ASAs, BSAs, CSAs . . . ZSAs

Bush's Phony Call for Tax Simplification

As we file our often-complicated income tax returns this April, should we take heart that President Bush's budget includes a section titled "Simplify the Tax Laws"? Not really. Elsewhere in the budget are some five dozen proposed tax-breaks that would cram even more lines onto the already overcrowded Form 1040. But Bush's feigned call to simplify is much worse than mere chutzpah.

Of Bush's three so-called "simplification" measures, one is trivial, one is nothing but a sop to a few very well-off taxpayers, and one is truly insidious.

The trivial item involves the tax code's definition of "dependent child." Currently, there are two slightly different rules. To qualify for the $3,000 per-child exemption, the $600 child tax credit and the daycare credit, parents must provide more than half their children's support. In slight contrast, parents who claim the earned-income tax credit and single parents who file as "heads of household" must live with their children for more than half the year (kids away at school also qualify). Not surprisingly, the distinction rarely matters in practice. Ninety-six percent of parents who claim the earned-income tax credit under the "live with" test, for example, also qualify for the dependent deduction under the support test. So Bush greatly exaggerates when he claims that using the live-with rule for all five kids' tax benefits will make tax filing far less onerous. And he undercuts even this modest gain by keeping the support test as an option for taxpayers who prefer it.

Bush's second "simplification" measure involves a tax subsidy for adoption. It's not a major item. Only 42,000 adopting parents claimed the tax break in 2000—although for the few who qualify, the tax savings can total as much as $13,000. Bush's plan to "simplify adoption tax provisions" makes only one change. He would repeal the current rule that denies the tax breaks to people making more than $192,000.

Finally comes the biggest item that Bush touts as simplification: more tax-free investment accounts. The President claims that this would make things simpler by consolidating the existing alphabet soup of savings tax breaks into fewer, more straightforward plans, specifically "lifetime savings accounts" (LSAs), "retirement savings accounts" (RSAs) and "individual development accounts" (IDAs). But that's preposterous. Instead, the new plans would generally be loaded on top of the existing ones. Indeed, rather than dropping things like education savings accounts (ESAs) and medical savings accounts (MSAs), Bush would actually expand them. Traditional tax-deductible IRAs (T-IRAs) would also be retained, albeit with diminished usage. So much for simplification.

What the President really likes about his new investment accounts is that they would scrap the current income limits, sharply boost the maximum annual contributions and in the case of LSAs, have no rules about when the money could be withdrawn or what it could be used for. As a result, the few people who could afford it could put upwards of $60,000 a year into tax-sheltered accounts. Bush hopes that eventually this will make almost all investment income tax-exempt—and leave wage-earners to pay almost all the taxes.

The way Bush structures his new savings plans is particularly disturbing. Most current savings tax breaks give a tax deduction when money is invested, but withdrawals (usually after retirement) are taxed. Under the new LSA and RSA plans there would be no initial deduction, but all investment earnings would be permanently tax-free.

An immediate deduction for contributions can be equivalent to an exemption for earnings—for any given person. If I'm in the 27 percent tax bracket and have $1,000 to invest, it only costs me $730 to make an investment that's tax-deductible. If my $1,000 grows to, say, $10,000 by the time I withdraw it, then I'll net $7,300 (assuming my tax rate remains the same). Under the exemption-for-earnings approach, I don't get a deduction and so can invest only $730, but at withdrawal, I still end up with $7,300, tax-free.

But among different people, the disparity between an initial deduction and an exemption for earnings can be huge. Suppose that one person is extremely lucky and his investment portfolio grows to $1 million, while another person has very bad luck and ends up with nothing. Under the initial-deduction approach, the lucky person will ultimately—and rightfully—pay a lot more in taxes than the unlucky one. But if investment earnings are tax-free, then both will pay the same zero tax.

Only someone utterly contemptuous of tax equity could tolerate such an unfair result. Unfortunately, that's an apt description of our President.