

CHAPTER ONE

Today's Federal Tax Code: Nightmare on Main Street

*"In this world nothing can be said to be certain,
except death and taxes."*

-BENJAMIN FRANKLIN

Benjamin Franklin's maxim about the inevitability of taxes is so familiar that it has the ring of a cliché. But it suggests a profound truth: Taxes are a certainty we dread almost as much as death. No matter what our politics may be, when tax time approaches we all do our best to pay as little as possible. Some people go so far as to avoid taxes altogether.

Taxes and tax law may seem like dry subjects, but they've incited passions from the beginning of time. Even the American Revolution, with its rallying cry of "No taxation without representation," had its roots in a quarrel over taxation. Years later, the Founding Fathers' need

to repay the debts of that war resulted in an excise tax on whiskey, which sparked the “Whiskey Rebellion,” crushed by George Washington in the backwoods of Pennsylvania.

In the next century, protectionist tariffs on imported goods perceived to favor the fast-industrializing North helped divide the nation before the Civil War.

In the late 1970s, a popular uprising in California against excessive taxation eventually led to Ronald Reagan’s election as president.

We so detest taxation that some people will resort to truly desperate measures. Lady Godiva’s famous ride was prompted by indignation over excessive taxes. Her nobleman husband agreed to honor her pleas for tax relief for her fellow citizens—but only if she rode naked through town. Her resulting one-woman protest made history, exposing the unfairness of taxes—and then some.

Today, hardly a day goes by when we don’t read about someone going to jail for tax avoidance. A handful of Americans have even given up their citizenship and moved abroad. Most of us condemn these tax dodgers, but shouldn’t the tax code get some of the blame?

Given America’s history of tax-o-phobia, how in the world did we end up with what we have today: our horrifically heavy, appallingly complex, corruption-inducing tax code? A monster of a system that not only reaches deep into our pockets—but overreaches into our lives. It influences our behavior, distorts our economy, and—yes—ruins our quality of life as individuals and a society. If you think that’s overstated, consider the experiences of unlucky taxpayers who ran afoul of the system. This story appeared in the April 13, 2005, edition of *USA Today*:

Eric Delore of Alameda, Calif., owes the IRS more than \$400,000. He didn’t participate in a tax shelter or invent illegal deductions for a home-based business. Delore, a technology professional, is in debt because he received incentive stock options from his former employer. Those options pushed him into the nightmare world of the alternative minimum tax.

In 2000, Delore exercised stock options worth \$1.1 million and held on to them so he could get a better tax rate when he sold. But his employer's stock price imploded when the tech bubble burst. By the time Delore sold his shares, they were worth \$5,000. But because the AMT values stock options at the time of exercise, Delore was hit with a \$420,000 tax bill.

There will be more on the Alternative Minimum Tax in subsequent chapters. Actually we think the name is a misnomer of Orwellian proportions—doublespeak for what really should be called the Alternative *Maximum* Tax, because the maximum is what you pay. Basically, the Alternative Minimum Tax is what you pay when Uncle Sam thinks you're able to take too many deductions. Sadly, AMT horror stories are all too common. As for Eric Delore, the married father of two, *USA Today* says that his struggles over the AMT have ruined him financially. "His bank accounts have been cleaned out and his paycheck intercepted. There's a lien on his house. He's tried twice to negotiate a lower tax bill with the IRS but was rejected both times." According to the paper, the ordeal may force him to file for bankruptcy protection.

Another AMT victim, Nina Doherty, worked for a small software company that gave her incentive stock options as part of her compensation. However she only got to exercise a portion of her stock options in 2000. Then the market fell and her stock value plummeted to virtually nothing.

But according to the IRS, she owed money to the government as a *prepayment* on future gains of the stock. While on a scouting trip with one of her daughters in 2001, her accountant called to inform her that her family's tax bill was essentially equal to their total annual income. Things went from bad to worse. The IRS seized \$30,000 the family was planning to use for home repair and to buy a minivan. A lien was placed on their house and they were pushed to the verge of bankruptcy. In testimony last year before the Ways and Means Committee Oversight Subcommittee, Doherty blamed her tribulations on "the highly complex nature of the Alternative Minimum Tax [that] befuddled both my highly trained financial advisor and my accountant."

Such IRS abuses of taxpayer rights have been sufficient to warrant congressional hearings several years ago that led to a series of major reforms. Most of us don't get ensnared in the agency's toxic web. But even for the average taxpayer, the system is riddled with injustices. We all know the complaints:

FIRST AND FOREMOST, WE PAY TOO MUCH

And more than you'd think. Most Americans don't realize how far the politicians reach into our pockets. Everything we do is hit with some sort of tax, fee, or toll.

Consider an average day. You get up in the morning and turn on the light: you're socked with an array of electricity taxes. Turn on the water. Utility taxes. Put the coffee on. You probably paid sales tax on the coffee. Ditto any food you might eat.

Drive to work and you pay gasoline taxes and maybe a toll or two. You already paid fees on your license and registration. Not to mention the sales taxes you paid when buying the car, along with transfer fees and various add-ons local pols devised.

You get to work—and politicians take gargantuan bites out of your pay: Federal income taxes, state income taxes, Social Security taxes, Medicare taxes, and perhaps a local income tax.

Anything you buy or eat during the day has also been subjected to taxes. This doesn't mean that you pay all of them directly. When you buy, say, a new sweater, you're paying countless disguised taxes. These include the taxes that companies pay on their profits, along with workers' social security taxes, property taxes, utility taxes, corporate excise taxes, and more—all passed along to you in the form of higher prices.

But wait, your day isn't over. You go home, and, after more of those gas levies and tolls, you go through the mail. Uh oh, your county or township has sent your property taxes. Have a pet? Probably time to renew the license on Fido. Maybe you're thinking about getting married. Politicians say they love families, but they're going to charge you a fee to get hitched.

So what's the total tab? Politicians and many economists insist that “only” about one-third of our “economic output”—i.e., what we the people produce in goods and services each year—goes for taxes. But actually, when you get away from their weasel definitions of what constitutes a tax, you probably pay something like half of your income—or more.

Feel like calling Uncle Sam to complain? Watch out. You're paying taxes on that phone call—including an excise tax of currently 3 percent passed as a temporary financing measure to pay for the 1898 Spanish American War!

The politicians have anesthetized us to the scale of their tax larceny. Did We the People really give them the mandate to empty our wallets like this?

TAXES ARE TOO DAMN COMPLEX, ESPECIALLY THE FEDERAL INCOME TAX CODE

Consider this, for starters: Abraham Lincoln's Gettysburg Address, which defined the character of the nation, is all of 268 words. The Declaration of Independence runs about 1,300 words. The Constitution, which has served us for more than 2 centuries, comes to some 5,000 words. The Holy Bible has 773,000 words. The federal income tax code and all of its attendant rules and regulations: **9 million** words and rising.

An appalling fact about the tax code is that *no one* really knows what's in it. That's why there are endless court cases over what our system actually allows and doesn't allow. And it's why there is so much ambiguity and confusion, why so many people and small businesses miss out on taking lawful deductions or end up making mistakes. It's why people with similar salaries can end up paying wildly different amounts of tax to Uncle Sam.

Indeed, how could anyone possibly know what's in the code when it reads like the following passage from the 2004 American Job Creation Act. And we quote:

Sec199(c) Special rule relating to election to treat cutting of timber as a sale or exchange.—

Any election under section 631(a) of the Internal Revenue Code of 1986 made for a taxable year ending on or before the date of the enactment of this Act may be revoked by the taxpayer for any taxable year ending after such date. For purposes of determining whether such taxpayer may make a further election under such section, such election (and any revocation under this section) shall not be taken into account. (p. 23)

Uh, run that by us again.

For those not fluent in taxcode-ese, the passage is explaining how cutting timber fits into the scheme of the new deduction for income from domestic manufacturing. If an owner of timber decides to cut and sell some trees, he can “revoke” his decision to file as having sold these trees for a gain under the new rules passed by Congress in October 2004.

We’ll take their word for it. Here’s another example, an excerpt from Section 274 (n) (2), titled “Exceptions to meals not allowed” as deductions under the code. Are you ready?

Sec 274 (n)(2) Exceptions to meals not allowed:

Paragraph (1) shall not apply to any expense if—

... (E) such expense is for food or beverages—

- (i) required by any Federal law to be provided to crew members of a commercial vessel,
- (ii) provided to crew members of a commercial vessel—
 - (I) which is operating on the Great Lakes, the Saint Lawrence Seaway, or any inland waterway of the United States, and
 - (II) which is of a kind which would be required by Federal law to provide food and beverages to crew members if it were operated at sea,
- (iii) provided on an oil or gas platform or drilling rig if the platform or rig is located offshore, or

- (iv) provided on an oil or gas platform or drilling rig, or at a support camp which is in proximity and integral to such platform or rig, if the platform or rig is located in the United States north of 54 degrees north latitude. Clauses (i) and (ii) of subparagraph (E) shall not apply to vessels primarily engaged in providing luxury water transportation (determined under the principles of subsection (m)). In the case of the employee, the exception of subparagraph (A) shall not apply to expenses described in subparagraph (D).

That's right, you deserve to deduct the full value of your meals if they're served on oil-rigs in Alaska located above fifty-four degrees north latitude. This passage may be more comprehensible than the first. Given its absurdity, we might have been better off if we hadn't understood it.

Little wonder that experts deciphering the code's perplexing prose are regularly flummoxed, as was powerfully illustrated in 1997 by a *Money* magazine survey. The editors gave 45 expert tax preparers a return to fill out on behalf of a fictional family, "the Bakers." What did they owe Uncle Sam? The experts came up with forty-five different answers! Not one came up with the right answer—or at least what *Money* thought was the right answer. Differences in their calculations ranged from a few hundred dollars to over \$50,000.

At least that confusion was make-believe. Most of the time it is all too real.

Even the government's own tax pros don't understand the system. A 2003 Treasury Department study found that IRS experts manning the agency's toll-free help lines gave the wrong answers to tax-related questions more than 25 percent of the time. And yes, you are still liable for any errors, even if it's the IRS that makes the mistake!

Then there are those tax issues that are more exasperating—and inane—than the most arcane questions of medieval theology. Back then, they used to debate how many angels can dance on the head of a pin. Today's equivalent: How should trees be treated for tax purposes? Trees take decades to grow, which make them very different from cars.

An auto today can be manufactured in sixteen to twenty hours. Therefore, shouldn't the sale of trees be treated as capital gains?

Do you really want to know the answer? Amazingly, countless treatises and legal briefs have been written by lawyers and academics debating what the proper tax status of trees should be! Ready to throw your hands up in despair? You're not alone.

(Chapter One continued...)

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