

Taxing value

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The question for the day: when should you count transfers among third parties as part of your taxable income? Here are two examples.

- Your pal gives \$1,000 to Amnesty International in your name. Gifts are counted as income; since this is a gift to you with a fair market value of \$1,000, does this count as income to you?
- Instead of giving you a rent check, your tenant sends the rent directly to CitiMortgage, who apply it to the mortgage on the house where your tenant is living. You never see the cash, but pay a smaller mortgage. Does it count as income to you?

To the intuition of most of the folks I've spoken with, the gift donation should not count as income, and the sidelong rent payment should be. So that's an easy consensus, but the next question is *why* one third-party transfer should count and the other shouldn't. Both are a transfer from one third party to another that benefits you, and at that level, are equivalent. The fact that one is a gift is irrelevant: if Grandma slipped a \$1,000 check into your birthday card, you would have to claim it like any other income. Amnesty is a charity, but that just means that after you claim the \$1,000 gift as income, you can deduct it as charitable giving. I mean no offense to the many people who have tried, but I have not yet seen a reasonable explanation as to why we should treat one of these cases as income but not the other.

Defining income is hard. A great deal of title 26 of the US Code is about questions like these. When your employer pays your health insurance for you, is it income? What if they reimburse you for it after you pay for it? Since you sometimes declare your income tax over a year after you earned it, other problems can arise: ¿If you live in Maryland but work in DC, to whom do you pay state income taxes? [Hint: only one of these areas has Congressional representation.]

We put the Service in Internal Revenue Service I called IRS's customer help line, because this question actually has some relevance to my own tax situation. This was probably mean. I'm looking for a valid definition of income—a question which is fundamentally hard, as I'll discuss below—and they're armed with a couple of publications on the IRS website that I've already read.

The first, IRS representative #2504624, decided that a mortgage counts as rental expenses. At this point I'm torn. Even I know this is false, but is it rude to call her on her made-up interpretation of tax law?

Her: As you can see from this publication, tenants paying rental expenses count as income.

Me: It also says here that you can deduct the full value of rental expenses, so would that mean that a person could deduct their full mortgage?

Her: No. You can never deduct your full mortgage.

Me: But you declared that it's a rental expense, and those are deductible.

Her: Mortgages can't be deducted. They don't count as rental expenses.

Me: So if it's not a rental expense, then it's not income when a tenant pays.

Her: Yes, it is income. When a tenant pays rental expenses, then it's income.

This went on for a while, as I politely pressed her for a consistent definition of rental expenses, or of income. She eventually hung up on me.

Which is why I'm bucking my normal habit of using only initials and am printing her full name here. That's right, IRS Representative #2504624, every time anybody searches for your name, the first hit will be this post about how you rudely treated a taxpayer after giving him blatantly false, made-up advice.

The second try gave similar results, albeit much more politely:

Him: This counts as income under the doctrine of constructive receipt. Let me transfer you to somebody else who will explain that to you so I don't have to talk to you anymore.

While on hold, I looked up this doctrine. Constructive receipt is about the timing of income. If you get a paycheck on 20 December, but don't deposit it until 2 January, it still counts as income as of 20 December, because there was nothing keeping you from receiving it then. But this doesn't apply to either of the above cases, because there's a whole lot keeping you from receiving money from either Amnesty or CitiMortgage.

The conversation with the third person went about the same, but he had the grace, wit, and courtesy to admit that he had neither the text of 26 CFR nor the wherewithal to interpret it, and wrote out an email inquiry that was to be replied to within 48 hours. [You can't directly email the IRS's service desk—you have to phone in and ask the operator to type out an email for you.] Naturally, I never got a response.

I checked 26 CFR myself and learned an interesting factoid: it doesn't actually define income, beyond the basic 'income is money you receive' definition that does not to justice to any of the above.

The root of the problem My purpose in elaborating on the Service part of Internal Revenue Service is to show how even the full-time professionals have little idea of how to define income. It is a hard problem. On the one hand, there's some intuition that when you gain value from an action, like when somebody pays your mortgage for you, then it is income. Many countries explicitly use this definition and call it a value-added tax (VAT). But on the other hand, we recognize that you sometimes gain value in ways that are not the government's business, like when somebody gives you a nice backrub or gives money to Amnesty in your name.

There are the no-brainer cases—if somebody hands you cash, then it’s income—but what if you loaned them fifty bucks that they paid back the next month? Is that \$50 income for them in month one and \$50 income for you in month two? Nothing is consumed and relatively little value is added, but it’s ambiguous whether there’s income. The law also considers things like large gifts to be income. Remember when Oprah Winfrey gave her audience members cars, and they then each got a \$7,000 tax obligation with the gift? The idea here is that any item that you receive is equivalent to its fair market value. But this opens the door for massive ambiguity: that backrub has a fair market value, after all.

The tax code is a mess because the problem of defining income is fundamentally unsolvable, because it starts with a fundamentally unsolvable question—¿Where does value come from?—and then adds on top another fundamentally unsolvable classification—¿What portion of value should be taxed?

The IRS only makes things more difficult by refusing to acknowledge that the income tax is a tax on value. But it remains in denial, both in order to sound smart and for political reasons (The VAT is unpopular because Europeans do it, and the IRS doesn’t want to admit that the income tax is a botched VAT). If we could use the word *value*, then the Amnesty-CitiMortgage conundrum is easy: the gift contribution adds a small amount of value to your life, while a \$1,000 mortgage payment adds \$1,000 in value. As the IRS’s service representatives demonstrated, when you can’t use the V word, you’re stuck making up ad hoc stories about rental expenses and constructive receipt that don’t quite work.

Solutions First, let me quickly dismiss one faux solution to the conundrum. Under a flat tax, we retain an income tax but lower tax rates on the rich and raise tax rates on the poor so everybody is paying the same tax. The painfully disingenuous justification for this is that it simplifies the tangle of tax forms. But the root of the mess is not in the problem of working out whether to multiply taxable income by 0.3 or 0.18, it’s defining taxable income—a problem that the flat tax doesn’t touch. A tax form for the flat tax would be exactly as long as the current 1040.

Another, much more effective alternative: the consumption tax. It has some aesthetic appeal: we aren’t bothered by the rich for making lots of money, we’re bothered by how they buy big yachts and overpriced shoes. We want to encourage savings, which is why there are so many exceptions in the income tax for savings like 401(k) plans (i.e., retirement plans conforming with 26 CFR 1.401(k)). By the simplified equation $\text{Income} - \text{Savings} = \text{Consumption}$, the current tax code makes you calculate income—already hard, as above—and then excruciatingly subtract every element that could somehow count as savings. The consumption tax just has you total up consumption, by billing you at point of sale like any other sales tax.

The consumption tax also reconciles the Amnesty-CitiMortgage problem. First, we would decide whether either of the above counts as consumption or not right off the bat. Instead of the situation we have now, where we tax your income and then if you contribute to Amnesty then you get to deduct that

portion of income (under a number of caveats), you would instead pay tax when you give money to CitiMortgage (depending on how you wanna count buying a house), and then not pay tax when giving to Amnesty.

Second, all those issues about who who is the final recipient just evaporate: tax is paid by the person making the outlay. Oprah pays taxes on the car when she bought them. There's the social problem of whether the tenants should pay the landlord's taxes, but that isn't complicated by the accounting issues.

Sure, there are still questions of how one defines consumption—like whether your house is consumption or an investment. But once we have an arbitrary decision on that question, the accounting is much easier.

We like progressive taxes, where poor folk pay a lower percentage than rich folk. There's intuition behind this, that economists can readily formalize: a dollar to a poor person that buys a loaf of bread is worth much more—has much higher value—than a dollar to a rich kid who uses it to buy a portion of jewellery or other useless items. [In formal terms, there is a diminishing marginal value to income, which is evidenced by risk-averse behavior, especially as shown by those who are well past the survival level. A progressive tax on cash terms approximates a flat tax on value terms.] ? proposes fixing this via a refund on the taxes paid on the first \$20,000 in spending. If the tax rate is 5%, everybody just gets handed \$1,000. Those who consumed less than \$20,000 are now making a small profit on the tax system, and thus pay a negative rate; those who spent \$20,000 last year are paying 0% taxes, and the yacht buyers are paying 4.999%.

So, the consumption tax really is a simplification of the tax scheme, because it takes taxes at the door, replacing the problem of defining income minus savings with the simpler problem of defining cash purchases for consumption. It encourages savings and discourages yacht purchasing. The only problem is that there are several industries built from the ground up around avoiding income taxes. Lindblom explains in his *Market as Prison* essay [?] that the market is the perfect system for preventing change, because no matter the change, somebody will resist it because they are optimized to make money the way things are now. So when you have a massive system like the income tax, no matter how fundamentally screwed up it is, there will always be a chorus of defenders.

So we're stuck with the tax law we have, that attempts to codify the answer to two impossible-to-answer questions. We'll get tax laws that simplify the situation a bit, and tax laws that complicate it a bit, but as long as the law requires a definition of value and a definition of what value is to be taxed or untaxed, the law will remain a mess. }

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@book{mccaffery:tax,  
author = "Edward J McCaffery",  
title = "Fair not Flat: How to Make the Tax System Better and Simpler",  
year = 2002,  
publisher = "University of Chicago Press" }
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