TEN TERRIBLE TAXES

- OVERVIEW -

Today's tax code is littered with items that create headaches and paperwork and yet collect limited amounts of revenue. Have you ever been annoyed by having to document and pay taxes on very small amounts of interest that you earned in a savings account? Surely the time and paperwork you, your bank, and the IRS spend in tracking small amounts of such income outweighs the taxes paid on it. In some cases, the administrative and compliance costs may even outweigh the taxes collected.

Take, for example, the interest income you might earn on a checking account. If your account paid $10 in interest during the year, your bank would have to document it and send both you and the IRS a 1099 form. You would have to retain the 1099 and report $10 on your tax return. The IRS must check and match all 1099s to insure that all interest is properly reported. All this for only $10 in income and perhaps just $1.50 in taxes owed!

In addition, there are many federal tax provisions that have outlived their original purpose. For example, the federal telephone excise tax was implemented as a temporary tax to fund the Spanish-American War, but it is still with us a century later. Taxes like this one unfairly target particular activities, and require businesses and IRS agents to spend time and effort in administration.

This report identifies ten small reforms which could spare taxpayers compliance costs, while having only a limited impact on the $1.8 trillion collected by the U.S. Treasury each year. The changes would be an important first step in reducing the $200-plus billion dollars and five billion person-hours now spent complying with the complex federal tax code.

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1. Exempt Small Amounts of Interest Income

Background

Individuals currently have to keep track of, and pay tax on, even small amounts of interest income. Even $10 of interest on a savings account must be reported. If it isn't, missing or inconsistent 1099 forms that document interest income can trigger an IRS audit. Also, taxpayers cannot use the relatively simple 1040EZ tax form if they have interest income above $400.

Brief Analysis

Creating a small exemption level for personal interest income would save time, money, and paperwork for taxpayers, businesses, and the IRS. In the past, the federal government did allow taxpayers to exclude some initial amount of interest income from taxation. Such a policy change would both simplify the tax code, and would promote savings and investment.

Suggested Reforms

- Exclude the first $500 in interest income from personal income tax.
- Allow businesses to forgo issuing 1099 forms for annual interest earnings of less than $25 per taxpayer account.

2. Exempt Small Amounts of Dividend Income

Background

Similar to interest income, individuals must keep track of, and are subject to tax on, even small amounts of dividend income. That means extra paperwork for taxpayers, businesses, and the IRS. And missing or inconsistent 1099 forms for dividends can trigger an IRS audit. Also, taxpayers currently cannot use the relatively simple 1040EZ tax form if they have any dividend income.

Brief Analysis

Creating a small tax-free dividend amount would save time and money for taxpayers, businesses, and the IRS. Such an exclusion for dividend income would be pro-savings and pro-investment.

Suggested Reforms

- Exclude the first $500 in dividend income from personal income tax.
- Allow businesses to forgo issuing 1099 forms for annual dividend earnings of less than $25 per taxpayer account.

3. Consolidate Capital Gains Rates and Holding Periods

Background

Under current tax rules, taxpayers must hold assets for five years to take advantage of the lowest capital gains tax rate of 8% for taxpayers in the 15% tax bracket, and 18% for taxpayers in other tax brackets. Assets held for one to five years are subject to the higher tax rate of 10% for taxpayers in the 15% tax bracket, and 20% for taxpayers in other tax brackets.

Brief Analysis

Having two sets of rates and holding periods for long-term capital gains adds undue complexity to the tax code, and requires additional paperwork and calculations for taxpayers, investors, and the IRS. Reducing the 10% and 20% tax rates for one-year holding periods to the lower rates for five-year holding periods would reduce complexity and improve investment efficiency.

Suggested Reform

- Conform the capital gains tax rates and holding periods. Capital gains rates for one-year holding periods could be lowered to 8% and 18%, or even lower. This would conform both the tax rates and the holding periods for capital gains income.

4. Allow All Taxpayers to Deduct Charitable Donations

Background

Currently, only taxpayers who itemize their deductions can deduct their charitable contributions. This means that over 80 million taxpayers – about 70% of all federal taxpayers – do not have the chance to get a tax benefit for their charitable donation.

Brief Analysis

Currently, only taxpayers who itemize their deductions can deduct their charitable contributions. Out of fairness, all taxpayers who donate to charities, even those who use form 1040EZ, should be able to deduct their charitable contributions. Also, claiming a small non-cash charitable contribution should not be so complicated. Taxpayers should be exempted from filling out IRS form 8283 if their non-cash contributions are less than $1,000. These changes would allow all taxpayers to deduct charitable contributions, would simplify the tax code, and would increase contributions to the nation's charities.

Suggested Reform

- Allow all taxpayers to deduct charitable contributions, and allow $1,000 of non-cash contributions without having to file form 8283.

5. Exempt Small Amounts of Income from "Nanny Tax"

Background

Currently, families and their household help, including "nannies," are subject to taxes, including the Social Security and Medicare payroll taxes, if the employee is paid $1,100 or more during a calendar year. For the millions of American families that have in-house child care, this means that they are required to pay a substantial amount of taxes just to provide care for their children.

Brief Analysis

Complicated "nanny tax" compliance could be avoided for many families by allowing annual childcare payments of perhaps $2,400 before taxes and paperwork kick in. This tax change would assist a large and growing number of working parents with childcare expenses.

Despite some liberalization of the nanny tax rules in 1994, recent evidence indicates that most Americans hiring household workers are evading the tax because of the complexity and substantial tax costs involved. A higher exemption for the tax will simplify the tax rules.

Suggested Reform

- Allow the first $2,400 ($200 per month) in childcare payments before nanny tax rules apply.

6. Reform Social Security Benefits Tax

Background

Social Security retirement benefits are subject to income taxes at fairly low levels of income today. Couples with modified income above $32,000 may be subject to tax on 50% of their benefits. And since 1993, couples with modified income above $44,000 may be subject to tax on up to 85% of their Social Security benefits.

Brief Analysis

Unfortunately the income thresholds for this tax are not indexed for inflation, so that each year increasing numbers of seniors are forced to pay taxes on their benefits - even if their real income has not increased. Increasing the current income thresholds by even $5,000, and indexing them for inflation, will prevent many seniors from falling into this tax trap.

Suggested Reforms

- Boost exemption for Social Security benefits tax by $5,000, and index for inflation.
- Repeal the 1993 tax increase which added the 85% inclusion rate.

Taxable Benefits	**Current Law: (Income Thresholds)**		**Change to: (Income Thresholds)**	
	Single	Married	Single	Married
Up to 50% Taxed	$25,000	$32,000	$30,000	$37,000
Up to 85% Taxed	$34,000	$44,000	Eliminate	Eliminate

7. Reform Individual AMT

Background

Congress adopted the Alternative Minimum Tax (AMT) to ensure that high-income taxpayers would pay their fair share of taxes. However, this goal was accomplished at a very high cost in terms of tax complexity because the AMT involves many complicated calculations that taxpayers find daunting. In addition, while the tax was aimed at high-income Americans, more middle-income earners are having to pay the AMT. Current projections indicate that taxpayers hit by this add-on tax will jump from under one million today to nine million by 2009.

Brief Analysis

Flaws in the design of the AMT mean that increasing numbers of middle-income taxpayers will be forced to deal with AMT calculations to see if they must make AMT payments above and beyond their regular tax amount.

A primary cause of the increasing headaches from the AMT is that exemption amounts ($45,000 for married and $33,750 for singles) are not indexed for inflation. So as incomes grow, more workers become subject to the AMT.

In addition, many middle-income taxpayers are being denied the full benefits of the child tax credit and other personal tax credits because these provisions interact with the AMT. Last year, Congress enacted a one-year fix for this problem, but the fix should be made permanent.

Suggested Reforms

- Index the AMT exemption amounts for inflation.
- Eliminate the AMT-caused reduction in the child credit and other personal tax credits.

8. Eliminate Telephone Taxes

Background

Americans pay a 3% federal excise tax on all local and long distance phone calls. The tax was imposed a century ago as a temporary luxury tax to fund the Spanish-American War, but today the revenues simply go into the Treasury's general fund and don't serve any one particular purpose.

In addition, new charges have been imposed on telephone bills since the passage of the Telecommunications Act of 1996. New "E-rate" taxes have shown up on phone bills as a result of actions by the Federal Communications Commission (FCC) to fund a new bureaucracy, even though the new taxes were not specifically authorized by Congress. The new tax supports the "Schools and Libraries Division of the Universal Service Administrative Company," which is supposed to wire public schools and libraries to the internet by spending up to $2.25 billion per year. The new E-rate tax on phone bills is sometimes referred to as the "Gore Tax" because of the Vice President's support of the project.

Brief Analysis

The 3% federal excise tax on telephone service is an historical anachronism that serves no clear purpose in today's telecommunication-dependent society. Since this tax raises the cost of telecom services, it runs counter to the goal of government support for the information revolution.

The E-rate tax is an unneeded new burden on phone and internet users. According to the General Accounting Office (GAO), 78 percent of America's public schools were already wired to the internet by 1997, so the new tax does not seem needed for that stated purpose. Besides, the GAO notes that there are already 27 other federal programs that may provide technology funding to public schools.

Suggested Reform

- Repeal all telecom taxes including the 3% telephone excise tax and the new E-rate tax.

9. Eliminate FUTA Payroll Surtax

Background

The Federal Unemployment Tax Act (FUTA) payroll charge funds the federal Trust Fund which makes payments to unemployed workers. The basic rate of the tax is 0.6 percent on the first $7,000 of all wages. But an additional "temporary" surcharge of 0.2 percent of wages was tacked on in 1976 and was extended in 1997 for the fifth time. As such, the temporary surcharge is in danger of becoming a permanent burden on workers.

Brief Analysis

As a tax on wages, the FUTA charge raises the cost of hiring workers. The tax is targeted particularly at lower-income workers because it is calculated based on the first $7,000 of wages. The unemployment insurance Trust Fund funded by the FUTA tax has a substantial excess balance indicating that the tax rate should be lowered.

Suggested Reforms

- Repeal the "temporary" FUTA payroll surtax.

10. Increase Income Limits for Deductible IRAs

Background

The federal income tax includes over 20 limitations that reduce the ability of taxpayers to take advantage of various deductions and credits. While many of these provisions are designed to eliminate benefits for higher-income Americans, a number of these rules apply to millions of middle-income taxpayers. Deductible Individual Retirement Accounts (IRAs), for example, are phased-out for middle-income couples with earnings above $51,000, and single taxpayers with earnings above $31,000.

Brief Analysis

The tax code is littered with limitations to allowable deductions and credits, with the result that many taxpayers have to deal with complicated phase-out calculations, and many are denied benefits. The Joint Committee on Taxation (JCT) estimates that over 30 million taxpayers are subject to such tax code complications.

The deductible IRA savings incentive is phased-out for taxpayers with quite modest income levels. (The phase-out is for taxpayers who participate in company-sponsored retirement plans). By contrast, the new Roth IRA has a much higher phase-out range beginning at $150,000 for married taxpayers and $95,000 for single taxpayers. By raising the income limits on the deductible IRA to Roth IRA levels, the tax code could be simplified and middle-income taxpayers would have an additional stimulus to save for retirement.

Suggested Reform

- Raise the income limits on deductible IRAs to conform to the higher limits for Roth IRAs.

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