

**Real World Graduation: Question 55: The Tax Code**

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Question 55

A man has earned income in a certain year. He took the "standard deduction" on his federal "gross income" tax, and as a result, his "taxable income" is taxed at 25%. If he had made a \$100 "tax-deductible" contribution that year, how much would his federal tax have changed?

- a) "Tax deductible" refers only to state taxes, so his federal tax would remain unchanged.
- b) His tax would have been reduced by \$100.
- c) The "tax deduction" only applies in the following year, so he would get a reduction next year, not now; his tax for the current year is unchanged.
- d) His tax would be 25% of his gross income less the \$100, or the amount previously calculated, whichever is less.
- e) His total tax is 25% of \$100 = \$25.

### Answer to Question 55

This is a trick question. All of the answers given are incorrect.

Answer a) is incorrect because "tax deductible" contributions are deductible for federal purposes.

Answer b) is wrong because "tax deductible" does not mean that you can deduct the contribution from your taxes; you can deduct it from your income. So, his tax would be reduced by 25% of the \$100 contribution (\$25) only if the \$100 deduction did not lower the "tax bracket" of his "taxable income"; in that case, his tax would be reduced by the tax rate at the lower tax bracket rate. However, if he had any income from rental properties, sales of stock or bonds, farm income or any of the other income sources called out in the Tax Code, there is no way to predict the effect of the donation.

Answer c) is incorrect because contributions can be used a tax deductible usually only in the tax year in which they are made.

Answer d) is wrong because it ignores the "standard deduction".

Answer e) is wrong because the tax depends only on the amount of a contribution instead of income.

See how simple the tax code is? The tax code (the regulations of which fill 20 volumes in the U. S. Code of Federal Regulations) is complicated because Congress wants it that way. Here is a bonus question: Why does Congress want a complicated tax code?

- a) In order to make the tax code as fair and equitable as possible.
- b) To ensure that everyone pays their fair share.
- c) To ensure that equal numbers of rich and poor do not have to pay taxes.
- d) Because the tax code must reflect the complexity of the economy, otherwise some people will pay less than they should.
- e) All of the above.

The answer is once again, "none of the above". The tax code is exceedingly complicated because it is a means by which members of Congress can acquire and utilize power to punish their political enemies, reward their allies, and generally coerce people's behavior. If a corporation does something a Congressman doesn't like, he can insert a provision in the code to penalize that corporation; if a corporation gives him a large campaign donation, he can insert a provision to lower that corporation's tax burden. The tax code requires centralized record-keeping of all financial data; any Congressman (in fact any federal legislative, regulatory, or enforcement official) can obtain any and all financial data on any business or person if they give a remotely plausible reason. Complying with the tax code requires an enormous amount of labor and effort. The cost of compliance with the tax code is estimated at \$400 billion [1]. Most of that effort is performed for free by taxpayers, or performed by experts who are in turn paid by the taxpayers. Compulsory unpaid labor was once known as slavery (back when words had meaning). A great many hours are expended by professional tax experts; their jobs depend on a complex tax code, hence they are indirectly dependent on Congress for their livelihood. This explains another reason why the tax code never will be simplified - too many people will become unemployed. The important point to remember is that the tax code is only partly about revenue. It is also about the use and abuse of power.

Here is an additional note about the complexity of the tax code. In 1927, three economists wrote in their economics book [2]:

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"The [tax] law itself is a lengthy document equivalent to about 100 ordinary printed pages, loaded with technical details and administrative provisions of the utmost complexity".

It is good to know that Congress continues to "simplify" the tax code such that we now have only 60,000 pages of tax-related case law to deal with (as of 2016).

[1] <https://taxfoundation.org/compliance-costs-irs-regulations/>

[2] Fred Rogers Fairchild, Edgar Stevenson Furniss, and Norman Sidney Buck, *Elementary Economics*, New York: The Macmillan Co., 1927, Vol. 2, p. 415.