phaseout also adds further complexity to a tax system that is already too complicated.

Mark-To-Market Accounting For Securities Dealers The House and Senate bills would tax dealers in securities on the unrealized gains on their inventories of securities being held for resale. The House version would phase in this change over 10 years; the Senate version, as amended on the floor, would limit the phase in to 7 years. This idea was put forward by the Bush Administration, but Congressional Democrats lost no time in embracing it warmly. The JCT had estimated that the 5-year tax hike would be $2.4 billion, assuming a 10-year phase-in.

Requiring a particular group of businesses to treat unsold inventories as though they have been sold at market prices is contrary to fact and a striking departure from the normal and established tax treatment of inventories. Much of the tax increase would fall on the securities held by investment banking firms. This provision would interfere with an important route by which successful businesses raise capital and grow because it would raise the costs that investment banks incur (and in large part pass along to clients and customers) when they help finance new equity issues. As it stands, this proposal is anti-growth, discriminatory, and complicated. Another threat is that this would be a big first step towards forcing owners of capital assets, in general, to value their holdings at market prices and treat them for tax purposes as though they were sold. This accrual taxation of capital gains would dramatically raise effective capital gains tax rates, create great uncertainty about end-of-year tax liabilities, cause some extremely serious liquidity problems, and be very complicated; it would have a devastating effect on future equity investments.

Lengthened Depreciation Period For Nonresidential Structures For regular income tax purposes, the House and Senate versions of H.R. 11 would increase the straight-line depreciation period for nonresidential real estate by almost one-third, from 31.5 years to 40 years. The bills differ slightly in their effective dates. The JCT estimates this tax hike would amount to $3 billion over 5 years.

The proper tax treatment of capital expenditures for tax purposes is to expense them — to write them off when they occur or, alternatively, to provide multi-year deductions the present value of which equals the amount of the capital outlay. The current depreciation period for nonresidential real property is already much too long, and the proposed change would move it considerably farther in the wrong direction. This proposal would hit a market that is already in terrible shape, largely because of blows that originated in Washington, i.e., prior increases in the depreciation period, the directive in the 1986 Tax Act that capital gains be treated as ordinary income, the passive loss limitation rules in the 1986 Tax Act, and the federal government's heavy-handed response to the S&L crisis. Ironically, the U.S. Treasury would be one of the biggest losers if this proposal became law and dealt another kick to the commercial real estate market, because of the government's large holdings of foreclosed assets and its guarantees to depositors at troubled financial institutions.

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Estimated Income Tax Payments For Corporations To avoid underpayment penalties, corporations must make estimated tax payments equal to 97% of their current-year tax liabilities. (An alternative safe harbor for corporations classified as "not large" is to

pay 100% of their prior-year tax liabilities. Large corporations can use this safe harbor only during the first quarter of the year.) Until last year, the safe harbor rate had been 90% of current-year tax liabilities, but it was increased to pay for a continuation of some expiring tax provisions and extensions of unemployment benefits. Under current law, the rate will decline to 91% in 1997. The Senate bill would increase the rate to 100% of current-year tax liabilities in 1993 and make it permanent. The House bill would set the rate at 95% of current-year tax liabilities beginning in 1997, instead of letting it fall to 91%. This is a major revenue raiser; the JCT scores the Senate version at $5.7 billion for 1993-1997.

The old 90% requirement was tough enough to meet. The House proposal and, more so, the Senate requirement are completely unreasonable. Until the year is over and receipts and expenses can be tallied, corporate officials have no easy way of knowing how much they will owe in taxes. Unanticipated changes in sales and costs frequently produce major surprises. Yet, the House and Senate bills demand unattainable precision and threaten tax penalties if their demands are not met. One response of corporate officers if either proposal became law would be to spend more time and effort in tax planning — and less producing useful goods and services. Another response would be to play it safe by overpaying their expected taxes, which would mean that they would have less money available for current-year investment. Paying taxes before they are due increases the present value of the taxes, hence raises the real, effective tax rate. The higher real tax rate increases the cost of capital and discourages investment.

Coming on top of all the other taxes assessed during people's lives, estate and gift taxes are among the most egregious examples in the tax code of multiple taxation. The people most adversely affected by these taxes, perversely, are farsighted entrepreneurs, astute investors, and successful small business operators who would like to keep their businesses in the family.

In many cases corporations would be tripped up by the rules and owe tax penalties; that, also, would reduce the funds they would have available for investment. By forcing corporations to speed up their tax payments, the House and Senate provisions would permanently raiseproducers' tax compliance costs and diminish their capacity to invest. These anti-growth, unjust provisions epitomize the shortsightedness for which Washington is so often criticized.

<u>Estimated Income Tax Payments For Individuals</u>
Until last year, individuals could protect themselves from underpayment penalties by making estimated tax payments equal to 100% of their prior-year tax liabilities. To offset the cost of extended unemployment benefits, however, this safe harbor was taken away until 1997 from some individuals with high and variable incomes. (An alternative safe harbor for individuals is to pay 90% of their current-year tax liabilities.) Given the difficulty of anticipating income and taxes, this change predictably caused much anxiety, higher tax-preparation costs, many excessively large estimated tax payments, and numerous penalties. The Senate version would restore a uniform prior-year safe harbor — but it would permanently boost the required rate to 120% of prior-year taxes. The House version is similar but slightly less rapacious; it would hike the safe-harbor rate to 115% of prior-year taxes. The JCT scores the Senate version at $3.9 billion over 5 years.

Either version would raise the effective tax rates on individuals who need to make estimated tax payments. The burden would fall primarily on small business people, members of partnerships, and

individuals with substantial investment income. These people should not be singled out for tax punishment, and it will hurt the economy's prospects for growth if they are. The proposed changes would discourage saving, investment, and risk taking and add to unproductive tax-compliance costs. The right course of action would be to reinstate for everyone the simple and fair safe harbor involving 100% of prior-year taxes.

Five Year Delay In Reducing The Top Estate And Gift Tax Rates Under the terms of the 1981 Tax Act, the top estate and gift tax rates were scheduled to decline to 50% by 1985. Subsequent tax bills have delayed the reductions, but they are now scheduled to occur at the start of 1993. The House and Senate bills have identical provisions that would keep the top rates at 55% for the next 5 years. The extension of the 55% top rate would also apply to the generation skipping transfer tax. This is scored as a 5-year revenue raiser of $1.4 billion.

The prevailing sentiment in the public policy forum is that it is politically correct to dislike and punish the wealthy. Coming on top of all the other taxes assessed during people's lives, estate and gift taxes are among the most egregious examples in the tax code of multiple taxation. The people most adversely affected by these taxes, perversely, are farsighted entrepreneurs, astute investors, and successful small business operators who would like to keep their businesses in the family. These taxes, in short, are restraints selectively targeted at the people most likely to be catalysts for growth. Estate and gift taxes discourage these people from working as hard or saving as much; the very high tax rates strongly encourage consumption. The high rates also encourage a great deal of wasteful estate planning activity. Further, when the tax comes due, the payments reduce the pool of funds available for continued saving and investment. Ideally, the estate and gift taxes should be abolished, but at a minimum the long delayed reductions should be permitted to go forward.

The current tax treatment of intangibles is extremely unclear and complicated and generates a stream of high-stakes litigation...The proper tax treatment of all business expenditures, including intangibles, would be to allow them to be written off when they are made.

Limitations On Moving Expense Deductions The House version of H.R. 11 would place a $5,000 cap on moving expense deductions (and make unreimbursed moves subject to the 2% floor on miscellaneous itemized deductions). The Senate plan would deny the moving expense deduction for all expenses incurred in selling or purchasing a residence or settling a lease. It would also deny the deduction for move-related meal and entertainment expenses. The Senate version would equal a $1.9 billion tax increase for the period 1993-1997, according to the JCT's estimate.

A basic principle of sound income taxation is that the expenses incurred in producing income should be deductible. If this rule is followed, it implies that job-related moving expenditures should be deductible. Thus, the House provision is not good tax policy, and the Senate provision is worse. The proposed moving-expense restrictions would occur at a particularly bad time. With the weaknesses of many job markets, both by region and industry, many people must relocate in order to secure positions that better utilize their skills or to find work at all. This is not the time for the government to be erecting an obstacle to these employment-related relocations. By discouraging relocations, Washington would prolong unemployment and the loss of productivity.

Intangibles The Senate version of the intangibles provision is scored as a revenue gainer (the House version is asserted to be revenue neutral.) This may be the least objectionable and most interesting revenue gainer in the package. The current tax treatment of intangibles is extremely unclear and

complicated and generates a stream of high-stakes litigation. The Senate plan would gain near-term revenues by allowing some taxpayers to settle disputes in return for scaling back their claimed deductions. The settlement figure had initially been 75% of previous claims, and that was expected to boost tax collections by $2.5 billion over 5 years. Unfortunately, the figure was scaled back to only 50% on the Senate floor. Because far fewer taxpayers would accept this less generous offer (more would decide they could do better by laying the facts before a court, despite the high litigation costs), estimated tax revenues actually declined when the change was made.

In addition to letting the government obtain funds more quickly (litigation usually drags on for years), it would save both sides very substantial litigation costs. Moreover, because the option would be voluntary, it would not disadvantage any taxpayers who preferred to litigate according to current law (avoiding the danger of pulling the rug out from under them, retroactively.) The 75% rate was better than the amended 50% rate, and both are better than current law which lacks this option.

With some exceptions, the intangibles provision would allow intangibles to be amortized over a uniform period: 14 years in the House version and 16 years in the Senate version. The proper tax treatment of all business expenditures, including intangibles, would be to allow them to be written off when they are made. Thus, instead of assigning intangibles an amortization period of about a decade and a half, businesses should be allowed either to write off intangibles immediately or else to claim depreciation deductions with a present value equivalent to expensing.

The proposed tax hikes are disconnected from the reality that tax policy influences economic growth...The revenue raisers in H.R. 11 should be rejected because they are anti-growth.

Higher Withholding Rates On Certain Income The Senate bill would increase the withholding rate on bonuses and other supplemental wages from 20% to 28%. It would similarly raise the withholding rate on gambling winnings from 20% to 28%. And it would boost the rate on backup withholding of interest and dividends from 28% to 31%. The House bill has no corresponding provisions, but the House Ways & Means Committee did approve other legislation with similar features. These changes would have a small revenue impact (less than $1 billion over 5 years); they are primarily annoyances.

On average, the government already withholds too much from taxpayers. These changes would exacerbate the problem. The transparent motivation for these provisions is to force taxpayers into extending larger interest-free loans to the government. Taxpayers would recover the excess withholding when they file their tax returns, but in the meantime the government would have had free use of their funds. Because these revenue raisers are inconsistent with accurate measurement and collection of tax liabilities, they should be rejected.

New Notification Requirements The Senate version of H.R. 11 includes several added reporting requirements. One would compel state and local governments to notify individuals and the IRS as to how much the individuals paid in property taxes. Another would require that when houses are sold, the IRS be notified of the amounts of property tax allocated to the buyer and seller. The most controversial reporting provision would require taxpayers to obtain written substantiation from charities of contributions of $100 or more in order to deduct the donations. Charities would also have to indicate the estimated value of donated goods and services. Another provision would apply to seller-

financed residential mortgages. It would order the two parties to notify the IRS on their tax returns of subsequent interest payments and include the other party's name, address, and taxpayer ID number.

The JCT estimates that these provisions would increase tax collections by $1.4 billion over 5 years. None of them are in the House bill (but the House used the last reporting requirement as a revenue raiser in the energy bill it passed.)

These provisions are viewed as revenue raisers because they would enhance enforcement, primarily by deterring taxpayers from overstating deductions. Persuading taxpayers to report their deductions accurately seems reasonable enough. What is omitted from the picture, however, is that the federal government would once again be forcing other parties to act as tax agents, without compensation and under penalty of law. The notification requirement on seller-financed mortgages would force literally millions of taxpaying individuals to include several pieces of added information on their tax returns. A special concern with the charitable notification requirement is that many of the relevant contributions are for religious purposes. Religious organizations are apprehensive that this would be another example of the federal government intruding into their affairs and that the extra paperwork would prove enormous. The Bush Administration had suggested earlier this year that reporting requirements for charitable contributions be stiffened, but the Senate plan has a dollar threshold that is much lower.

<u>Repeal Of De Minimis Rule On Rental Income</u> Another proposal that reveals a cavalier attitude towards taxpayer compliance costs is contained in the Senate version of H.R. 11 (but not in the House version). Currently, taxpayers who rent their homes for no more than 2 weeks yearly need not include the rental income on their tax returns. This not only relieves these infrequent renters of having to keep track of their rental income but also means they do not have to go to the considerable trouble of determining what share of their home-related costs are deductible business expenses. Under the Senate rule, affected taxpayers would either have to incur substantial tax preparation costs in computing and maintaining records on their legitimate rental expenses or else neglect to report their expenses and be grossly overtaxed on their net-of-expense rental income. Instead of trying to get an extra $0.3 billion out of taxpayers over 5 years, the reasonable, simple de minimis rule now in force should be retained.

<u>Other Tax Hikes</u> The bills have a grab-bag assortment of additional revenue raisers. The Senate version, for example, would extend the diesel fuel tax to recreational motorboats, deny section 197 amortization to attorney's fees, increase the ozone-depleting-chemical tax, extend the 45-day interest-free rule, add a provision concerning the tax treatment of FSLIC financial assistance, tax precontribution gain on partnership redemptions, add new tax-payment requirements involving the taxable year election for partnerships, S corporations, and personal service corporations, deny all deductions associated with spousal travel, add a provision concerning binding characterization of financial instruments, add a provision concerning child support bad-debt treatment, and disallow travel expenses when away from home for more than 1 year. The JCT estimates that these provisions would collect, in total, $1.9 billion of additional revenue over the period 1993-1997.

Conclusion

The main economic problem of the 1990s has been slow growth. Compared to the results that would have been achieved if the vigorous expansion of the 1980s had continued, it has meant fewer jobs, lower paying jobs, diminished opportunities for advancement, lower incomes, and smaller improvements in living standards. The slowdown has been caused, in part, by a series of tax changes that have increased the tax penalties on saving, investment, and some work activities. Because the

government created this problem, it can correct it — and it should do so at once by passing a growth-oriented package of tax reforms.

The House and Senate versions of H.R. 11 are not responsive to this need, and their revenue raisers move in the opposite direction. The proposed tax hikes are disconnected from the reality that tax policy influences economic growth. It would be better to approve a tax bill that loses revenue for the Treasury but strengthens the economy than to insist on a bill that appears revenue neutral in a static (no growth effect) model. The revenue raisers in H.R. 11 should be rejected because they are anti-growth.

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Note: Nothing written here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before Congress.