



Thoughts on Tax Reform

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Our representational democracy rewards politicians who secure benefits for their constituents. Successful elected officials are oftentimes those who write into law tax benefits superior to those enjoyed by industries or groups in the state or district next door. Over time this dynamic complicates the tax code and results in questionable public policy. Almost three decades after the Tax Reform Act of 1986, frustration has built to a point where it looks like there is a reasonable chance Congress will enact a major overhaul of the tax code. If Michigan Republican Rep. Dave Camp and Montana Democrat Sen. Max Baucus can pull it off, reform will come not a moment too soon.

The most important need is for greater permanency in the tax code. The constant starts and stops in tax policy leave individuals and business owners, in particular, uncertain of what to do and whether to invest. They also complicate tax administration. The IRS somehow has produced a smooth filing season this year even though Congress was still changing the tax law after 2012 was over. The fiscal cliff deal did make many Bush-era individual rate cuts permanent, a good thing, but simply rolled over short-term extensions for critical business incentives like the R & D tax credit. My counsel to Congress is to write tax laws that stay on the books for at least ten years, matching budget windows used to gauge the long-term fiscal health of our nation.

The tax code cries out for simplification. There has been no broad call for tax reform, though, because most Americans don't really suffer directly from the code's complexity. Only one-third itemize. Further, tax software makes it easier to complete returns than years ago when taxpayers thumbed through mind-numbing 1040 instructions. Certainly large corporations have little trouble keeping up with and taking advantage of constantly changing tax provisions. Officials I worked with at the IRS called a tax return from a Fortune 500 company typically just an "opening offer." The real damage from a bloated, overly complex tax code falls upon small and mid-sized businesses, which generally operate without sophisticated finance staffs and accounting systems, and who don't have a lot of high powered lobbyists watching after their interests in Washington. Businesses with fewer than 1000 employees do, however, employ two thirds of the private sector workforce, a point worth remembering as we contemplate reform.

The simplification effort should extend beyond paring tax expenditures from the code or standardizing overlapping provisions that create confusion. Rewriting the tax code also needs to assure that similar kinds of economic activity are treated consistently, eliminating incentives to select differing organizational forms based on tax, rather than economic conditions. Fortunately, the discussion has evolved over the last two years and is no longer dominated by big corporations clamoring for lower statutory rates and repatriation of overseas earnings. The tax writers, particularly Mr. Camp, have recognized that reform needs to encompass both

individual and business code provisions in order to achieve fairness and minimize tax avoidance. I would further suggest a thorough examination of what is tax exempt, an issue I don't see getting any attention. Recent months have seen vocal advocacy of a robust charitable deduction. Fair enough. A far bigger issue is establishing the proper line between what is deemed for profit or not-for-profit under the code. As a leader at one prominent Indiana tax-exempt organization said to me recently, "Not-for-profit is just a tax status, not a way of doing business." The continuing drift towards tax exemption can only lead to erosion of the revenue base at a time when we need the money.

I do not favor retention of the current code with dollar or percentage limitations on deductions. That only makes taxes more, not less, complex. Let's really simplify and make the difficult policy choices, hard as it may be. I won't be moving to Mexico or China if there is no mortgage interest deduction and I rent rather than own my condo in Indianapolis. On the other hand, thousands of jobs in Indiana are created or destroyed when factories open or close based in part on tax considerations. In these challenging economic times we should do what whatever we can to foster innovation and help small and mid-sized businesses.

Finally, a comment on what it will take to meaningfully change the code. Tax reform is a dance where it takes three to tango. So far, just Mr. Baucus and Mr. Camp are dancing. The administration has evidenced a strong commitment to immigration reform and gun control, but thus far given only lip service to tax reform. The president needs to take the floor.

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