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Simplified handling of deductions under the individual income tax.

(January 13, 1944)

Alternative methods of simplifying the handling of deductions under federal income tax

"Deductions" under the federal income tax are one of the chief sources of complication. In general they call for more detailed records than do the major items of receipts; the instructions on the return are harder to follow; the taxpayer has more apparent choices as to how much to report; there is more scope for taxpayers to take advantage of unusual ability in construing the statute and Internal Revenue regulations, or to take advantage of being able to obtain legal advice. Consequently, deductions deserve close scrutiny whenever efforts are being made to simplify the individual income tax.

PURPOSES OF ALLOWING DEDUCTIONS

The first step in studying deductions is of course to ask what use they are. They serve two major sorts of purposes:

A. EQUALIZATION Putting taxes more nearly on the basis of the income the taxpayer actually enjoys -- i.e., devotes to consumption or to building up his estate.

B. INCENTIVES Offering the taxpayer inducement to follow or avoid lines of behavior in which public policy is interested.

The first type of purpose is served by deductions which take out elements of income of which the

taxpayer does not get the benefit -- for example, what he pays in state income taxes; what he loses (uninsured) through damage to his property, bad debts, etc.; what he has to pay out in unusual medical expenses on account of a run of illness or on account of some disability. The effect of such deductions is to make more nearly equal the taxes of people of like family status who have the same amount actually available for consumption and for building up their estates.

The second type of purpose is served by the refusal to permit deduction of gambling losses (beyond the amount of gambling gains), and by the allowance of deductions for home mortgage interest and for taxes on owner-occupied homes. The first represents an incentive to avoid gambling, the second an incentive to own a home rather than rent. The allowance of deductions for contributions serves both an incentive purpose and an equalization purpose. It gives stimulus to gifts to charitable, educational and religious institutions; and at the same time it allows for income of which the taxpayer deprives himself to make such gifts, and of which he personally does not get the benefit.

INCOMPLETE EQUALIZATION

It should be pointed out that from the equalization standpoint the existing deduction system is very imperfect, since it is far from allowing for all the major elements of income of which individual taxpayers fail to get the benefit. The most important shortcoming from this standpoint is the lack of recognition of the extra costs of acquiring an income which fall upon a family in which all the adult members work and none are at home to take care of housework, etc., -- the "working wife problem". The financial advantage of having a competent unpaid housekeeper can scarcely be estimated at less than $500 a year /1/, against which the present law offers no tax advantage except the benefit of one additional $624 exemption under the Victory tax (giving a tax reduction of about $20). Another very serious inequality for which the tax system offers no offsets is the difference in living costs between metropolitan centers and congested "boom towns" on the one hand and smaller places less affected by war activity on the other.

Further inequalities are generated by some of the incentive deductions. While some incentives deductions also help toward equalization -- the deduction for contributions, cited above, is a case in point -- some work in the opposite direction. The most important case is that of the home-owner deductions for mortgage interest and property taxes. Interest and taxes are not dead-weight burdens on the taxpayer like (say) state income taxes. On the contrary, they enable him to occupy a house without paying rent. Consequently, to permit deduction of these expenses is to give an advantage to the home-owner who pays them as against the renter, who must be regarded as paying the same charges indirectly, through his rent, without benefit of tax deductions. On the other hand, to disallow them would create an inequality as between home-owners with mortgage debts and home-owners who are debt-free or who can render themselves debt-free by selling securities and other income-yielding assets to raise funds to lift the mortgage. In short, either allowing or disallowing home-owner deductions involves a particular type of inequality. Equalization of burdens could be achieved only by following the British example and treating the gross rental value of owner-occupied homes as receipts, but simultaneously allowing the owners as business deductions the same amounts allowed to landlords - - including not only interest and taxes but also insurance and depreciation. NET rental value would then be included in gross personal

income.

FOOTNOTE
/1/ The major items of extra cost for a family in which the wife works (as compared with a family of similar composition in which the wife serves as housekeeper) are: buying lunches for one or more family members instead of eating at home; greater use of commercial laundries instead of home washing; higher cost of groceries because of necessity of shopping at late hours and in downtown shops, and because of inability to use items needing long cooking; greater wear and tear on clothing and less opportunity for mending; greater expense in case of illness in the family; additional expense of getting family breadwinners to and from work by public transportation. For a family with children in school, the first two items also can easily absorb $500 a year. At present wage levels, hiring a housekeeper to offset these drawbacks would

BASIC SIMPLIFICATION METHODS

There are obviously many ways to simplify deductions. The chief ones are:

1. To shorten -- perhaps even to eliminate entirely -- the list of allowable deductions.

2. To replace calculated amounts by presumptive deductions -- either in all cases or at the option of the taxpayer (as we now do for taxpayers eligible to use Form 1040A).

3. To simplify the basis of restricted deductions (contributions and medical expenses).

4. To reframe the regulations and the instructions on Form 1040.

Some combination of these methods seems to be called for. This memorandum will not attempt to make final recommendations, but will sketch the possibilities under each heading.

TAXING GROSS INCOME -- THE EXTREME CASE OF SHORTENING THE DEDUCTION LIST

Carried to its extreme, the method of shortening the list of allowable deductions leads to a Gordian know solution of the whole deductions problem -- abolishing deductions and basing taxation on "gross income", less personal exemptions and credit for dependents. This solution has been recommended in various quarters as offering the maximum of simplification.

Under the present definition of gross income, however, taxation on this basis would discriminate most unfairly against business men; roughly speaking, the tax base for the proprietor of a business (or a partner) would be his gross PERSONAL income less exemption, etc., plus all his business expenses except "cost of goods sold". /1/ All other business expenses are now provided for by deductions under Form 1040. These business deductions could not well be swept away; if no "deductions" were to be permitted, they would have to be taken care of as "exclusions" from gross income, which would require a new and careful statutory definition of gross income. As will be seen presently, such a redefinition would help greatly toward simplification even if a less drastic solution than abolishing personal deductions were adopted. /2/

FOOTNOTES

/1/ Section 22 of the Internal Revenue Code defines gross income to include "gains, profits and income derived from salaries, wages or compensation for personal service . . . or from professions, vocations, trades, business, commerce, or sales, or dealings in property . . .; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever".

REGULATIONS III of the Bureau of Internal Revenue, however, states (Section 29.22(a)-5) that "In case of a manufacturing, merchandising or mining business, 'gross income' means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. In determining the gross income, subtractions should not be made for depreciation, depletion, selling expenses, or losses, or for items not ordinarily used in computing the cost of goods sold."

The consequence is that for a proprietor of unincorporated business "gross income" includes the business expense for which "subtractions should be made" under the REGULATIONS; all these expenses thus have to be accounted for as deductions on Form 1040. There seems to be some room for doubt as to whether this was the only admissible construction of "gains, profits and income" under the statute in the first place; but to change it now, in view of the legal structure built up around the REGULATIONS, would clearly call for an explicit amendment of the statute.

/2/ It is a curious fact that the Internal Revenue Code and REGULATIONS do not distinguish (except for contributions) among deductions made by corporations, deductions made in determining the net income of unincorporated business, and deductions made by individuals in their personal (non-business) capacity. Logic would seem to require at least a separation of personal from business deductions, perhaps also a separation of corporate and non-corporate business deductions.

Basing taxation on gross income would mean giving up both the equalizing and the incentive effects of personal deductions. The revenue effects (at unchanged rates) might be fairly substantial. In 1941, taxable returns on Form 1040 showed $35.3 billion of net income, of which $16.1 billion was absorbed

by exemptions and credits for dependents, leaving a tax base (surtax net income) of $19.2 billion. Total deductions claimed on taxable 1040's were $4.5 billion. Of this amount various types of losses (which would count as business deductions) made up $0.9 billion. Items composed of a mixture of business and personal deductions were interest ($0.8 billion), taxes paid ($1.4 billion), and "other deductions" ($0.5 billion), totalling $2.7 billion. On the purely personal side, contributions were $0.9 billion. Personal deductions on taxable returns filed on Form 1040 thus amounted to some $2.5 billion (supposing rather over half of the mixed group to be personal). Allowing for the fact that Form 1040A allowed for presumptive exemptions of about 6 percent ($0.6 billion) and for the fact that eliminating personal deductions would shift some returns from the non-taxable to the taxable column, the total addition to the tax base would have been toward $4 billion, or about one-fifth of the existing tax base. Since this addition would go into the highest surtax bracket for each return, the addition to revenue would have been more than one-fifth -- perhaps even more than one-fourth.

On the other hand, insofar as deductions are spread uniformly over the field, eliminating deductions and maintaining tax rates unchanged would be substantially equivalent to cutting exemptions slightly and raising rates. Thus, the revenue effects could be obtained in other ways and it is the equalization and incentive effects on which attention should be concentrated. These are covered in the next section, where the different personal deductions are considered separately.

SHORTENING THE LIST OF ALLOWABLE DEDUCTIONS

If some personal deductions are to be allowed and some disallowed, what different does it make which are retained? Since the considerations underlying different types of incentive deductions are more or less incomparable with each other, this question is best approached by listing deductions in the general order of their equalizing effects.

1. ALLOWANCE FOR WORKING WIFE While not included in the existing list of deductions, this allowance could be made with reasonable equity and a minimum of complication by allowing deduction of a lump sum (say $500 but not to exceed wife's actual earnings) from the income of a wife who is gainfully employed. /1/

2. ALIMONY this is clearly income of which the taxpayer gets no direct benefit; and under present law the recipient is taxable.

3. MEDICAL DEDUCTION

4. STATE INCOME TAXES, POLL TAXES, ETC. Money paid in taxes of this sort is about as thoroughly unavailable for the taxpayer's personal use as possible. In addition, the federal deduction for these taxes is one of the few effective

coordinating devices for the combined effect of state and federal taxes. On the other hand, it is arguable that this coordination should be achieved by having states permit the deduction of federal taxes (which most states do, New York being a conspicuous exception) and that where there are state income taxes those who pay them are benefited either by lower taxes of other sorts or by better service from state and local government.

5. CONTRIBUTIONS. In principle contributions are very important from the standpoint of equalization; but to establish the precise amount calls for record-keeping of an uncommon type, and it is suspected that many taxpayers claim deduction for contributions not actually made. It might be worth considering to allow deduction (following the pattern of the medical deduction) only on the excess of contributions over 5 percent of income, and only on presentation of evidence.

6. INCIDENTAL TAXES (sales, excise, etc.) As these deductions stand, their equalizing value is doubtful, since taxes which are the same in substance are not deductible according to form. Furthermore, this deduction (like that for contributions) gives advantages to taxpayers who have either usually full records or an unusually strong willingness to make claims unsupported by records.

7. INTEREST ON PERSONAL DEBT OTHER THAN MORTGAGES (installment loans, insurance policy loans, etc.). It is arguable that these are expenditures from which the taxpayer DOES enjoy a benefit -- i.e., he has the use of goods sooner than if he saved up the cash price. Incidentally, such debt is often second-mortgage debt on homes, in disguise.

8. HOME-OWNER DEDUCTIONS (mortgage interest and property taxes). As shown above, these deductions actually widen rather than narrow the gap between tax burdens of comparably situated taxpayers.

FOOTNOTE

/1/ This magnitude is suggested both by the analysis of burdens above (p.2, footnote /1/) and by the existing allowances to "single persons heads of families", which are founded on similar considerations of differential burden. Such single persons are allowed in place of the regular $500 single-person exemption the $1200 head-of-family exemption. If their claim as heads of families rests on dependents over the age of 18 and not incapacitated, they are relieved from taxes on the $700 difference in exemptions. If all their dependents are either under 18 or incapacitated, they lose the $350 dependent credit for the first dependent, and are relieved of the tax on $350.

This list pretty well covers all quantitatively important PERSONAL deductions (losses, etc., being regarded as BUSINESS deductions).

In terms of complication, a restricted list extending only through the first four items would present few difficulties. Item 1 could be taken care of as a lump sum. For items 2 and 4, records are almost automatically available. For item 3, since the deduction is restricted to the excess over 5 percent of income, only the small minority who are heavily burdened by medical expenses need be inconvenienced with extra record-keeping, etc. For item 4, record- keeping is very simple. Of the remaining items, 8 (and in some cases 7) can be handled from records the individual in question will normally have on hand; but there is often some room for discussion between the taxpayer and the tax collector as to the interpretation of those records. Items 5 and 6 can be estimated accurately only from rather full records. In general, the deductions which contribute least to equalization contribute most to complication.

In terms of incentive effects, items 5 and 8 are most important. It must be questioned, however, whether item 5 (contributions) does not do more to further CLAIMING THE DEDUCTION of contributions than actually MAKING contributions, at least below the income levels where revenue agents customarily ask to see the records. Item 8 -- home- owner deductions -- may well be highly effective in swapping people who are considering buying the houses they live in. /1/ but in a strictly economic view, it is very doubtful that this advantage is worth the drawbacks of making tax burdens more unequal and of tempting home-buyers to over-extend themselves.

FOOTNOTE

/1/ The easiest way to visualize the gain is to imagine two neighbors with equal salary incomes, living next door to each other in identical houses -- each of which happens to be owned by the neighbor next door and rented by him to the occupant. Each neighbor is now in a position to claim his mortgage interest and taxes as a BUSINESS deduction in his capacity as landlord (together with insurance and various other costs); but he has to report the cash rent received as an element of gross income more than offsetting the deduction. If the two neighbors now swap titles to their houses or move into the houses they own -- so that each becomes and owner- occupant --, mortgage interest and taxes continue to be deductible, now classifying as PERSONAL DEDUCTIONS. But since they have stopped swapping rent checks, the rent received is no longer part of gross income. Thus each reduces his statutory net income by the amount of the rent he used to get, less the charges for insurance, maintenance and depreciation which as home-owner he cannot deduct.

If one neighbor continues to rent while the other borrows the entire price and buys the house he lives in (thus becoming owner of both houses), the renter's tax position is unchanged; but the buyer gains in just the same way as when ownership was exchanged. This time the home-buyer's gross income is uncharged. But out of the money he formerly paid in rent (none of which was deductible for tax purposes), the part which covered property taxes and interest on the capital invested in the house is added to his deductions, and again his net income falls.

Once one owns the house he lives in, it is not very important from the tax standpoint whether he pays off mortgage debt by parting with other assets or not. It is simply a question whether the reduction of gross income arising from the other assets is more or less than the reduction of deductions by reducing the interest charge. Thus the tax incentive makes it worth getting into debt if necessary to buy a home, but does not much affect inducements to pay the debt down.

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