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## TAX LOOPHOLES: THE LEGEND AND THE REALITY

by Roger A. Freeman

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*Dr. Freeman delivered this presentation at Hillsdale College in the most recent Center for Constructive Alternatives Seminar, "The Power of The Purse String: Taxes and the IRS."*

For close to twenty years so-called loopholes in the federal income tax have been the subject of a lively public controversy. They were investigated in several extensive hearings by the two tax writing committees of Congress—the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate. A large majority of Congress as well as the Executive Branch, not to mention the nation's press, television networks and some of the largest organizations supported tax reform, a term that has come to be virtually synonymous with the drive to close loopholes.

It is thus not surprising that the Congress took repeated action to close loopholes in the income tax—in 1969, 1971, and again in 1975. What may be surprising is the fact that every time Congress enacted a tax reform bill, the amount of untaxed income was larger afterwards than it had been before and the percentage of total personal income exempted from the federal income tax as well as the number of Americans paying no income tax had substantially increased. In other words, whenever Congress tightened or closed some loopholes—or acted as if it had—it always opened or widened others more extensively. That strongly suggests that the real

aim of the "close the loopholes" drive is not so much to subject more tax free personal income to the tax as to shift the burden of taxation from some economic groups to others—to tax some more lightly and others more heavily. To be specific, the real goal and purpose of the campaign to close loopholes is to redistribute income from some less favored groups—presumably from groups with less voting power—to some with more votes and therefore greater political appeal to office holders and office seekers.

The amounts we are talking about here are huge. All personal income in the United States totalled \$945 billion in 1972 (according to the national income and products accounts) of which only \$445 billion showed up as taxable on federal income tax returns. In other words, \$500 billion—or 53 percent of all personal income—went tax free in 1972, up from \$363 billion or 48 percent in 1969. Counting offsetting items—amounts which are taxed although they are not personal income under prevailing economic definitions—untaxed income totalled \$563 billion in 1972, up from \$414 billion in 1969.

That increase in tax free income is easily explained by the fact that several "tax reform" measures went



into effect between 1969 and 1972, especially the Tax Reform Act of 1969, which has since become more affectionately known as the Lawyers and Accountants Full Employment Act of 1969. About \$70 billion in personal income escaped federal income taxation in 1972 as a direct consequence of the Tax Reform Act of 1969.

You are probably acquainted with complaints that the property tax and the sales tax permit many exemptions which have eroded the tax base and thereby not only cut the revenues of schools, cities and states but also given advantages to certain favored groups of taxpayers over others. But exemptions in the property and sales taxes equal only between one-fourth and one-third of their respective tax bases. In the federal income tax they total more than half the base—and it has become the leakiest tax known.

Yet the income tax is by far the most important revenue producer in our fiscal system. While the United States imposed a personal income tax later than most other industrial nations, in 1913, after the adoption of the XVI Amendment to the U.S. Constitution, it now leans more heavily on income taxes—graduate personal income tax and corporate profits tax—than any other major country. Other industrial countries use a general consumption tax as a major producer of revenue for their national government. The United States is the only country not to do so.

Yet it has restricted the personal income tax base to less than half of the personal income. If all exclusions, exemptions, deductions and credits were repealed and *all* personal income were subjected to the tax, the tax rates could be halved—from the present 14 percent to 70 percent range to a 7 percent to 35 percent range. Alternatively, a flat 10 percent tax on *all* personal income would yield about as much revenue as the present rate scale on half the income. Some would favor such a system. But there is not a chance in a million that such a plan could ever be adopted. The simple facts of political arithmetic—of counting where the votes are—rule it out.

Let me quote to you from a recent article by a leading spokesman of the tax reform movement, Stanley S. Surrey of the Harvard Law School, who served as Assistant Secretary of the Treasury for Tax Policy from 1961 to 1969. It appeared in the *New York Times Magazine* for April 13, 1975, under the title "The Sheltered Life":

To most people, the Federal income tax is a complex system designed to extract large sums from their pocketbooks—about \$150-billion, or more than half the Government's total income. Few realize, however, that while collecting these taxes from individuals and corporations, the Government is simultaneously paying between \$80- and \$90-billion to some of them. It does this by simply not collecting any or all the taxes it might on certain types of activities—those that, because of their claimed value to society, are permitted special tax benefits. If the Government were first to collect this \$80-to \$90-billion in the regular income tax sweep and then to disburse it again for these benefited activities, we would

refer to the process as a subsidy . . . . Since the special tax benefits a person may claim generally increase as his income rises, the poor gain little from them, while the wealthy may utilize them as a major way to supplement their incomes at Government expense.

As ordered by the Budget Reform Act of 1974, the budget volume sent by the President to the Congress with his recommendations for the forthcoming fiscal year now contains a chapter and a table on so-called tax expenditures. (*Special Analyses, Part I F*) But the biggest tax concessions are not classified tax expenditures, only certain selected ones. No total is given and the budget states "Tax expenditure estimates cannot be simply added together to form totals for functional areas or a grand total."

Despite this warning, Surrey and some congressional enthusiasts have added the tax expenditures shown in the budget and came up with a total of \$78 billion for FY 1975, a completely unrealistic and meaningless figure.

In his mentioned article in the NYTM for April 13, 1975, Surrey refers to the tax expenditure table in the U.S. budget which he says "explains why some of our wealthiest individuals pay little or no income tax."

Which are the largest items of "tax expenditure" listed by Surrey? The biggest is the deduction allowed homeowners for the property taxes and mortgage interest they pay—\$10 billion—which Surrey calls a housing assistance program for homeowners. But homeownership is not concentrated in the top brackets. About two-thirds of American families live in their own homes and the great majority of them are in the middle income brackets.

The next biggest items listed by Surrey are long-term capital gains, which are usually taxed at half the rate of ordinary income and which he estimates at between \$7 and \$10 billion. Then there is interest on municipal bonds which Surrey places at \$4 billion, of which \$3 billion is refunded to states, cities and schools in the form of lower interest rates. This leaves \$1 billion for investors. Other tax expenditures listed by Surrey are small—\$1 billion each or less.

This leaves the big question: where are the items that composed the \$563 billion of untaxed income in 1972, or the bulk of the \$78 billion tax expenditures claimed for 1975? Mr. Surrey never says. The plain fact is that most of the \$563 billion in untaxed income is in the middle and lower income brackets and is broadly distributed through all sections of the American public with only a tiny percentage accruing to high-income persons. The truth is that most high income persons pay very high income taxes.

What then are the big "loopholes," the provisions which account for most of the \$563 billion of untaxed income in 1972? By far the largest loophole is personal exemptions—at \$750 a head—which total \$155 billion. Many feel that \$750 is not enough, that it costs more to support a child. That may well be true. But then, why should the U.S. Government pay a tax bonus for every child at a time when we are trying to reduce population growth and reach ZPG? Should there not



be a penalty rather than a premium?

Tax free income from social benefits—social security, unemployment compensation, public assistance, veterans benefits, employer contributions to pension and welfare funds and other transfer payments account for another \$93 billion. Those remedial provisions largely benefit low-income and low-to-middle-income persons. Little of it goes to wealthy families.

The other big item is itemized deductions. They totalled in 1972 \$97 billion. But those itemized deductions equalled 55 percent of reported income on returns itemizing deductions in the adjusted gross income (AGI) bracket under \$5000, 20 percent in the \$15,000 to \$25,000 income bracket, and 22 percent in the income class from \$100,000 on up. In other words, itemized deductions free a much larger share of the income from taxation in the low brackets than in the high. More importantly, most persons in the lower income brackets use the standard deduction instead of itemizing. Under the liberalized provisions of the Tax Reform Act of 1969, standard deductions went up 218 percent between 1969 and 1972—from \$22 billion to \$70 billion—while income increased only 26 percent and itemized deductions 21 percent.

Of the \$301 billion difference between adjusted gross income (AGI) and taxable income (TI) on 1972 income tax returns only \$13 billion was in brackets from \$50,000 income on up. That still leaves the possibility open that many rich people pay little or no income taxes. I'll discuss that in detail a little later.

However, the conspiracy theory of tax law—that loopholes are the result of sinister machinations of lobbyists for moneyed interests who either bribed lawmakers or pulled the wool over the eyes of unsuspecting congressmen and the public—won't stand up under examination. No public laws are subjected to more painstaking and detailed congressional study, to more open hearings, to more thorough debates, year after year, than the tax laws.

It may be helpful to say a few words about the history of the income tax and the tax reform movement. When first imposed in 1913, the federal income tax was levied at rates from 1 percent to 7 percent and was a minor factor in the fiscal picture. That changed sharply during World War I when rates were lifted to between 6 percent and 77 percent. After the war they were cut to a range from 1/2 percent to 24 percent.

In World War II the income tax turned into a mass tax, the number of taxpayers multiplied tenfold, and the rate scale was pushed to its highest level—23 percent to 94 percent. Not until 1964 was the scale reduced to between 14 percent and 70 percent, where it now stands.

The huge amounts of untaxed income were first called to broad public attention in 1955. The subject soon caught attention and has been on the public agenda ever since. When in 1961 the most articulate spokesman for loophole closing, Stanley Surrey, became Assistant Secretary of the Treasury for Tax Policy—and thus the highest tax policy official in the land—energetic action on tax reform might have been expected. But neither President Kennedy nor President

Johnson would send Mr. Surrey's major recommendation to Congress. On balance, they recommended a widening of tax loopholes. Before leaving office after eight years, Surrey submitted a comprehensive report on tax reform, especially on loopholes, which he called tax expenditures. It soon began gathering dust because President Johnson was no more anxious to open that Pandora's box than was his successor.

But then an event occurred that made tax reform the hottest subject in Congress. In the interim period between the resignation of Henry Fowler, President Johnson's Secretary of the Treasury, and the appointment of David Kennedy by President Nixon, Joseph Barr served as Secretary of the Treasury for 31 days. On January 17, 1969, two days before leaving office, Mr. Barr testified before the House Ways and Means Committee with a statement that reverberated throughout the nation's media and stirred the country:

We face now the possibility of a taxpayer revolt if we do not soon make major reforms in our income taxes. The revolt will come not from the poor but from the tens of millions of middle-class families and individuals with incomes of \$7,000 to \$20,000, whose tax payments now generally are based on the full ordinary rates and who pay over half of our individual income taxes.

The middle classes are likely to revolt against income taxes not because of the level or amount of the taxes they must pay but because certain provisions of the tax laws unfairly lighten the burdens of others who can afford to pay. People are concerned and indeed angered about the high-income recipients who pay little or no Federal income taxes. For example, the extreme cases are 155 tax returns in 1967 with adjusted gross incomes above \$200,000 on which no Federal income taxes were paid, including 21 with incomes above \$1,000,000.

It is understandable that such a sensational story—that the very rich escape paying income taxes—emanating from the Secretary of the Treasury would cause a national stir. There was no taxpayers' revolt brewing before Mr. Barr exploded his bomb. But there was one in the making soon afterwards. It prodded Congress into frantic action which, within a few months, produced probably the worst piece of tax legislation ever—the Tax Reform Act of 1969.

For reasons of his own Mr. Barr did not discuss the methods or specific code provisions which enabled some high-income recipients to avoid paying taxes, though he must have known what they were or could easily have found out. Thus it was widely interpreted as an accusation against all rich people as tax evaders and against Congress for permitting such a scandal. It was not until much later that the Treasury made all of the relevant facts public, though some of them had been available right along, especially on the comparative tax burden of the middle class. Recipients of an AGI between \$7000 and below \$20,000 accounted in 1972 for 57 percent of the reported income and paid 49 percent of the tax. So, clearly they were not overburdened relative to the rest of the population.



The real shift is between the groups at the top and at the bottom of the scale: those under \$7000 income received 16 percent of AGI and paid 6.5 percent of the tax; those at \$20,000 and up received 27 percent of AGI and paid 44 percent of the tax.

For 1972, 22,929 individual income tax returns were filed with an AGI of \$200,000 or more; 22,821 of those returns or 99.5 percent were taxable. They reported an average AGI of \$414,640, an average taxable income of \$302,015 on which they paid a tax of \$177,640, or an average rate of 59 percent. There were 108 returns (0.5 percent) with an adjusted *gross* income of \$200,000 or more which reported no *taxable* income.

There were 1030 returns with an AGI of \$1 million or more of which 1024 (99.4 percent) were taxable. Each individual involved paid on the average \$1,019,577 in income tax, equal to 46 percent of his AGI and 65 percent of his taxable income.

What this means is that well over 99 percent of all high-income returns for 1972 paid high income taxes. Between 0.5 percent and 0.6 percent of the earners of a high *gross* income reported no taxable *net* income because losses, deductions, credits, or other offsetting items exceeded their gross income. Obviously it is only under very unusual circumstances that recipients of a high *gross* income have no taxable *net* income.

The most frequent case of this type is this: a person borrows money to invest at a higher rate of return than the interest he is paying. For example an individual borrows \$10 million and earns on it 10 percent, or \$1 million. He must report that \$1 million as AGI and is classified as a man with a million dollar income. He is of course entitled to an itemized deduction of the interest he paid, e.g., \$800,000. That leaves him with a taxable income of \$200,000. If the taxpayer has big losses that year or pays high state and local taxes because of a non-recurring high income in a preceding year he may wind up with no federal tax liability for a particular year. There was one case out of every 172 recipients with a *gross* income of \$1 million or more in 1972 which showed no *taxable* income.

There were altogether 16.7 million individual income tax returns in 1972 which reported no taxable income—21.5 percent of all 77.6 million returns. Ninety-two percent of the nontaxable returns were in the under \$5000 AGI bracket. At \$10,000 and above AGI only 0.4 percent of the returns were not taxable.

Many additional Americans have been freed of any tax liability by various "tax reform" laws of recent years and many of them have also been made the recipients of governmental largesse. That division of the American people into two groups—those who support the government and those who are supported by it—has created a dangerously high incidence of "representation without taxation" which in recorded history has more often destroyed free government than "taxation without representation," which the founders of this country fought.

Those who aim at an even stronger redistribution of income by repealing some types of remedial tax provisions while widening those that benefit persons

in the low brackets appear to believe that government has a prior claim to all income and that a person is really not entitled to the earnings resulting from his individual effort. There can of course be—and there are—wide differences of opinion of how a fair tax load should be allocated, and whose hardships should be recognized in the income tax. Most of the current provisions that shield some income from the full impact of the rate schedule—or from any tax—were put there not by inadvertence but to meet one or both of these objectives:

- (1) to provide greater equity, horizontal or vertical, among taxpayers and different types and magnitudes of income by taking into account differing circumstances and offering relief for hardships;
- (2) to provide incentives to taxpayers to engage in or enlarge activities which are held to be desirable as a matter of public policy. This is done by offering rewards to some and imposing penalties on others.

These two objectives often produce conflicting results when translated into tax policy.

One of the most frequently attacked "loopholes" is the provision to tax long-term capital gains at half the normal tax rate. Some ask: why should money made from money be taxed more lightly than money made from working? That sounds persuasive but is misleading. Suppose you bought a house ten years ago for \$20,000 and now sell it for \$30,000. Should you have to pay income tax on the \$10,000 you gained? Obviously, that gain is fictitious, a mere paper gain. If you wanted to buy another home of equivalent value you would have to pay at least \$30,000. That is why the law exempts such "gains" on the sale of residences under certain circumstances. But the same situation exists with other types of investment, except that the owner has to pay an income tax on half the paper gain even if it is fictitious. When you change from one investment to another you may only roll over your money but may have little or no real gain. Capital gains are not included in personal income in the national income and products accounts and the advocates of taxing capital gain as if it were ordinary income must engage in elaborate mathematical gymnastics to adjust their statistics.

The United States once tried taxing capital gains as ordinary income, from 1918 to 1921. What happened was that investments with gains were not sold, only those with losses, so that the Treasury had a net revenue loss. That would happen again if normal tax rates were applied to long-term capital gains. Investments would be effectively "frozen" which could well be the most effective way to assure stagnation in the national economy. This is why most industrial countries either do not tax capital gains at all or tax them at lower rates than ordinary income, usually at lower rates than the United States. Claims that federal revenues would increase \$7 to \$10 billion a year by taxing long-term capital gains as ordinary rates are sheer demagoguery. The chances are there would be a net loss.

Much of the controversy over loopholes focuses on



itemized deductions which in 1972 totalled \$96.7 billion:

Deductions for state and local taxes paid	\$36.2 billion
Deductions for interest paid	27.3 billion
Deductions for charitable contributions	13.2 billion
Deductions for medical & dental expenses	10.1 billion
Deductions for casualty losses, child care expenses & other	9.9 billion
	<hr/> \$96.7 billion

As I mentioned earlier, itemized deductions free a larger percentage of the income in the lower income groups than in the higher. Still, Mr. Surrey has a point when, in the earlier cited article, he charges that a \$1000 deduction may mean a net \$140 benefit to a person in the low brackets and up to \$700 to a person in the high brackets. That is simply the result of our progressive rate scale—from 14 percent to 70 percent. As long as it is regarded to be equitable to tax one person's income at 70 percent and another's at a mere 14 percent, it seems natural that a deduction is more valuable in the higher brackets. Those who want it otherwise appear to believe in the principle: Heads I win, tails you lose.

A correction of the unequal benefits of deductions could be achieved by converting from deductions from the tax base to credits against tax liability. This would be desirable in some cases, such as education.

But to abolish deductions and shift to direct governmental subsidies, as Surrey suggests, would be about the worst that could be done. It would sound the death knell to most voluntary activities and private education, concentrate all power in the federal government, and extinguish much of the freedom that is still left to Americans after the vast expansion of governmental authority in recent decades.

The largest deduction is for state and local taxes paid, with the heaviest concentration in the center of the income scale. Not to allow this deduction would be to levy a tax on a tax or on mere phantom income, not on real and available income. We already impose too much double taxation, as it is. If, for example, a person earns a monthly salary of \$2000, about \$400 may be withheld for federal income tax, aside from \$117 for social security tax, so that he gets less than \$1500 in take-home pay (minus possible other deductions). But he is federally taxed on \$2000, that is on \$500 more than he actually receives. About 30 states do the same: they impose their income tax on the gross income, making no allowance for the fact that in the above cited case the recipient gets only \$1500 and not \$2000. To curtail the existing—and inadequate—federal deduction for state and local taxes would be a move in the wrong direction and make our tax system even more capricious and unfair than it already is.

The deductibility of interest paid was originally allowed mostly with the thought in mind of borrowing for business purposes, i.e., with the intent of earning income. But interest on home mortgages and for consumer financing now accounts for three-fourths of the interest-paid deduction. Home ownership has tremendously expanded, to a point where now nearly two-thirds of all American families live in their own

homes, helped and deliberately encouraged by the deductibility of mortgage interest and real estate taxes. Consumer financing also has sharply grown. To disallow those deductions without an equivalent would deal a severe blow to residential construction and the major retailing and manufacturing activities and to the entire economy. It is inconceivable that Congress would do this. Politically it would be suicidal. Millions of families could not afford to own and furnish their homes were it not for such tax advantages. An extension or carry-through for renters may at some time be considered. Meanwhile the popularity of condominiums is growing by leaps and bounds, to a large extent because of the tax advantages they confer.

It was particularly the deductibility of charitable contributions which caused Mr. Surrey and others to call deductions "tax expenditures." Instead of allowing a deduction of donations, government could provide direct subsidies to private schools, colleges and thousands of other institutions, as has been suggested. That would, within a short time, bring the end of private education and most other voluntary activities in the United States. That may be the real goal of those who advocate repeal or curtailment of the deduction for contributions. Of course it would be enormously expensive to the taxpayers to educate at governmental institutions the millions of young people who presently attend private schools and colleges.

Disallowance of the charitable deduction would hit churches and all religious activities especially hard. They could not be granted direct governmental subsidies because of the U. S. Supreme Court's interpretation of the "no establishment" clause of the First Amendment to the U. S. Constitution. Could it be regarded as good policy and in the public interest to deal a devastating blow to religious activities in the United States, contrary to a well founded tradition that antedates even the Constitution?

Some regard the joint income tax return—or split-income provision—to be a loophole. Undoubtedly it saves many married couples sizeable amounts in taxes. Between 1948 and 1969 a single person had to pay up to 42 percent more in income taxes than a married couple with the same income. Organizations of single people continued to complain about this inequity and demanded redress. They succeeded in 1969 in having Congress reduce the tax disadvantage of single persons to a maximum of 20 percent. That created another, unexpected and unintended inequity. A man and a woman in the upper-middle income brackets who earn about equal incomes now pay up to 19 percent more in income taxes than if they were not married. They could of course, live together, but they could not get married without getting a sizeable boost in their tax bill. This has been called a "tax on marriage" and a bonus for divorce or "living in sin."

There is a way out of this dilemma that could do justice both to married and single persons. But in the strife of contesting forces, Congress has not seen fit to provide a fair method of taxing single and married persons on a more equitable basis.



*In conclusion:*

In its allocation of mitigative features—or “loopholes” if you please—the federal income tax shows the same bias which characterizes the entire American tax structure: in favor of consumption and against capital formation and investment, in favor of the low (or no) producer and against the high producer and earner.

That is politically understandable. Four out of every five personal income tax returns in 1972 reported an AGI under \$15,000 and 95 percent were under \$25,000. On the other hand, only 3 percent of all returns showed AGI of \$30,000 or more and a mere 0.8 percent of \$50,000 or over. With whom is the vote-hungry member of Congress or candidate going to place his bet—and vote: with the 51 percent who report an income under

\$8000 or with the 0.8 percent with an income of \$50,000 or more?

But the American people are paying a high price for this bias—in a much lower rate of investment than is enjoyed by other industrial countries, in a smaller rate of economic growth, and in higher unemployment.

Even more ominous is the creation of a growing mass of people who clamor for ever greater benefits from the government to whose support they do not have to contribute. The growing irresponsibility of voting—of representation without taxation—poses a grave threat to the preservation of free government in the United States. History issues a stern warning which we can neglect at our dire peril.

## Center for Constructive Alternatives

Hillsdale College recently completed its first seminar this fall in the Center for Constructive Alternatives titled “The Power of the Purse String: Taxes and the IRS.” Participating in the week-long seminar from September 28 to October 3 were:

George C. Roche  
President of Hillsdale College

C. Lowell Harriss  
Columbia University  
and the Tax Foundation

Herbert Stein  
former chairman of President Nixon's  
economic advisers

Gordon Tullock  
Virginia Polytechnic Institute

Alan Berlow  
Capitol Hill News Service

Lindley Clark  
Economic News Editor  
*The Wall Street Journal*  
Congressman Benjamin Rosenthal  
D-New York

Roger Plate  
District Director of the IRS

David Friedman  
University of Pennsylvania

Roger Freeman  
Senior Fellow  
The Hoover Institution

From November 2 through 7 the Center for Constructive Alternatives examined the topic, “Roots of American Order.” The seminar's focus covered the founding of the country, and the various historical and philosophical roots which shaped this nation as it was born. Participants for the seminar included:

Russell Kirk  
author and lecturer

M. E. Bradford  
University of Dallas

Gordon Wood  
Brown University

Congressman Steve Symms  
R-Idaho

Reid Buckley  
author and social critic

Erik Kuehnelt-Leddihn  
author and lecturer

Gottfried Dietze  
Johns Hopkins University

Anthony Kerrigan  
author and translator

Peter Stanlis  
Rockford College

William Dennis  
Denison University

Michael Novak  
author, political philosopher

Louis Filler  
Antioch College

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