

# Loophole, Schmoophole!

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The infamous tax “loophole”. Something that is sure to raise the hackles of every hardworking tax-paying American. After all, if I have to pay my taxes, why do you get “loopholes” to get out of paying yours? Well the reality of the situation is that it is the complexity of the tax code itself that leads to this situation. It is also critical to realize that when it comes to any human endeavor, once rules are set, people will try to maximize their benefits within those set rules.

Let’s look at the criminal justice system as an example of this. This system also doubles to show the hypocrisy of the whole tax system. What is the entire basis of our criminal justice system? Innocent (or at least not guilty) until proven guilty. This is based on the idea that it is better that 100 guilty people go free than to let 1 innocent person go to jail. To maximize the likelihood of this result, certain rules are put into place within the system.

Well, couldn’t these rules be described as a “loophole”? Take for instance the “you have the right to remain silent, you have the right to an attorney ...” Miranda warning. If a person makes a confession without being given this warning, it could be grounds to throw the confession out entirely. Why is this rule in place? The principle is that the burden of proof is on the state to prove a suspect’s guilt. Due to the state having a disproportionate amount of power, the state has to make the suspect aware of their rights.

Now moving back to the tax code. Isn’t this the exact opposite situation when you file your tax return? When you take a deduction (especially when it comes to small businesses), the burden is on you to prove that you were allowed to take those deductions if the IRS comes knockin’. Of course, there is no way for legislators or the IRS to foresee EVERY single possible situation, so the laws are written to cover the most common circumstances. As there are exceptions to every rule, and the vast majority of adults have to file a tax return, there are bound to be situations that fall into the “gray area” when claiming a particular deduction. When this happens, this is when politicians/people running for office love to promise how they are going to “close the loopholes”!

This is even more infuriating when you think about how certain deductions are explicitly written into the tax code. Somehow “explicit loopholes” are more “legitimate” than people trying to interpret ambiguities in the tax code is to find out exactly how much they are required to pay. Take the mortgage interest deduction, which has been in the news somewhat recently.

Homeowners who take out a mortgage on their home are allowed to deduct the amount they pay in INTEREST over the course of the year towards their mortgage. Well, couldn’t it be argued that this is a form of “loophole” to allow people who own homes to pay fewer taxes than people who rent homes? After all, there is no “renter payment deduction”. So, why is this “loophole” more fair? Just because the government wrote this explicitly into the tax code?

Some might say that the reason for this is to encourage home ownership. The first argument I would raise against that ism WHY is it the government’s job to encourage one type of living arrangement over another? What is wrong with renting? But suppose you buy this is a

legitimate goal for the federal government. Okay, why isn't there a "mortgage principal deduction"? Or a "mortgage down payment deduction"? Why only allow deductions for people who have to borrow money to buy homes? Some might argue that this was all set up to get people in debt to the banks. That might dip into conspiracy theory a little. Also I don't know if I believe the legislators that first introduced the mortgage interest deduction were smart enough/had enough foresight to plan all this out.

I subscribe more to the idea that the federal government wanted to promote home ownership for whatever reason. Maybe this was born out of perfectly good intentions, such as the government feeling that people would take better care of their neighborhoods if they owned a part of it. Even if this was born out of good intentions, it just further proves that government cannot anticipate every situation when implementing a particular policy.

Again, why aren't ALL forms of payment towards owning a home deductible? For instance, if you have enough money to buy your house with cash right off the bat, then you cannot deduct this amount (which is likely to be over \$100,000). Maybe this was just an oversight by the legislators. Fair enough, but the mortgage interest deduction has been around for close to 100 years. There has been plenty of time to make changes to encompass all forms of house payments.

I have not read the exact code section with the mortgage interest deduction. Let's just say for instance that it was written somewhat ambiguously. For instance, "monthly payments towards a mortgage are deductible". Well, this could mean just the interest, just the principal, or both the principal and the interest. If one attorney/CPA/tax advisor interpreted it to mean the principal, and one interpreted it to mean the interest and another tried to deduct both the principal and interest, some might say the last attorney/CPA/tax advisor is exploiting a "loophole".

In reality though, there is really not a "right answer" because a convincing argument could be made for all three instances. In fact, some might argue that the first two attorneys/CPA/tax advisor are actually not taking all the deductions they are entitled to. This is just one example of a situation where ambiguities could arise. Now multiply this situation over thousands of pages of tax code for thousands of different tax laws and it should be clear that this is not a cut and dried situation of individuals "cheating the tax system". It is just people trying to pay the lowest amount they are legally required to pay.

I'm sure some people will argue that people should just "bite the bullet" and not take any deductions that might lie in a gray area. The only thing I can say to that is, did you take this approach the last time you filed your taxes? Did you ask to read the code sections to make sure that all your deductions were 100% clearly explained and did not rely on any ambiguities? If not, couldn't it be argued that you are taking advantage of "tax loopholes"?

Hopefully this gets you to at least reconsider the reflex reaction to getting upset about "tax loopholes". For a further discussion on government rules and how they affect the economy, check out Anti Social: Rebooting Capitalism and the American Dream, available at [www.rebootingamericandream.com](http://www.rebootingamericandream.com)!