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INDIVIDUAL TAX REFORM FOR FAIRNESS AND SIMPLICITY: LET ECONOMIC GROWTH FEND FOR ITSELF*

MARTIN J. McMAHON, JR.**

I. INTRODUCTION

The federal income tax system has undergone significant change since 1981. First, in a paean to supply-side economic theory the Economic Recovery Tax Act of 1981¹ slashed both maximum marginal tax rates and the tax base. Subsequent tax acts in 1982² and 1984³ broadened the base in an effort to increase revenues without expressly increasing rates. Then the much heralded Tax Reform Act of 1986⁴ broadened the tax base sufficiently to lower rates even further. Tax acts subsequent to 1986 again were designed to increase revenues by broadening the base while holding rates at the then current levels.⁵ Despite the myriad changes in the tax laws during the 1980s and the almost universal cry for stability from tax practitioners, the need for further reform cannot be denied.

Although many of the base broadening provisions of the tax legislation of the 1980s were well grounded in tax policy analysis, some of the most significant provisions, such as the passive activity loss rules, are difficult to understand from a theoretical tax policy perspective. They must be justified, to the extent possible, as *ad hoc* solutions to problems in the tax system that were not addressed directly or as facets of tax expenditure analysis. In addition, many exclusions from the tax base that cannot be justified on tax policy grounds survived the tax reform of the 1980s. Finally, the 1986 Act etched into the statute the low effective tax rates for high income taxpayers that previously had been achieved through tax planning and tax shelters and did serious damage to the vertical equity of tax rates.

The 1992 election promises to sire still more tax reform. But preliminary indications are that the Clinton Administration's view of tax reform for the

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** Laramie Leatherman Professor of Law, University of Kentucky College of Law. I am indebted to Paul McDaniel and Dan Simmons for their helpful comments on a draft of this essay. Neither of them, however, necessarily subscribes to the views I express here.

1. Pub. L. No. 97-34, 95 Stat. 172 (codified as amended in scattered sections of 26 U.S.C.).

2. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (codified as amended in scattered sections of 26 U.S.C.).

3. Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (codified as amended in scattered sections of 26 U.S.C.).

4. Pub. L. No. 99-514, 100 Stat. 2085 (codified as amended in scattered sections of 26 U.S.C.).

5. See generally C. EUGENE STEUERLE, *THE TAX DECADE: HOW TAXES CAME TO DOMINATE THE PUBLIC AGENDA 166-84* (1992) [hereinafter *TAX DECADE*].

1990s is narrow, and to some extent is tax "deform" rather than "reform."⁶ Some of the "populist" oriented proposals from the Clinton Administration, such as raising the maximum marginal rates⁷ and further limiting the deductibility of business entertainment,⁸ actually have a sound theoretical basis in tax policy analysis, but other proposals, such as the proposed investment tax credit⁹ and targeted capital gains preference¹⁰ for new small business investment in no way represent tax reform. Introducing new tax expenditures will serve only to increase complexity and exacerbate perceived, if not real, unfairness in the tax system.

Both the reforms of the 1980s and the Clinton Administration's early proposals for tax reform for the 1990s generally fail to address a number of significant problems in the individual income tax system. Complexity and inequity continue to permeate the tax system. Although much of the complexity is attributable to efforts accurately to measure economic income,¹¹ more of it probably is attributable to limitations on tax expenditures,¹² stop-gap restrictions on exploitation of unjustifiable exclusions from the tax base,¹³ and arbitrary limitations on deductions that serve as disguised rate increases.¹⁴ Tax expenditures and the resulting *ad hoc* limitations on their benefits may be the major culprit in complexity.

Inequity in the tax system derives from two sources. First, despite a decade of "tax reform," the Internal Revenue Code remains riddled with exclusions that result in horizontal inequity. Some, such as nonrecognition for like-kind exchanges, probably are best viewed as historical artifacts. Others, such as statutory tax-free fringe benefits, are not just remnants of the past, but continue to multiply. Second, the supply-side economics emphasis that strongly influenced tax policy in the 1980s has seen the effective tax rates on very high-income individuals—the top 10%—fall dramatically relative to the tax rates of the remaining 90% of individual taxpayers. This presents serious vertical equity issues that must be addressed.

6. TREAS. DEP'T, SUMMARY OF THE ADMINISTRATION'S REVENUE PROPOSALS (1993) [hereinafter ADMINISTRATION'S PROPOSALS].

7. *Id.* at 34-35 (proposing increase in top marginal rate for individuals to 36% with 10% surcharge for very high incomes), 44 (proposing increase in top corporate rate to 36%).

8. *Id.* at 38 (proposing reduction in amount of deductible entertainment expense from 80% to 50%).

9. *Id.* at 5-8 (proposing small business and incremental investment tax credit).

10. *Id.* at 11-12 (proposing targeted capital gains exclusion).

11. See, e.g., I.R.C. § 163(h) (Supp. 1993) (dissallowing deductions for consumer interest); Treas. Reg. § 1.163-8T (1987) (providing interest tracing rules).

12. The passive activity loss rules of I.R.C. § 469 and the alternative minimum tax provisions of I.R.C. §§ 53, 55, 56, 57, 58 and 59 are examples.

13. See, e.g., I.R.C. § 170(e) (Supp. 1993) (limiting amount of deduction for charitable contributions of appreciated property).

14. See, e.g., I.R.C. §§ 67 (Supp. 1993) (imposing 2% floor on miscellaneous itemized deductions), 68 (Supp. 1993) (phasing out itemized deductions for taxpayers whose adjusted gross income exceeds certain levels), 151(d)(3) (Supp. 1993) (phasing out personal exemptions for taxpayers whose adjusted gross income exceeds certain levels).

Traditional tax policy analysis focuses on whether the system (1) raises adequate revenue, (2) in an equitable manner, (3) without undue complexity, and (4) without undue interference with the economic system.¹⁵ Since 1981, however, the dominant characteristic of tax policy debate in the political arena has been the effect of the current rules and proposed changes on economic behavior. When tax reform is considered, the focus rarely is on the tax system as a source of revenues the effectiveness and fairness of which should be measured against the full range of traditional criteria of tax policy. Nor is the redistributive function of taxation considered in a balanced manner. Use of the tax system to redistribute the social product has been decried. Instead, tax policy analysis has been dominated by demands for either investment neutrality¹⁶ or investment incentives,¹⁷ with pseudo-economists somewhat amazingly demanding both simultaneously.¹⁸ Advocates of changing the tax system to encourage economic growth do not seem to view the tax system as a vehicle to collect adequate revenues fairly or to soften the harsh distributional results that capitalism sometimes produces. They evaluate the tax system solely as a tool for managing economic activity, both on a macroeconomic and microeconomic scale. In other words, much of what passes for "tax policy" in the political arena today is in reality "tax expenditure policy."¹⁹

"Fairness" questions sometimes are raised, but even then the notions of "fairness" that are debated do not appear to correspond to the traditional tax policy criteria of vertical and horizontal equity. Too often the "fairness" being discussed is divorced from an analysis of the structure of the income tax and in reality is a disguised complaint with respect to the overall level of taxation. Largely because economic analysis dominated the tax policy criteria in the 1980s,²⁰ the tax system has continued to be only mildly progressive, even as the distribution of income and wealth in the United States has become more concentrated over the past decade and a half.²¹

15. See Joseph T. Sneed, *The Criteria of Federal Income Tax Policy*, 17 *STAN. L. REV.* 567, 568 (1965) (listing seven factors that shaped federal income tax rates and structure: "(1) to supply adequate revenue, (2) to achieve practical and workable income tax system, (3) to impose equal taxes on those who enjoy equal incomes, (4) to assist in achieving stability, (5) to reduce economic inequality, (6) to avoid impairment of operation of market oriented economy and (7) to accomplish high degree of harmony between income tax and sought-for political order").

16. See, e.g., Michael Boskin, *Taxation, Savings, and the Rate of Interest*, 86 *J. POL. ECON.* S3, S18-25 (1978); David F. Bradford, *The Economics of Tax Policy Toward Savings*, in *THE GOVERNMENT AND CAPITAL FORMATION* 11, 20-28 (George M. von Furstenberg ed., 1980); Martin Feldstein, *The Welfare Cost of Capital Income Taxation*, 86 *J. POL. ECON.* 29 (1978).

17. Martin Feldstein, *On the Theory of Tax Reform*, 6 *J. PUB. ECON.* 77, 89-90 (1976).

18. JACK KEMP, *AN AMERICAN RENAISSANCE* 49-76 (1979).

19. For tax expenditure analysis, see STANLEY S. SURREY & PAUL R. MCDANIEL, *TAX EXPENDITURES* (1985).

20. See generally *TAX DECADE*, *supra* note 5.

21. See JOSEPH A. PECHMAN, *TAX REFORM, THE RICH AND THE POOR* 17-27 (1989); HOUSE COMM. ON WAYS AND MEANS, *1992 OVERVIEW OF ENTITLEMENT PROGRAMS* 1454 (Comm. Print 1992) [hereinafter 1992 GREEN BOOK].

Two major threads of the debate of recent years have lead us astray in a our search for sensible tax policy. First, we have misunderstood and misapplied what economics can tell us about the tax system. Second, in endeavoring to cure a wide variety of economic and societal problems by tinkering with the Tax Code, we have lost the forest for the trees; forgetting the purposes of taxation, we have focused only on certain of its effects. True tax reform cannot occur without coming to grips with the fallacious notions that have been generated by these failures. On the positive side, however, we have become much more astute in our ability to determine the accrual of economic income, as is evidenced by the numerous changes in the Tax Code relating to the time value of money. More complete tax reform will require that we remember the purposes of taxation and apply our ever developing knowledge about how to measure income in contexts where we have continued to accept significant mismeasurement of economic income.

As far as individual taxpayers are concerned, the tax legislation of the 1980s was as much "deform" as "reform." Not only did the legislation fail to eliminate many horizontal inequities in the tax base, but it introduced new irrationalities in the tax base and gave rise to a rate structure that is both unfair and fails to raise adequate revenue. One need look no further than the Annual Budget of the United States for any year in the last decade to see that the tax system fails to raise adequate revenue. The perpetual large deficits of the federal government, which, measured by standards of the rest of the industrialized world, spends only a modest percentage of gross domestic product, is *prima facie* proof of this failure. To some extent, the failure of the tax system to collect adequate revenues is attributable to the attacks during the 1980s on the progressivity of the rate structure that characterized the income tax system for most of its first seventy years.

II. PROGRESSIVE RATES

A. Taxing Millionaires

One of the major goals of future tax reform should be a renewal of the ideals of progressive income taxation. Over the past decade and a half, the effective tax rate on families in the top 1% of the population by income class—a group of families with 2.5 million members²²—has been dramatically reduced while the share of income realized by this group has dramatically increased.²³ This group's effective federal income tax rate fell from 35.5% in 1977 to 31.7% in 1980 and to 26.7% in 1989; by 1993 its effective tax rate was projected to have increased only slightly, to 28.8%.²⁴ From 1977 to 1989, the income of this group increased by 80.3%, while the income of

22. 1992 GREEN BOOK, *supra* note 21, at 1517, Table 18.

23. *Id.* at 1512, Chart 1.

24. *Id.* at 1510, Table 14.

all families in the United States increased by only 15.5%; the income of the lowest 40% actually decreased over this period.²⁵ The after-tax income of the top 1% increased by 104.4%, while overall after-tax incomes increased by only 15.6%; after-tax incomes of the bottom 40% of the population decreased.²⁶

These are striking comparisons that have important implications with respect to both the fairness of the tax system and its ability to raise adequate revenues. While it is true that the share of total federal taxes paid by the top 1% of income earners increased from 13.6% in 1977 to between 15.4% and 15.9% during the 1988-1993 period,²⁷ this does not indicate that the tax system has become more progressive. The share of pre-tax adjusted family income realized by this group increased from 8.3% in 1977 to 13.4% in 1988, and the pre-tax income of the top 1% increased by a much higher percentage than its share of taxes paid.²⁸ The group's share of disposable after-tax income increased from 7.3% in 1977 to 12.8% in 1988.²⁹ From 1977 to 1989, the effective federal income tax rate for the top 1% fell by 17.9%, while the overall effective income tax rate fell only .9%.³⁰

During the past decade opponents of progressive taxation, advocating proportional or slightly progressive taxation, have raised two arguments in their successful attack on the historic rate progressivity for high income taxpayers. One, which finds its roots in the seminal work by Blum and Kalvin, *The Uneasy Case for Progressive Taxation*,³¹ was to assert that the burden of proof was to be born by advocates of progressive taxation. From this premise, "flat taxers" argued that unless the diminishing marginal utility of money could be theoretically proven, progressive taxation could not be justified. These flat-tax-rate advocates wound up their case with the conclusion that the diminishing marginal utility of money could not be proven, and that therefore proportional taxation should be adopted.

The second line of attack on progressivity was based on economic analysis of capital investment, and assertions that high tax rates stifled economic growth. Low tax rates, it was asserted, would bring bounteous growth in the gross domestic product.³² The low-flat-tax proponents largely ignored the issue of vertical equity.³³

25. *Id.* at 1511, Table 15.

26. *Id.* at 1513, Table 16.

27. *Id.* at 1528, Table 28.

28. *Id.* at 1521, Table 22.

29. *Id.* at 1520, Table 21.

30. *Id.* at 1529, Table 29.

31. Walter J. Blum & Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation*, 19 U. CHI. L. REV. 417 (1952).

32. See, e.g., ROBERT E. HALL & ALVIN RABUSHKA, *LOW TAX, SIMPLE TAX, FLAT TAX* (1983).

33. See Daniel L. Simmons, *The Tax Reform Act of 1986: An Overview*, 1987 B.Y.U. LAW REV. 151, 167-171.

One of the major issues for tax policy in the 1990s is to re-evaluate the flattening of the tax rates that was the centerpiece of tax legislation in the 1980s.³⁴ Even if it cannot be theoretically proven that money has diminishing marginal utility, simple observation tells us that across broad ranges of income, money clearly has diminishing marginal utility. Even without first hand data, one need only watch the television show "Robin Leach's Lifestyles of the Rich and Famous" or read about Malcolm Forbes' birthday party in Morocco to realize that individuals with large fortunes or incomes are not as careful about how they spend their dollars as those of modest means—the middle class, however it may be defined.³⁵ If equity in the tax rates requires an attempt to approximate equal sacrifice or to measure "ability to pay" across broad ranges of incomes, rates should be far more progressive than the current rate schedule.

The economic arguments against progressive taxation should not be controlling. First, the argument that low rates are necessary for economic stimulation proves too much because it can be carried forward to support regressive taxation. If high income taxpayers should pay taxes at a marginal rate no higher than middle income taxpayers because their higher propensity to save will increase investment, and thus productivity, why not reduce their tax rates even further and allow them to save even more? Moreover, for the purpose of this type of analysis, the overall tax rate—taxes as a percent of gross domestic product—is more important than the tax rate on any particular income group. From this perspective, it is worth noting that the United States is a tax haven among industrialized democracies. No important industrialized democracy has a lower tax burden, and many have significantly higher taxes.³⁶

Second, the argument is based on a theory, not on incontrovertible fact. It usually is based on analysis of income from capital, not from salaries, and it may not be true even insofar as it applies to income from capital. Even though the theory that higher yields to capital will increase savings and investment is plausible and almost universally believed, empirical linkage is weak at best.³⁷ Furthermore, there is a respectable competing

34. See Marjorie E. Kornhauser, *The Rhetoric of the Anti-Progressive Income Tax Movement: A Typical Male Reaction*, 86 MICH. L. REV. 465 (1987).

35. See generally Mark S. Stein, *Diminishing Marginal Utility of Income and Progressive Taxation: A Critique of The Uneasy Case*, 12 No. ILL. L. REV. 373 (1992) (arguing that diminishing marginal utility of income theory is correct).

36. LESTER THUROW, *HEAD TO HEAD: THE COMING ECONOMIC BATTLE AMONG JAPAN, EUROPE, AND AMERICA* 269 (1992) (presenting table of taxes as percentage of gross domestic product for industrialized democracies, based on OECD data).

37. See Robert E. Hall, *Intertemporal Substitution in Consumption*, 96 J. POL. ECON. 339 (1988); David A. Starrett, *Effect of Taxes on Saving*, in *UNEASY COMPROMISE: PROBLEMS OF A HYBRID INCOME-CONSUMPTION TAX* 237-68 (Henry J. Aaron et al. eds., 1988) (stating that empirical and theoretical bases for savings behavior have been elusive) [hereinafter *UNEASY COMPROMISE*]; George M. Von Furstenberg, *Saving*, in *HOW TAXES AFFECT ECONOMIC BEHAVIOR* 327, 328, 365 (Henry J. Aaron & Joseph A. Pechman eds., 1981) (stating that empirical data do not conclusively prove that savings incentives increase national savings rate) [hereinafter *HOW TAXES*].

theory, based on differing assumptions regarding savings motivations, that for many people higher yields to capital may decrease savings,³⁸ and the empirical data indicate that over the long term the United States personal savings rate has varied inversely with the yield to capital.³⁹

In addition, unlike the millionaires of earlier eras, many current high income taxpayers realize a substantial part of their incomes from salaries and compensation for personal services.⁴⁰ Although some economic models conclude that high tax rates will constrict the labor supply,⁴¹ it is questionable whether they take into account fully limitations on workers' ability easily to expand and contract their work effort in response to tax rates. Notwithstanding these economic models and popular belief that taxes affect work effort, most empirical studies indicate that the work effort of primary wage earners does not change significantly in response to after tax pay changes; the data indicating responsiveness is based on the second wage earner in families.⁴²

The partial victory of the "flat taxers" should be repudiated and progressivity in the rate structure restored. Small steps already have been taken, with the introduction of a 31% bracket and current proposals for new 36 and 39.6% brackets applicable to taxable incomes reported on joint returns in excess of \$140,000 and \$250,000, respectively.⁴³ These proposals are salutary,⁴⁴ but do not go far enough. Marginal income tax rates for those at the very top of the income distribution should be increased even more. Doing so will improve vertical equity and enhance revenues.

Notwithstanding that the deficit cannot be cured solely by taxing the wealthy, there is good reason to believe that if millionaires—taxpayers with annual incomes in excess of \$1,000,000—were taxed at rates that applied as recently as 1985, federal tax receipts would be significantly increased. In 1985, taxpayers with an adjusted gross income of \$1,000,000 or more reported aggregate taxable income of \$35,995,725,000 and paid taxes of \$17,591,119,000.⁴⁵ As a group the 1985 millionaires paid taxes at an effective

38. BENJAMIN FRIEDMAN, *DAY OF RECKONING: THE CONSEQUENCES OF AMERICAN ECONOMIC POLICY* 252-55 (1988) (arguing that higher returns could "depress" savings because people may save less in order to produce same future value at higher interest rate).

39. Jonathan Skinner & Daniel Feenberg, *The Impact of the 1986 Tax Reform on Personal Saving*, in *DO TAXES MATTER? THE IMPACT OF THE TAX REFORM ACT OF 1986* 50, 58-63 (Joel Slemrod ed., 1990) [hereinafter *DO TAXES MATTER*].

40. See Marc Linder, *Tax Glasnost' for Millionaires: Peeking Behind the Veil of Ignorance Along the Publicity-Privacy Continuum*, 18 *N.Y.U. REV. OF LAW & SOC. CHANGE* 951, 957-59 (1990-91).

41. See Jerry A. Hausman, *Labor Supply*, in *How TAXES*, *supra* note 33, at 27-83 (concluding high taxes impair economic efficiency and constrict labor supply).

42. FRIEDMAN, *supra* note 38, at 242-43; Vane G. Gravelle, *Behavioral Responses to Proposed High-Income Tax Rate Increases: An Evaluation of the Feldstein-Feenberg Study*, 59 *TAX NOTES* 1097 (May 24, 1993).

43. ADMINISTRATION'S PROPOSALS, *supra* note 6, at 32-35.

44. Imposing the 39.6% rate through a "surtax" rather than an express rate bracket is not salutary. Surtaxes should be eschewed in favor of clearly visible rates.

45. INTERNAL REVENUE SERVICE, *STATISTICS OF INCOME BULLETIN* 7-10 (Winter 1986-1987)

rate of 48.87% of taxable income; the average income tax liability was \$922,256.⁴⁶ In 1988, taxpayers with adjusted gross incomes of \$1,000,000 or more in the aggregate reported \$150,744,777,000 of taxable income and paid income taxes of \$42,422,678,000.⁴⁷ While the total tax collections from millionaires increased by approximately \$25,000,000, the average income tax liability fell by approximately \$240,000 to \$684,546.⁴⁸ As a group, the millionaires paid income taxes at an effective rate of 28.14% of taxable income—an average rate decrease of twenty percentage points. Although due to base broadening the effective tax rate on the very top income earners did not drop quite as much when computed with respect to expanded definitions of income,⁴⁹ there is no a priori reason not to be concerned with the change in taxes as a percentage of taxable income. Indeed, since politically we have decided—rightly or wrongly—that “taxable income” is the base on which the income tax is levied, unless we have some other taxes that impact particular income classes highly disproportionately, taxes paid as a percentage of taxable income may be the best measure of “effective tax rates” in determining the proper level of progressivity in income taxation. Applying the twenty percentage point decrease in tax rates to the approximately \$150,000,000,000 of taxable income reported by millionaires in 1988, and ignoring behavioral effects, would indicate a revenue loss of approximately \$30,000,000,000 as a result of the decreased rates.

Serious consideration should be given to raising the marginal rate on incomes in excess of \$1,000,000 to 50%. Rates for taxpayers with adjusted gross incomes between \$500,000 and \$1,000,000 should be increased as well. In 1985, taxpayers with adjusted gross incomes between \$500,000 and \$1,000,000 paid an average income tax of \$238,813 on an average taxable income of \$516,008—an effective rate of 46.28%.⁵⁰ In 1988, this group had average taxable income of \$589,656, but the average income taxes paid had fallen to \$167,097—an effective rate of 28.4%.⁵¹ Total taxable income for this group in 1988 was \$67,552,225,000.⁵² Thus, assuming away behavioral effects of the rate difference, the eighteen percentage point drop in average

(listing preliminary data for 1985) [hereinafter PRELIMINARY DATA]. This represents 19,016 returns. The total adjusted gross income of the millionaires represented 1.93% of aggregate AGI, and the taxes paid represented 5.35% of total taxes.

46. *Id.* at 10.

47. INTERNAL REVENUE SERVICE, STATISTICS OF INCOME—1988, INDIVIDUAL INCOME TAX RETURNS 18-19 (1991) [hereinafter SOI—1988].

48. The total adjusted gross income of the 62,065 millionaires in 1988 represented 5.5% of aggregate AGI, and the taxes paid represented 10.3% of total taxes. *Id.* at 18.

49. See TAX DECADE, *supra* note 5, at 195 (containing chart showing effective federal tax rules).

50. PRELIMINARY DATA, *supra* note 45, at 7-10. This represents approximately 39,400 returns. *Id.* at 7-10.

51. SOI—1988, *supra* note 47, at 18-19.

52. *Id.* at 18.

rates cost the Treasury over \$12,000,000,000.⁵³ If incomes above \$250,000 are taxed at a 39% marginal rate, and incomes above \$1,000,000 are taxed at 50%, a 45% rate should be applied between \$500,000 and \$1,000,000.

Of course it is overly simplistic to conclude that retaining the 1985 effective rates would have increased 1988 tax collections by approximately \$40,000,000,000. Surely the lower rates had some behavioral effects and increasing the rates will as well. Perhaps if a 50% tax had been levied since 1988 Madonna would have performed fewer concerts or failed to write her infamous book and earned a few million dollars less, thereby decreasing her tax liability.⁵⁴ But it is likewise overly simplistic to conclude that substantially higher rates on millionaires would not raise very significant amounts of revenue for the government. Although some economists theorize that as income tax rates increase, work effort generally diminishes, to do so in many cases they must assume away market-driven requirements of continued undiminished work effort. Common sense tells us that they very well may overstate the case. In some cases, the flexibility simply does not exist. The hundreds of professional athletes in this group hardly could tell team management two-thirds of the way through the season that the Tax Code has eliminated their incentive to finish the season. In many cases, at-the-margin work effort may be motivated more by nonmonetary factors such as interest and prestige.⁵⁵ It is doubtful that multi-million dollar a year corporate executives, financiers, and Wall Street lawyers will scale back their work efforts to the extent that the economy noticeably will be harmed.⁵⁶ Perhaps, following the lead of Ronald Reagan, who claimed that high tax rates caused him to make fewer movies than he otherwise would have made, Bill Cosby and Michael Jordan will make fewer television commercials, but diminished work effort by entertainers, or financiers for that matter, is of little import to the economy. Their incomes represent a reallocation of production far more than they represent new production.

Furthermore, it is difficult to accept arguments that "fairness" requires lower rates and militates against tax rates in the 50% range for millionaires. The average *taxable income*—which understates disposable income—for the 61,896 millionaires who reported taxable income in 1988 was \$2,435,453.⁵⁷ It is difficult to sympathize with the plight of an individual left with more than \$1.2 of *after-tax* income. In fact, the converse is true. It is difficult to justify a tax system that tolerates the relatively low effective tax rates

53. $18\% \times \$67,552,225,000 = \$12,159,400,500$.

54. Less work effort by Madonna might be a positive result in and of itself. See MADONNA, SEX (1992).

55. See RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 300 (5th ed. 1989) (stating high wage earners may be less responsive to changes in net wage rate because nonwage factors such as prestige, interest in work, etc. may control).

56. See THOMAS H. SANDERS, EFFECTS OF TAXATION ON EXECUTIVES 17-32 (1951) (containing Harvard Business School study concluding that executive work effort was unaffected by taxes at time when maximum tax bracket exceeded 80%).

57. SOI—1988, *supra* note 47, at 18.

that the Tax Code currently applies to such large incomes. In 1988, more than twenty corporate Chief Executive Officers or chairmen received compensation of \$6,000,000 dollars or more, eleven made more than \$10,000,000, topped by Michael Eisner of Walt Disney Studios.⁵⁸ A dozen Wall Street financiers reportedly topped the \$50 million mark in profits that same year.⁵⁹ The top ten earners among lawyers reportedly each received more than \$5,000,000 that year.⁶⁰ At these income levels, marginal tax rates in excess of 50% could be justified.

Proponents of low flat taxes no doubt will argue that increased progressivity would stifle investment incentive and work effort. The burden of proof, however, should rest on those trying to justify retention of low marginal tax rates on millionaires. The tax policy analysis of the 1980s, based on welfare economics, focused on "efficiency" in the economy. Efficiency maximizes gross domestic product—it produces the biggest pie.⁶¹ But economic efficiency is not necessarily in and of itself the paramount social goal. How tax policy affects the distribution of gross domestic product—how the pie is sliced—also is very important.⁶² Perhaps this question was not considered thoroughly because of the siren song that a bigger pie will result in bigger slices for all. But that is not necessarily so.

Notwithstanding analytical arguments against progression based on welfare economics, progressive taxation may be justified on political grounds.⁶³ Over the past decade and a half the share of wealth accumulated by the top decile of the population undeniably also has increased. The concentration is even more pronounced when the top 1% is compared with the remaining 99%. There are sound reasons for mitigating this growing economic disparity through more progressive income taxation. Mitigation of vast disparities in wealth helps to insure that democratic systems function. The populace must believe that the overall political-economic system is fair. If the results are too disparate, the fairness of the system is questionable. Finally, concentration of wealth and incomes in a very small segment of society can result in an unjustifiable concentration of political power.

Tax policy for the 1990s should examine how the pie is sliced as well as how big a pie a country can bake. A simple example illustrates why this is necessary. Assume a society with five members, *A*, *B*, *C*, *D*, and *E*. *A* and *B* each have income of \$10, *C* and *D* each have income of \$12, and

58. KEVIN PHILLIPS, *THE POLITICS OF RICH AND POOR, WEALTH AND THE AMERICAN ELECTORATE IN THE REAGAN AFTERMATH* 179 (1990) (providing table comparing chief executive compensation for years 1981 and 1988).

59. *Id.* at 173.

60. *Id.* at 176.

61. John B. Shoven & Paul Taubman, *Saving, Capital Income, and Taxation*, in *THE ECONOMICS OF TAXATION* 203, 204 (Henry J. Aaron & Michael J. Boskin eds., 1980).

62. See Richard A. Westin, *When One-Eyed Accountants are Kings: A Primer on Microeconomics, Income Taxes, and the Shibboleth of Efficiency*, 69 MINN. L. REV. 1099 (1985) (discussing efficiency of tax system in terms of equity).

63. See Harold M. Groves, *Toward a Social Theory of Progressive Taxation*, 9 NAT'L TAX J. 27 (1956) (discussing progressivity in terms of societal values).

E has income of \$56 ; the total product of the society is \$100. Suppose now that the society requires an aggregate contribution of \$30 for national defense, and that \$8 is the minimum amount necessary to avoid privation. The first proposal is to levy a 10% tax on *A* and *B*, a 20% tax on *C* and *D*, all of whom will continue to produce as before, and 50% tax on *E*, who because of the tax burden will not be as productive and will now produce only \$44. *A* and *B* each will be left with \$9, *C* and *D* each will be left with \$9.60, and *E* will be left with \$22. As a result of the progressive tax, the gross domestic product of this society fell from \$100 to \$94, of which \$30 was allocated to the public sector for common defense and \$64 was retained in the private sector.

An alternative proposal is to levy a flat rate 30% tax, which we are assured will not affect productivity and thus will collect \$30. *A* and *B* each will pay \$3, leaving them \$7 for consumption and in a state of privation. *C* and *D* each will pay \$3.6, leaving them slightly above privation. *E* will pay \$16.8, leaving \$39.2 for private consumption instead of the \$22 *E* was left under the progressive model. Welfare economists will tell us—possibly correctly—that the proportional tax is more efficient than the progressive tax. But the inquiry should not stop there. Although aggregate production of goods and services under the proportionate tax may be greater, all but one of the citizens of the hypothetical society are worse off under the proportional tax than under the progressive tax. This demonstrates that economic efficiency is not inherently an all encompassing goal. It is but one element of the overall calculus, which must take into account other societal values. If the social economic values of the hypothetical society are based on a leximin welfarist theory of distributive justice, the economically efficient proportional tax system will be rejected in favor of the less efficient progressive tax system because the latter is fairer.⁶⁴ Furthermore, the proportional tax validly may be rejected in favor of the progressive tax simply because the latter reduces the inequality between *E* and the remaining members of the society.⁶⁵

Admittedly, this analysis does not definitively answer the question of how progressive taxation ought to be, particularly at the upper income levels. Under a vertical equity analysis, as opposed to an optimal tax welfare economics analysis, the issue becomes one of distributive justice. The more interested one is in using the tax system to mitigate economic inequality caused by the market, the more progressive one believes the tax system ought to be. As Henry Simon stated, "The case for drastic progression in taxation must be rested on the case against inequality—on the ethical or

64. See Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 CAL. L. REV. 1905, 1949-50 (1987) (praising Rawlsian approach to distributive justice through progressive taxation). But see Charles R. O'Kelley, Jr., *Tax Policy for Post-Liberal Society: A Flat-Tax-Inspired Redefinition of the Purpose and Ideal Structure of a Progressive Income Tax*, 58 S. CAL. L. REV. 727 (1985) (arguing that flat tax with appropriate exemptions is "progressive" and just).

65. HENRY L. SIMONS, PERSONAL INCOME TAXATION 24-25 (1938).

aesthetic judgment that the prevailing distribution of wealth and income reveals a degree (and/or kind) of inequality which is distinctly evil or unlovely."⁶⁶ It has been said that the decision ultimately is one of personal preference, not logic.⁶⁷ Collectively, however, the personal preferences of the citizenry are a political decision, and thus the proper degree of progressivity ultimately is a political issue. Economics cannot dictate that we enact a Tax Code that maximizes production. The polity validly may choose to mitigate inequality at the expense of production.

B. Capital Gains

Increasing the marginal rates on high income taxpayers should not be permitted to result in the reintroduction of a significant preferential tax rate for capital gains. To the contrary, even the mild rate preference provided by the 28% maximum rate under Code section 1(h) should be repealed. Inflationary gains aside, capital gains are no different than any other income. They either can be spent on consumption or invested. Thus, under income taxation principles, capital gains should be taxed at the same rate as other income. Any significant capital gains preference substantially erodes the impact of a graduated progressive rate structure. A large percentage of the income of millionaires is realized as capital gain, and a large percentage of all capital gain is realized by those millionaires. In 1988, 75% of the returns with an adjusted gross income of \$1,000,000 or more reported net capital gains.⁶⁸ As a group, their gains were almost \$58 billion, averaging \$1,229,988 per return.⁶⁹ This group, which represented less than .5% of all individual tax returns, reported approximately 38% of total capital gains.⁷⁰

Preferential taxation of capital gains is based on the theory that capital gains taxation reduces economic efficiency and that reduced rates on capital gains promote economic growth. This argument proves too much. The same can be said with respect to taxation of any income, particularly income from capital. Arguments for preferential taxation of capital gains based on welfare economics efficiency logically cannot be stopped short of exempting yields to capital from taxation entirely. If the arguments are to be accepted, income taxation should be abandoned and a cash flow consumption tax should be adopted. It may be debated whether our current system is a conscious hybrid or a merely a flawed income tax system. But it is clear that the current mixed system is more likely to create both inequities and inefficiencies than either a well designed income tax system or consumption

66. *Id.* at 18-19.

67. BORIS I. BITTKER, *Second Lecture*, in CHARLES O. GALVIN & BORIS I. BITTKER, *THE INCOME TAX: HOW PROGRESSIVE SHOULD IT BE* 28 (1969).

68. Calculated from SOI—1988, *supra* note 47, at 21, 27.

69. *Id.* at 27.

70. *Id.* at 21, 27.

tax system.⁷¹ Thus we should try to move toward one or the other. Whether to tax income or consumption is more a matter of theology than reason and logic. It turns on whether one believes income from capital ought to be taxed. I am a believer in income taxation because I believe it to be the fairer of the two systems.

Even stopping short of a consumption tax, the economic argument for true preferential rates on capital gains, as opposed to the rough justice equivalency of an inflation adjustment or an averaging function, is based on the assumption that most capital gains are reinvested. To the extent this is not true, the argument for preferential rates is fallacious.⁷² Furthermore, even if it is true that most capital gains are reinvested, the argument in favor of preferential taxation of capital gains turns on the validity of the assertions that lower taxation of capital gains increases the amount of risky investment and that the benefits of the resulting increased production inure to society generally. There is no persuasive evidence that a preferential rate for realized capital gains encourages investment in productive assets.⁷³ Even if it did, if the benefits do not in fact trickle down but are retained by the individuals realizing capital gains, there is little or no reason to provide a lower tax rate for capital gains.⁷⁴ Finally, allowing either a preferential rate for all capital gains or just for capital gains that are rolled over into a new investment⁷⁵ unfairly discriminates in favor of established wealth holders against those trying to accumulate new wealth by saving income from labor because new savings must come from fully taxed income.

Even if there is a tax-expenditure-based benefit from taxing capital gains at a preferential rate, the benefits of the tax expenditure must be weighed against the complexity engendered by a capital gains tax preference. That complexity is enormous, and economists do not pay attention to the cost of complexity in the tax system as much as they should.⁷⁶ As long as the Tax Code provided a significant rate preference for capital gains, some

71. *But see* Edward J. McCaffery, *Tax Policy Under a Hybrid Income-Consumption Tax*, 70 TEX. L. REV. 1145 (1992) (arguing hybrid income-consumption tax has several benefits).

72. *See* Calvin H. Johnson, *The Consumption of Capital Gains*, 55 TAX NOTES 957 (May 18, 1992) (arguing that reduction in capital gain rates causes consumption rather than reinvestment of capital).

73. Henry J. Aaron, *Lessons for Tax Reform*, in *DO TAXES MATTER?*, *supra* note 39, at 320, 326-27.

74. *See Interview with Martin D. Ginsburg*, 12 SECTION OF TAX. NEWSLETTER (ABA, Wash. D.C.), Fall, 1992, at 6. Mr. Ginsburg stated:

[T]he argument for preferential treatment is supposed to be that it encourages investment and therefore is good for the country. It was popular not too long ago to refer to the benefits "trickling down" until, I guess, people decided that they had been trickled on long enough, so new rhetoric is now being used.

Id. at 8.

75. *See* Cynthia Blum, *Rollover: An Alternative Treatment for Capital Gains*, 41 TAX L. REV. 383 (1986).

76. *See* J. Gregory Ballentine, *Tax Policy and Revenue Sufficiency in the 1980's*, in *PERSONAL SAVING, CONSUMPTION, AND TAX POLICY* 34, 37 (Marvin H. Kosters ed., 1992) (containing confession by economist).

taxpayers, with the aid of an army of tax lawyers and accountants strove mightily to arrange business transactions in a structure that would result in the realization of capital gains rather than ordinary income; others, with the same soldiers, structured transactions that before taxes did no better than break even, but created ordinary losses and capital gains that netted-out but gave rise to tax savings. Many provisions of the Internal Revenue Code are concerned primarily with preventing the conversion of ordinary income into capital gains.⁷⁷ Included among them are some of the most complex and difficult to apply tax rules. The complexity engendered by capital gain preferences makes the law difficult to understand and makes planning business transactions more complex. Not only must initially business motivated transactions be analyzed to determine if the tax burden can be reduced, but energies are diverted from business motivated transactions to transactions motivated almost solely by tax planning. This is not desirable.

Finally, the arguments for preferential rates based on "bunching" due to isolated realization of gains and the over-taxation of inflationary gains cannot justify a preferential rate structure at all like any ever incorporated in the Internal Revenue Code or politically proposed. Bunching may not be as much of a problem as often is asserted. The data indicate that a high percentage of taxpayers who realize capital gains do so regularly.⁷⁸ Nevertheless some taxpayers do bunch capital gains,⁷⁹ and therefore may face a higher than normal marginal tax rate. The most appropriate response to this problem would be to provide an averaging rule along the lines of former Code sections 1301-1305, which were repealed by the Tax Reform Act of 1986.⁸⁰

As for the inflationary gains argument, neither a maximum rate of tax on capital gains, as provided in Code section 1(h), nor an across the board rate reduction, like that in former Code section 1202, comes anywhere near approximating an adjustment to eliminate inflationary gains other than by accident. The only way to eliminate inflationary gains is to index basis, as has been widely suggested.⁸¹ It would, however, be unwise to index basis

77. See, e.g., §§ 302 (1988) (redemptions), 305 (Supp. 1993) (distributions of stock and stock rights), 306 (Supp. 1993) (section 306 stock), 341 (collapsible corporations), 355 (Supp. 1993) (spin-offs, split-offs and split-ups), 541, 543 & 545 (Supp. 1993) and 542, 544, 546, & 547 (1988) (personal holding corporations), 732(b) (1988) (basis of property distributed by liquidating partnership), 751 (1988) ("hot assets"), 1239 (1988) (gain from sale of depreciable property between related taxpayers), 1245 (Supp. 1993) (depreciation recapture on personal property), 1250 (Supp. 1993) (depreciation recapture on real property), 1254 (Supp. 1993) (recapture of intangible drilling costs), and 1256 (1988) (depreciation recapture on real property).

78. See Albert J. Davis, *Measuring the Distributional Effects of Tax Changes for the Congress*, 44 NAT'L TAX J. 257, 259-60 (1991) (explaining how multi-year research confirmed capital gains tax cut mainly benefitted those with taxable incomes of \$75,000 and over).

79. See Joseph J. Minarik, *Capital Gains*, in *HOW TAXES*, *supra* note 37, at 241, 251

80. I.R.C. §§ 1301-1305 (repealed 1986) (allowing income averaging). Indeed, if a serious graduated rate schedule is reintroduced it would be altogether proper to reenact the income averaging provisions in some form.

81. See, e.g., Daniel Halperin & Eugene Steuerle, *Indexing the Tax System for Inflation*, in *UNEASY COMPROMISE*, *supra* note 37, at 347.

without also indexing debt, and indexing both debt and basis would be very complex.⁸² Thus, taxation of gains attributable solely to inflation, to the extent it occurs, is a problem that is not easily solvable. Perhaps, however, it is a "problem" that from a practical perspective might not require a solution.

If the model on which the tax system is based is an accretion income tax, gains should be taxed annually as they accrue.⁸³ Thus, because of the realization requirement of current law, taxation of capital gains is deferred and capital gains thus are undertaxed relative to current yield. This deferral is valuable. Both the risk of illusory gains attributable to inflation and the benefit of deferral due to the realization requirement increases as the holding period increases, and the two may largely offset one another, even though imperfectly.⁸⁴

C. Low Income Allowances

Reform is likewise necessary at the lower end of the income scale. Low income individuals are relieved from an income tax burden through three major allowances: the personal and dependency exemptions, the standard deduction, and the earned income credit. Currently, as adjusted for inflation, the personal exemptions and standard deduction establish a tax threshold that exceeds the poverty line for household units of two or more individuals, whether spouses or parent and dependent child. Single individuals, however, pass the threshold for taxation at \$5,900 of adjusted gross income, which is nearly \$1,000 below the poverty income guideline published by the United States Department of Health and Human Services.⁸⁵ An additional allowance is provided through the refundable earned income credit in Code section 32, but the earned income credit is not available to single taxpayers with no dependents.

All low income taxpayers who earn wages or self-employment income are subject to the social security tax even though they may be below the poverty level. Elimination of the effective burden of social security taxes for families below the poverty level was one the rationales for the introduction of the earned income credit.⁸⁶ From the outset, however, the earned income credit has served dual purposes. It can refund more than the social security tax on wages. Thus, it is a low income allowance for qualifying

82. For a comprehensive indexing proposal, see 2 TREAS. DEP'T, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 177-200 [hereinafter FAIRNESS, SIMPLICITY].

83. See David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111 (1986).

84. See Daniel Halperin & Eugene Steurle, *Indexing the Tax System for Inflation, in UNEASY COMPROMISE*, *supra* note 37, at 347, 353-56; Calvin H. Johnson, *The Undertaxation of Holding Gains*, 55 TAX NOTES 807 (May 11, 1992).

85. Jonathan Barry Forman, *Poverty Levels and Federal Tax Thresholds: 1992*, 26 CLEARINGHOUSE REV. 519 (1992).

86. See H.R. REP. No. 19, 94th Cong., 1st Sess. 29 (1975).

taxpayers.⁸⁷ To some extent, it can be viewed as a tax expenditure as well, because the particular structure was designed to encourage work and reduce welfare dependency.⁸⁸

Viewed as a refund of social security taxes, the earned income credit reflects some implausible policy decisions.⁸⁹ The most important qualification factor, apart from the income ceiling, is that a "qualified child" under the age of nineteen, with limited exceptions, lives with the taxpayer.⁹⁰ Thus, as previously noted, the credit is not available to single taxpayers; nor is it available to childless married taxpayers. This differing treatment makes no sense. There is no rational reason why childless taxpayers below the poverty level should be any less entitled to a refund of social security taxes than should be taxpayers with dependent children.⁹¹

Analyzing the earned income credit as an additional low income allowance presents other difficulties. Because the earned income credit provides a significant refund to a qualifying taxpayer whose income is below the taxable income threshold for income tax liability, the credit does not appear to be an element of the normative tax system. Rather it is wholly a tax expenditure, the purpose of which appears to be to encourage people with minor children to seek employment. As such, analysis of its propriety and effectiveness has nothing to do with tax theory. Nevertheless the credit is intended to serve substantially the same function as the personal exemptions and standard deduction—to exempt a minimum amount of income from taxation.

From this perspective, the structure of the earned income credit again is difficult to justify. The problem is not that the allowance is a disappearing credit. A low income allowance in the form of a disappearing credit may make as much sense as personal exemptions. It clearly makes more sense than the current rule in Code section 151(d)(3), which "recaptures" the benefit of the personal exemptions through a surtax that creates a rate bubble. The primary problems lie in the limitations on the availability of the earned income credit tax and the inordinate administrative complexity created and imposed on low income taxpayers.⁹² It would be fairer to remove all low income taxpayers, with the possible exception of dependent students, from the tax rolls, not just those with dependent children, and far easier to remove low income individuals from the tax rolls solely through expanded personal exemptions.

87. See S. REP. NO. 36, 94th Cong., 1st Sess. 11 (1975).

88. *Id.* at 33.

89. See Deborah H. Schenk, *Simplification for Individual Taxpayers: Problems and Proposals*, 45 TAX L. REV. 121, 140-42 (1989) (discussing need for simplification of earned income credit).

90. I.R.C. § 32(c)(3)(A)(ii) (Supp. 1993).

91. Students who are dependents of their parents might present a different case.

92. See James E. Williamson & Francine J. Lipman, *The Earned Income Tax Credit: Too Complex for the Targeted Taxpayers?* 57 TAX NOTES 789 (Nov. 9, 1992).

Congress ought to re-examine completely the method for providing low income allowances.⁹³ Viewed as a whole, the current system is incomplete and unnecessarily complex, largely because the standard deduction and earned income credit serve dual roles. It is important that we continue to keep individuals and families below the poverty level off the tax rolls. As far as the income tax is concerned, that goal should be accomplished solely and completely through expanded personal exemptions. Alternatively, if it is considered proper to limit the benefit of low income allowances to tax reduction at the lowest rate, rather than phasing them out altogether, a credit equal to fifteen percent of the exempt amount could be substituted for the deductions. The standard deduction should be abolished,⁹⁴ and the earned income credit should be revised to function as a mechanism for refunding social security taxes. Whether Congress in addition to removing the poor from the tax rolls wants to adopt a negative income tax, of which the earned income might be considered a variant, is another question entirely. If a negative income tax provision is desirable, it should be designed to operate independently of and in addition to provisions designed merely to remove the working poor from the tax rolls.

To use personal exemptions as the sole method of eliminating income tax liability of low income taxpayers requires reconsideration of the manner in which personal exemptions are computed. Nothing dictates that each personal exemption on an income tax return be the same amount. It would be quite logical to provide for a large personal exemption for the first taxpayer on the return and exemptions of decreasing amounts for the second taxpayer on a joint return and dependents claimed on either a single, head of household, or joint return.⁹⁵ The specific amounts might be keyed to the poverty level as determined annually. To prevent the generous initial allowance from being claimed by dependent minor children with unearned income, it should not be allowed to minor children living with a parent.

D. Rate Bubbles

Numerous tax allowances are phased out as income increases. Some, like the earned income credit, are targeted allowances. Others, like the deduction for individual retirement accounts for employed taxpayers who participate in an employer sponsored qualified retirement plan, are based on volitional behavior. Still others limit the availability of otherwise universal allowances, such as the phase-out of personal and dependency exemptions

93. See generally Jonathan Barry Forman, *Improving the Earned Income Credit: Transition to a Wage Subsidy Credit for the Working Poor*, 16 FLA. ST. U. L. REV. 41 (1988).

94. To the extent that the standard deduction is viewed a floor for tax expenditures, if it is determined that such a provision is desirable, Code section 67 should be revised and expanded.

95. The Tariff Act of 1913 allowed each taxpayer a \$3,000 personal exemption, with married taxpayers allowed an additional \$1,000 exemption. Act of Oct. 3, 1913, ch. 16, § II.C., 38 Stat. 114, 168. No dependency exemption for children was allowed until 1917, when it was set at \$200. Act of Oct. 3, 1917, ch. 63, § 1203(1), 40 Stat. 300, 331.

in Code section 151(d)(3).⁹⁶ Phase-outs of various deductions and credits occur at varying income levels.⁹⁷ All of these phase-out or limitation rules produce the same strange effect on the rate structure. They create marginal rate "bubbles" that result in marginal rates decreasing at income levels above the bubble.⁹⁸ It is difficult, if not impossible, to justify regressive marginal rates at any income levels. Accordingly, the use of phase-outs and allowances that require phase-outs should be re-examined. Because of the variety of contexts in which phase-outs are used, they must be examined individually. An argument may be made that some of the phase-outs relate to tax expenditures, and that they therefore do not present a regressive tax rate issue.

The rate bubble resulting from the phase-out of the personal exemptions, while possibly not creating the highest bubble rate, may well be the farthest beyond the pale from the perspective of tax theory. The object of this provision is to restore some of the progressivity to average tax rates that was dramatically reduced by the Tax Reform of 1986. The intent was salutary, but the implementation is flawed. The particular device of the phase-out of the personal exemptions in section 151(d)(3) was a compromise between the House, which in 1990 proposed replacement of the then existing five percent surtax in former section 1(g), which phased-out both personal exemptions and the benefit of the fifteen percent bracket, with an explicit top rate bracket of thirty-three percent, and the Senate, which had not proposed any change.⁹⁹ By compromising on a thirty-one percent top rate coupled with a phase-out of the personal exemptions, Congress adopted an effective maximum rate in excess of thirty-one percent but perpetuated the regressivity that characterized former Code section 1(g). Furthermore, between the phase-out of personal exemptions and the phase-out of the benefits of the fifteen percent bracket, the phase-out of the exemptions had the more curious effect. The rate bubble increased as family size increased. If tax burdens are intended to reflect ability to pay, between two families with equal incomes but of different sizes, the family with fewer members should have a higher tax burden. Section 151(d)(3), however, can result in equal tax burdens for the two families.

Vanishing exemptions are not necessary to achieve any given level of progressivity.¹⁰⁰ The effect of tax allowances can be phased out without

96. I.R.C. § 151(d)(3) (Supp. 1993). This provision is scheduled to expire after 1995.

97. See Allen H. Lerman & Jim Cilke, *The Distribution of Effective Marginal Tax Rates*, 84 ANNUAL CONF. OF THE NAT'L TAX ASSO.—TAX INST. OF AM. PROC. 245, 251-52 (1991) (depicting rate bumps graphically).

98. Glenn E. Coven, *Congress as an Indian-Giver: "Phasing-Out" Tax Allowances Under the Internal Revenue Code of 1986*, 6 VA. TAX REV. 505, 505-06 (1987); Philip J. Harmelink & Phyllis V. Copeland, *'Hidden Taxes' Through Phaseouts and Floors: Assessment and Policy Implications*, 58 TAX NOTES 77 (Jan. 4, 1993).

99. See H.R. REP. NO. 964, 101st Cong., 2d Sess. 1028-1030 (1990), reprinted in 1990 U.S.C.C.A.N. 2374, 2733, 2735.

100. TREAS. DEP'T, BLUEPRINTS FOR BASIC TAX REFORM 106 (1977) [hereinafter BLUEPRINTS].

creating a marginal rate bubble. To do so simply requires use of a larger number of graduated rate brackets, with the phase-out being effected through one or more increasing rate brackets above the lowest nominal bracket but below the highest nominal bracket.¹⁰¹ When dealing with the personal and dependency allowances, however, the issue is a bit more complex because different numbers of dependency exemptions may be claimed by taxpayers who are identical in all respects other than the number of dependent children. For this reason, phasing out personal and dependency exemptions without a rate bubble would require separate rate schedules that varied with the number of personal and dependency exemptions on the return. This should not be a problem. It would present no significant administrative complexity, and actually may be more theoretically proper than the current system. At the very least, Code section 151(d)(3), phasing out personal and dependency exemptions, should be repealed or allowed to expire, and it should be replaced with additional graduated rate brackets for high income taxpayers.

Code section 68 is another rate bubble that probably should be eliminated. This provision, which disallows a portion of itemized deductions to certain high-income taxpayers, is one of the more difficult phase-outs to categorize. If charitable contribution, home mortgage interest, and state and local tax deductions are considered tax expenditures, as they are in the United States Budget, Code section 68 may be viewed as limitation on tax expenditures. But if these deductions are normatively proper, as is argued by a number of commentators, section 68 performs a function similar to that of Code section 151(d), has the same effect, and should be analyzed in the same manner. The rationale for Code section 68 expressed in the legislative history is phrased in terms of matching tax burdens with ability to pay.¹⁰² This indicates that Congress viewed the provision as a normative tax rate increase, not as a limitation on tax expenditures. Sophisticated analysts likewise have viewed Code section 68 as a proxy for a higher maximum rate in section 1.¹⁰³ This view is reinforced by the applicability of Code section 68 to unreimbursed employee business expenses and section 212 expenses, which clearly are proper normative deductions. Thus, even though it may be possible to use tax expenditure analysis to justify retention of Code section 68, it should be analyzed as another disguised marginal rate increase, not as a tax expenditure limitation. Since it too creates a bubble maximum rate, it should be repealed.

All of the other phase-out rules should be critically examined with a jaundiced eye. Where it is determined that it is undesirable not to phase-out the benefit and it is mechanically impossible to phase-out the allowance

101. See William J. Turnier & Douglas G. Kelly, *The Economic Equivalence of Standard Tax Credits, Deductions and Exemptions*, 36 U. FLA. L. REV. 1003 (1984).

102. See H.R. REP. No. 881, 101st Cong., 2d Sess. 361 (1990), reprinted in 1990 U.S.C.A.N. 2014, 2363.

103. See Gene Steuerle, *Bubbles, Bangles, and Beads: Fixing Up the Top Rate*, 59 TAX NOTES 425 (April 19, 1993).

without creating marginal rate bubbles, the wisdom of the basic provision itself should be re-examined.

III. BASE BROADENING

Tax legislation of the 1980s, particularly the Tax Reform Act of 1986, significantly expanded the tax base. Nevertheless, significant items of economic income for which no exclusion can be justified on any tax policy criteria, including administrative convenience, and which also would be of dubious validity under the most favorable analysis by a proponent of using tax expenditures, still escape taxation. These items are special preferences for particular investments or transactions that are difficult to justify using any generally applicable objective criteria. Several changes in the tax base would significantly enhance horizontal equity, make tax burdens more closely correspond with true economic ability to pay, and increase tax revenues to deal with the budget deficit and other priorities.

A. *Like Kind Exchanges*

Code section 1031, which provides for nonrecognition of gain (and a concomitant exchanged basis) on exchanges of like-kind property, should be repealed.¹⁰⁴ Although section 1031, is subject to a number of exceptions, including partnership interests and corporate stock, tax free like-kind exchanges are available for all business and investment tangible property. Recently promulgated regulations restrict the ability to use Code section 1031 to defer gain on exchanges of personal property, but those regulations are in reality of relatively little importance. The significance of section 1031 always has lain in its application to real estate.

In essence, the standard for determining if two real estate properties are like kind as developed by the Service and the courts is "real estate is real estate."¹⁰⁵ This rule belies any justification for Code section 1031 based on the argument that the taxpayer has not liquidated the original investment. When an oil well is exchanged for an apartment building, no reasonable person honestly can contend that the first investment was not liquidated and a new and different investment made. To tax a sale and immediate reinvestment while exempting an exchange cannot be justified.

Even if the operation of Code section 1031 had been limited to contemporaneous exchanges with no other property involved, the provision could not have been justified on the grounds of administrative convenience—avoiding the need to value the properties where the parties had not valued them in dollars but simply had determined that they were of the same

104. Marjorie E. Kornhauser, *Section 1031: We Don't Need Another Hero*, 60 S. CAL. L. REV. 397 (1987); Eric M. Jensen, *The Uneasy Justification for Special Treatment of Like-Kind Exchanges*, 4 AM. J. TAX POL'Y 193 (1985).

105. See BORIS I. BITTKER & MARTIN J. MCMAHON, JR., FEDERAL INCOME TAXATION OF INDIVIDUALS ¶27.2, at 27-6 (1988) ("As applied to real estate, [the Treasury's] interpretation of 'likekind' is extraordinarily liberal").

undetermined value. The same could be said for any barter transaction, and, except when Code section 1031 applies, barter transactions are all taxable.

When Code section 1031 is put in context, any claim that it is an administrative convenience evaporates, as does any claim that a sale and reinvestment in like-kind property always is taxed. The combination of a long line of cases dealing with "three-corner" and "four-corner" exchanges¹⁰⁶ and the *Starker*¹⁰⁷ case, dealing with deferred exchanges with an interest factor and a cash out option culminated in the enactment of Code section 1031(a)(3) and the promulgation of detailed Treasury Regulations¹⁰⁸ providing both limitations and safe harbors for structuring both contemporaneous and deferred multi-cornered like-kind exchanges. These regulations make it clear that the form of the transaction controls completely; the substance is irrelevant.

Suppose that *A*, who owns Blackacre, wishes to sell Blackacre to *B* and to buy Whiteacre from *C*. If *A* sells Blackacre and buys Whiteacre, both transactions are taxable. But the regulations permit *A* to accomplish the same economic end-result in a nonrecognition event. To obtain like-kind exchange treatment, *A* enters into a contract to sell Blackacre to *B*. *A* then hires an intermediary to whom *A* will assign all of *A*'s rights in the agreement with *B*. Thus the intermediary is paid by *B* when *A* conveys Blackacre to *B*. The intermediary enters into a contract with *C* for the purchase of Whiteacre. Pursuant to the contract, *C* deeds Whiteacre directly to *A* and is paid by the intermediary, who uses the funds from the sale of Blackacre.

Subject to numerous technical qualifying requirements, this transaction is tax free to *A*. This result is nonsensical. There is no good reason that investors should be able to move among various real estate investments without paying taxes on realized gains when the same privilege is not accorded to reinvestment of sales proceeds in a different investment. Because adopting the latter rule—a "rollover" of capital gains operating akin to the manner in which Code section 1034 operates with respect to a primary residence—would substantially erode the concept of taxing economic income, Code section 1031 should be repealed to enhance horizontal equity.

B. Taxation of Gains at Death

Code section 1014 provides a fair market value at date of death basis for property acquired from a decedent, but death is not a realization event for including gains and losses in taxable income. The step-up in basis at death effected by section 1014 thus forgives taxes permanently. This tax

106. See, e.g., *Barker v. Commissioner*, 74 T.C. 555 (1980) (holding four-party real estate exchange qualified under I.R.C. § 1031).

107. *Starker v. United States*, 602 F.2d 1341 (9th Cir. 1979).

108. Treas. Reg. § 1.1031(k)-1 (1991).

expenditure is projected to result in a revenue loss of over \$28 billion for fiscal 1993.¹⁰⁹ Allowing a tax free step-up in basis at death is inequitable. From the horizontal equity perspective it discriminates against those who sell property during their lifetimes and who recognize gains. The exclusion of appreciation accrued as of the property owners date of death violates vertical equity principles because it benefits primarily the wealthy. The rule also has an economically undesirable "lock-in" effect that distorts the allocation of capital between competing sources.¹¹⁰

Both equity and efficiency would be enhanced by treating death as a realization event with respect to all property passing from a decedent to anyone other than the decedent's spouse. A similar rule should be applied to gifts. Concomitantly, Code section 1015 would be repealed and Code section 1014 should be expanded to provide a fair market value at the date of the gift basis for donees. Transfers to spouses should continue to be nonrecognition events, and the spouse should receive a carryover basis, as under Code section 1041, whether the transfer is by gift or upon death. Charitable gifts should be subject to the general rules, which would permit significant simplification in Code section 170, including the complete repeal of section 170(e).

This is not a new or radical idea. Recognition of gains at death and upon gift was proposed by President Kennedy in 1963,¹¹¹ and by the Treasury Department in 1969.¹¹² The idea has been explored by commentators and is theoretically sound.¹¹³ Canada currently has a recognition of gains at death rule. Given the illogic and significant revenue cost of the current rules, the time for this change has come. Despite the fiasco with respect to the retroactively repealed experiment with carryover basis at death under Code section 1023 in the late 1970s, the administrative difficulties of taxing gains at death should not be significant. Claims that a successor in interest cannot ascertain the decedent's basis for property are largely spurious. It can be expected that those who claimed they could not ascertain the decedent's basis for purposes of Code section 1023 would have little trouble determining the decedent's basis if necessary to minimize the tax if death were a

109. BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 1993, Part II-39 (1992) [hereinafter U.S. BUDGET].

110. H.R. REP. NO. 1380, 94th Cong., 2d. Sess. 36-37 (1976).

111. See *Hearings Before the Comm. on Ways and Means of the House of Representatives on the Tax recommendations of the President Contained in His Message Transmitted to the Congress, January 24, 1963*, 88th Cong., 1st Sess., pt. 1, at 24 (1963).

112. HOUSE COMM. ON WAYS & MEANS & SENATE COMM. ON FINANCE, 91ST CONG., 1ST SESS., TAX REFORM STUDIES AND PROPOSALS, DEP'T TREASURY, part 1, 28-29 (Comm. Print 1969).

113. See Marjorie E. Kornhauser, *The Constitutional Meaning of Income and the Income Taxation of Gifts*, 25 CONN. L. REV. 1 (1992); Michael J. Graetz, *Taxation of Unrealized Gains at Death—An Evaluation of Current Proposals*, 59 VA. L. REV. 830 (1973); Louis M. Castruccio, *Becoming More Inevitable? Death and Taxes . . . and Taxes*, 17 UCLA L. REV. 459, 475-76 (1970) (attacking current tax treatment of capital gains at gift and death on economic grounds).

realization event. The Canadian experience with taxing gains at death indicates that establishing basis is not a significant problem.¹¹⁴

Minimizing exceptions will eliminate much of the complexity that plagued now repealed Code section 1023. There should be no special treatment of any assets except as absolutely necessary for technical and administrative reasons. Perhaps tangible personal property, other than collectibles, held for personal use could be excepted with little revenue effect, but there should be no exemption for small estates or any minimum basis provisions.

Apart from the factual inquiry necessary to determine basis, the most significant administrative "complexity" caused by this proposal would be the computations under an income averaging provision, which would be necessary to mitigate the bunching of income in the year of death. Some additional technical problems may arise in coordinating realization at death with the estate tax, in particular coordinating the marital deduction in the estate tax with the exception from realization at death for transfers to spouses. These problems, however, are minor in comparison to the equity and efficiency gains that would result from treating a transfer by death or gift as a realization event.¹¹⁵

C. Taxing the Inside Build-up on Whole Life Insurance

As recommended by the Treasury Department in 1984,¹¹⁶ the inside build-up of whole life insurance ought to be currently taxed. Current taxation of the inside build-up on whole life insurance policies is completely justifiable on grounds unrelated to the realization of gains at death.¹¹⁷ Whole life insurance, unlike term life insurance, has a significant financial investment component. The interest build-up is analogous to a savings account. The interest earnings can be withdrawn at any time through a policy loan; what purports to be interest on the policy loan is in reality an increased premium charge on the increased amount of term insurance necessary to pay the death benefit as a result of the withdrawal.¹¹⁸

The tax benefit of deferral, plus the potential benefit of exclusion through Code section 101, is inefficient to the extent that it provides insurance companies a competitive advantage over other financial institutions in competing for investment dollars, as well as inequitable to the extent that the tax benefits are not fully capitalized in lower interest rates. This situation presents not only horizontal inequity, but also vertical inequity

114. See Lawrence Zelenak, *Taxing Gains at Death*, 46 VAND. L. REV. 361, 391-92 (1993).

115. *Id.*, *passim*.

116. 2 FAIRNESS, SIMPLICITY, *supra* note 82, at 258-62.

117. See Andrew D. Pike, *Reflections of the Meaning of Life: An Analysis of Section 7702 and the Taxation of Cash Value Insurance*, 43 TAX L. REV. 491, 523-534 (1988) (providing tax policy analysis of policyholder tax treatment and I.R.C. § 7702's limitations with respect to interest credited under cash value life insurance).

118. I am indebted to Paul McDaniel for this insight.

because the ownership of whole life insurance policies is relatively more common as income increases.¹¹⁹

Even if the inside build-up of whole life insurance were currently taxed, Code section 101(a) would prevent taxation to anyone of the mortality gain portion of life insurance proceeds received upon death. From a tax policy perspective there is no reason that these mortality gains should be excluded from income. Life insurance proceeds, however, may be somewhat different than unrealized appreciation in property held at death in that the fundamental purpose of most life insurance policies is to replace a long-term income stream. Because of this purpose, some special long-term averaging rules may be appropriate.

D. Limiting Tax-Free Fringe Benefits

Restricting the scope of tax free fringe benefits is high on almost every list for tax reform.¹²⁰ In 1984, the Treasury proposed virtual wholesale repeal of tax-free fringe benefit provisions; only medical plans were spared, and they were to be limited.¹²¹ Under traditional tax policy criteria, tax-free fringe benefits generally should be limited to those described as working condition or de minimis fringe benefits in Code section 132 and for administrability reasons, if for no other, *nondiscriminatory* free parking on the employer's business premises. Allowing additional tax-free fringe benefits, designed to help solve some perceived "problem," can be justified only on the basis of tax expenditure analysis. As such, the burden of proof for justifying using the Tax Code rather than direct spending should be high.¹²²

The "qualified transportation fringe benefit" rules¹²³ recently enacted as part of the Energy Policy Act of 1992¹²⁴ are an example of a tax-free fringe benefit of the type that should be very critically examined. Under new section 132(f), employer-provided transit passes, "commuter highway vehicle" use and "qualified parking" are tax-free fringe benefits. A "commuter highway vehicle" is defined in section 132(f)(5)(B) as a vehicle that seats six adults in addition to the driver and at least eighty percent of its total use is for transporting employees between their homes and workplace, on trips on which at least half of the passengers seats (excluding the driver) are filled by commuting employees. "Qualified parking" includes not only parking at or near the employer's place of business but also parking at a remote location from which the employee commutes by way of a "commuter highway vehicle," carpool, or mass transit qualifying for the transit pass

119. 2 FAIRNESS, SIMPLICITY, *supra* note 82, at 262.

120. See, e.g., Karla W. Simon, *Fringe Benefits and Tax Reform Historical Blunders and a Proposal for Structural Change*, 36 FLA. L. REV. 871 (1984).

121. 2 FAIRNESS, SIMPLICITY, *supra* note 82, at 20-50.

122. See STANLEY S. SURREY, *PATHWAYS TO TAX REFORM* 147-54 (1973) [hereinafter *PATHWAYS*] (arguing that much is lost by using tax incentive rather than direct expenditure).

123. I.R.C. § 132(f) (Supp. 1993).

124. Energy Policy Act of 1992 § 1911(b), 26 U.S.C. § 132(f) (Supp. 1993).

exclusion.¹²⁵ The exclusion is limited to \$155 per month for qualified parking and \$60 per month in the aggregate for transit passes and qualified highway vehicle use, subject to adjustment for inflation.¹²⁶ According to the legislative history, the purpose of this exclusion is to "create a meaningful incentive for employers to support commuting by public transit" which "could provide substantial benefits to society, such as reduced traffic congestion and reduced environmental degradation."¹²⁷

Other already existing, similar tax-free fringe benefits include qualified group legal services plans,¹²⁸ educational assistance programs,¹²⁹ and dependent care assistance programs.¹³⁰ All of these programs have social goals that may be justifiable. Furthermore, the tax expenditure subsidy resulting from providing tax-free treatment for some of these fringe benefits very well may have the intended effect of increasing the availability or use of the tax-free benefit. Nevertheless, some skepticism regarding whether the benefits outweigh the costs of achieving these goals through the tax system is warranted.

Tax planning may be important, but it is difficult to believe, for example, that many individuals who otherwise would commute in their own car will accept lesser cash compensation in exchange for tax-free public transit passes as allowed by section 132(f). If that is true, the intended effects will not materialize and the tax benefits of this provision would inure largely to employees who already commute by mass transit. In that case the provision would serve no purpose. Not only would it unnecessarily lose revenue, but it also would be statutory clutter, increasing complexity.

Even if the qualified transportation fringe benefit provision has the intended effect, the public perceptions that arise from achieving this goal through a tax expenditure must be considered. Many people do not have a realistic option to commute by mass transit. Many employees will find their employers simply unwilling to provide "commuter highway vehicles" for use by their employees because administrative transaction costs are too high. These individuals will continue to be required to pay for commuting with after tax dollars while other luckier taxpayers are able to transmute non-deductible costs to a tax-free fringe benefit. This sort of distinction is the type of rule that breeds disrespect for the tax system among the public. When a special preference is made available to limited numbers of taxpayers, whose ability to take advantage of the preference is determined largely by luck, other less favored taxpayers become more likely to try to make their own "luck," and enforcement problems multiply. Similar issues arise with respect to the other statutory tax-free fringe benefits.

125. I.R.C. § 132(f)(5)(C).

126. I.R.C. § 132(f)(2).

127. H.R. REP. No. 474, part VI, 102d Cong., 2d Sess. 34 (1992).

128. I.R.C. § 120 (Supp. 1993).

129. I.R.C. § 127 (Supp. 1993).

130. I.R.C. § 129 (Supp. 1993).

Congress should reconsider carefully the various tax-free fringe benefit provisions. A few are difficult, if not impossible, to justify even as tax expenditures. No additional cost services,¹³¹ qualified employee discounts,¹³² and qualified tuition reductions,¹³³ are discriminatory, favoring employees in particular industries, and serve no readily apparent well defined national policy. These provisions are inequitable and add complexity. They should be repealed.

Rather than continue to enact more tax-free fringe benefits, such as qualified transportation fringe benefits, Congress should systematically reconsider the remaining tax expenditure based fringe benefit provisions and weed out those that do not actually further an important national policy in the best possible manner. Those fringe benefits subject to sunset provisions, such as qualified group legal services plans and educational assistance plans should be allowed to expire unless their efficacy can be well established.

Code sections 105, excluding accident and health benefits, and 106, excluding accident and health coverage, should be reconsidered in the context of the nascent current examination of national health care policy. In any event, however, the current system under which some individuals are able to purchase medical insurance with before-tax dollars while other individuals must pay with after-tax dollars should not be perpetuated. If national health reform stalls, either Code sections 105 and 106 should be repealed or, if the tax expenditure justification for these provisions is considered to outweigh the tax policy considerations for their repeal, a universal deduction for medical insurance premiums should be enacted.

The remaining statutory fringe benefits should be scaled back if Congress can devise better methods for achieving the intended results. In evaluating the desirability of these provisions Congress should not minimize the problems of limited availability and the public perceptions of unfairness that arise when tax-free fringe benefits in fact are made available by only a limited number of employers. Although policy analysts may understand the difference between normative tax rules and tax expenditures, the public generally does not. The public views all tax rules through the same lens. Absent compelling reasons to the contrary, the goal should be to leave working condition fringes, including nondiscriminatory on-site parking, and de minimis items as the only tax-free fringe benefits to the extent administratively feasible.

Prohibit Deductions for Business Meals and Entertainment

President Clinton's 1993 Revenue Proposals would reduce the deductible portion of business meals and entertainment from 80% to 50% and disallow

131. I.R.C. § 132(a)(1).

132. I.R.C. § 132(a)(2).

133. I.R.C. § 117(d) (Supp. 1993).

entirely deductions for club dues.¹³⁴ The stated rationale for disallowing these expenses is that it is inappropriate to allow a deduction for expenses that are inherently personal. This rationale makes sense, of course, when the payor is being entertained or consuming the meal. Current law permits a privileged class of taxpayers—generally very high income taxpayers—to pay for a large portion of their personal entertainment with before-tax dollars simply by adding some business trappings to the event.¹³⁵ But there is no reason to limit to 50% of the expenditure the amount that is deemed to be inherently personal. Deductions for meals and entertainment should be disallowed entirely, with the possible exception of meals provided to employees as a tax-free fringe benefit under section 132. To the extent that the payor receives the meals or entertainment, the entire expense ought to be nondeductible. Any attempt to divine the portion of the expense that exceeds the value of the personal consumption enjoyed would be futile.

As far as meals and entertainment provided to others, such as customers or clients or employees of a corporation that reimburses expenses, the personal benefit rationale does not apply. Nevertheless, no deduction should be allowed unless the value of the entertainment is taxed to the recipient.¹³⁶ Theoretically, the meals and entertainment provided to others should be deductible and the person enjoying the meal or entertainment ought include the value in income. Because this treatment is not administrable, simply disallowing a deduction will serve as a proxy.¹³⁷

Eliminating the deduction for meals and entertainment also will have salutary economic effects. The current deduction is a significant subsidy to the restaurant and entertainment industries. The market prices for meals and entertainment are driven up by the tax-induced increased demand. Thus, while some taxpayers benefit from the deductibility of meals and entertainment, under the current rules most taxpayers are forced to pay higher prices with after-tax dollars.¹³⁸

F. Further Restricting Home Mortgage Interest Deductions

Prior to the Tax Reform Act of 1986, interest was virtually universally deductible. One of the significant base broadening aspects of the 1986 Act was elimination of the deduction for consumer interest other than limited home mortgage interest. Since 1987, generally speaking, section 163(h) has allowed a deduction for interest on mortgages of up to \$1,000,000, the proceeds of which are used to purchase or improve the taxpayer's principal

134. ADMINISTRATION'S PROPOSALS, *supra* note 6, at 38-39.

135. 2 FAIRNESS, SIMPLICITY, *supra* note 82, at 81-83.

136. See TREAS. DEP'T, THE PRESIDENT'S 1978 TAX PROGRAM: DETAILED DESCRIPTIONS AND SUPPORTING ANALYSIS OF THE PROPOSALS 182 (1978).

137. See Daniel I. Halperin, *Business Deduction for Personal Living Expenses: A Uniform Approach to An Unsolved Problem*, 122 U. PENN. L. REV. 859 (1974) (arguing for elimination of deduction for excess of personal satisfaction over cost of personal items).

138. 2 FAIRNESS, SIMPLICITY, *supra* note 82, at 84-85.

residence and one other residence. In addition, interest on "home equity mortgage indebtedness" of up to \$100,000 also is deductible.¹³⁹

The home mortgage interest deduction long has been a target of tax reformers.¹⁴⁰ It is attacked as inequitably favoring homeowners over renters, the wealthy over the poor. It has nothing at all to do with measuring net income. Because the imputed rental value of owner-occupied housing is excluded from gross income, the home mortgage interest deduction is a tax expenditure to subsidize housing.¹⁴¹ As a housing subsidy it provides benefits that bear a direct relationship to income. The blue collar worker who earns \$25,000 a year and pays home mortgage interest of \$3,000 on a loan to purchase a \$50,000 house receives a subsidy of \$450 (assuming that the worker itemizes deductions). As income increases, the amount of the benefit increases. The corporate executive with a \$1 million salary, who pays \$60,000 interest on a loan to purchase a \$1 million dollar house receives a subsidy of \$18,600 (ignoring Code sections 67 and 68). No direct subsidy for housing ever would be structured in that manner.¹⁴²

Notwithstanding its theoretical weakness and inequitable economics, the home mortgage interest deduction is as American as apple pie. Neither of the two major Treasury Department studies of tax reform proposals published in the last quarter-century have proposed its repeal, despite the strong base-broadening tenor of both of those studies.¹⁴³ But the current deduction goes far beyond what is necessary to fulfill the publicly stated goal of the defenders of the home mortgage interest deduction—to make the American dream of home ownership available to the average American.¹⁴⁴ Code section 163(h)(3) allows a deduction for interest on home mortgage of up to \$1,000,000. This amount is far in excess of the median price of housing in the United States, or in any particular region or standard metropolitan statistical area.¹⁴⁵ In 1990, the median sales price of new homes was slightly below \$125,000 and the median sales price of existing homes under \$100,000.¹⁴⁶ Even in the Northeast, the most expensive region, median prices of both new and existing homes were less than \$160,000.¹⁴⁷ Only California and Hawaii had any standard metropolitan statistical areas with a median sales price for homes in excess of \$200,000 in 1990.¹⁴⁸

139. I.R.C. § 163(h)(3)(C)(ii) (Supp. 1993).

140. See, e.g., William F. Hellmuth, *Homeowner Preferences*, in *COMPREHENSIVE INCOME TAXATION*, 163 (Joseph A. Pechman ed., 1977).

141. U.S. BUDGET, *supra* note 109, at Part II-32.

142. See *PATHWAYS*, *supra* note 122, at 232-36.

143. *BLUEPRINTS*, *supra* note 100, at 88-89; 1 *FAIRNESS, SIMPLICITY*, *supra* note 82, at 39.

144. That the home mortgage interest deduction actually lowers the cost of housing is a proposition of questionable economic theory. To a large extent the tax benefit may be capitalized into the cost of purchasing homes.

145. COMMERCE DEP'T, *STATISTICAL ABSTRACT OF THE UNITED STATES* 714, 722-23 (1991).

146. *Id.* at 714.

147. *Id.* at 722.

148. *Id.* at 723.

Subsidizing opulent home ownership through the tax system is unnecessary and inequitable. Even if we accept the rationale espoused by supporters of the home mortgage interest deduction and continue it in some form, the availability of the deduction should be much more severely curtailed. There is no good reason whatsoever for allowing a deduction for interest to purchase a home that costs many times the median home price. Drawing a precise line may be difficult, particularly because the median price of housing differs throughout the country. If the cost of housing were uniform, it might make sense to limit the deduction to interest on a purchase money mortgage in an amount equal to the median price of housing in the year the residence was purchased. Because it is unlikely for political reasons that the deduction could be so limited, perhaps a ceiling of double the median cost of housing would be an acceptable compromise. Some consideration also should be given to the need for special ceilings for standard metropolitan statistical areas with extraordinarily high median housing prices.

In any event, allowing a deduction for interest on mortgages on second homes should be repealed entirely. Second homes are virtually always a luxury. There is absolutely no reason for subsidizing the ownership of vacation homes. The deduction is both inequitable and economically inefficient. This is even more readily apparent when one considers that a large pleasure boat with a galley, berths, and a head qualifies as a second home for purposes of deducting home mortgage interest. Even viewed as a tax expenditure, the current rules reflect an implausible policy decision when one considers that interest on a loan to buy a pleasure yacht may be deducted, while interest on a loan to pay education expenses is nondeductible, unless the education expenses are deductible, other than as an employee business expenses, under the Treasury Regulations.¹⁴⁹

Deductibility of interest on home equity loans likewise should be repealed. The legislative history of the provisions allowing a deduction for interest on home equity indebtedness provides no coherent explanation of the policy reasons underlying Congress's decision to allow the deduction.¹⁵⁰ Indeed, when the allowance of a deduction for home mortgage indebtedness is compared with the disallowance of personal interest, it is readily apparent that there cannot be any rational policy reason for the deduction. Even more so than the general tracing rules of section 1.163-8T of the Treasury Regulations, the home equity mortgage interest deduction can be said to limit the impact of the disallowance of deductions for personal interest to the level of a tax on "the stupid and the poor."

Apartment dwellers and homeowners with little or no equity are denied any deduction for loans to finance their own or their child's education or to purchase an automobile or other consumer durable. Homeowners, how-

149. See *Treas. Reg.* § 1.162-5 (as amended in 1967) (discussing deduction for education expenses).

150. See H.R. REP. NO. 391, 100th Cong., 1st Sess. 1031-34 (1987), reprinted in 1987 U.S.C.C.A.N. 2313-1, 2313-647 to 2313-650.

ever, subject to the \$100,000 debt ceiling can obtain a deduction for interest to finance any of these purchases, or even a Caribbean vacation, simply by giving the lender a mortgage on their residence. This result is manifestly unfair from the perspective of horizontal equity, and when one considers that both home ownership and the net equity in homes increases as income and wealth increase, it also presents vertical inequities. When one considers that the median price of housing is under \$125,000, purchase money mortgages generally originate at approximately eighty percent of purchase price, and home equity lenders generally limit the combined debt of the first mortgages and home equity loan to 90% of value, it becomes readily apparent that the provision allowing deductibility of interest on home equity loans of up to \$100,000 is an allowance disproportionately benefitting the wealthy.

Even viewed as a tax expenditure, the allowance of a deduction for interest on home equity indebtedness makes no sense. It encourages mortgaging homes to satisfy demand for consumption. In other words, because most consumption expenditures and consumer durables lose value more rapidly than residential real estate, it encourages homeowners to decrease their net worth and increase the risk of foreclosure on their residences. Whatever benefits the deductibility of interest on home equity indebtedness arguably may produce surely cannot outweigh these costs.

IV. DEDUCTIBILITY OF PROFIT-SEEKING EXPENSES

Only real expenses of producing income should be deductible, but *all* real expenses of producing income should be deductible. Neither of these propositions is true under current law. Despite the base broadening in the Tax Reform Act of 1986, the Internal Revenue Code continues to be riddled with tax expenditure investment incentives. Although these incentives may be well intentioned, ultimately their costs outweigh their benefits.¹⁵¹ These have led to enormous complexity, including the passive activity loss rules of Code section 469 and the alternative minimum tax. It was these tax incentives that were the backbone of the flourishing tax shelter industry of the 1970s and 1980s, which high income taxpayers used to reduce their tax burdens. As long as these incentives, such as accelerated depreciation under section 168, remain in the Code, unnecessary complexity is inevitable.

A. *Passive Activity Loss Rules*

The passive activity loss disallowance rules of Code section 469 have been lauded for their salutary effect of closing down the tax shelter industry.¹⁵² But the price has been fearful statutory complexity and in some

151. See Charles R. Hulten & Robert A. Klayman, *Investment Incentives in Theory and Practice*, in *UNEASY COMPROMISE*, *supra* note 37, at 317, 335-36 (concluding that investment incentives incur more cost than benefit).

152. See, e.g., Calvin H. Johnson, *Why Have Anti-Tax Shelter Legislation? A Response to Professor Zelenak*, 67 *TEX. L. REV.* 591 (1989) (arguing that passive activity rules have been successful at screening out artificial losses that arise under normal tax rules).

circumstances mismeasurement of economic income.¹⁵³ Whether the passive activity loss rules should be continued is an important issue that should be studied. As a result of Code section 469, it is fair to say that the income tax system has begun to resemble a schedular system rather than a global system. To be sure, section 469 is not the only culprit. Investment income and expenses long have been subject to special treatment. Capital loss limitations and preferential rates for capital gains entail some features of schedularization, as does the investment interest limitation in Code section 163(d). But the passive activity loss limitations magnify the problems greatly.

Nevertheless, the passive activity loss rules should not be condemned without weighing in their favor a different type of simplicity that they have fostered. As a result of the enactment of section 469, and certain other changes in the Tax Reform Act of 1986, the tax shelter industry virtually has been shut down. Large numbers of inordinately complex, mostly non-productive transactions that previously occurred and absorbed the time and energy of investors, lawyers, accountants, and government officials, as well as significant amounts of capital, have been eliminated. Furthermore, the passive activity loss rules affect a limited number of taxpayers. Although in theory section 469 may apply to a passive sole proprietor, in fact almost the entire impact is reflected in reporting of items from partnerships and real estate.¹⁵⁴ In 1988, approximately nine million returns reported income or loss from rental activities, and nearly six million returns reported income or loss from partnerships and S corporations.¹⁵⁵ Thus, approximately fifteen million (not allowing for any overlap) out of nearly one hundred and ten million taxpayers possibly had to consider the applicability of Code section 469.

The complexity argument alone may not be sufficient to justify repeal of section 469. Involvement in tax shelter investments is a voluntary assumption of complexity. However, in addition to disallowing the artificial losses that drove tax shelters, section 469 also structurally disallows actual economic losses incurred by "passive" business owners.¹⁵⁶ This effect goes beyond the stated reason for enacting the passive activity loss rules: "in order for tax preferences to function as intended, their benefit must be directed primarily to taxpayers with substantial and *bona fide* involvement in the activities to which the preferences relate."¹⁵⁷ This stated rationale for section 469 makes little economic sense, however, if the benefit of tax

153. See, e.g., Robert J. Peroni, *A Policy Critique of the Section 469 Passive Loss Rules*, 62 S. CAL. L. REV. 1 (1988); Lawrence Zelenak, *When Good Preferences Go Bad: A Critical Analysis of the Anti-Tax Shelter Provisions of the Tax Reform Act of 1986*, 67 TEX. L. REV. 499 (1989).

154. SOI-1988, *supra* note 47, at 5.

155. *Id.* at 29, 31.

156. Compare the Limitation on Artificial Loss (LAL) proposal of the Treasury in 1973, which would have deferred only losses attributable to accelerated cost recovery tax expenditures. TREAS. DEP'T, PROPOSALS FOR TAX CHANGE 94-104 (1973).

157. S. REP. NO. 313, 99th Cong., 2d Sess. 716 (1986).

preferences is capitalized into the price of the preferred assets, as is widely believed.¹⁵⁸ On the other hand, the market may have failed to capitalize the benefit in many tax shelter transactions, particularly those involving seller nonrecourse financing.¹⁵⁹ In that case, Congress's decisions regarding the beneficiaries of its largesse is more of a political question than one of logical reasoning.

Accepting Congress's stated reason for adopting the passive activity loss rules, it still is fair to conclude that it painted with too broad a brush. Most tax shelters depended on the convergence of two factors, accelerated cost recovery and nonrecourse financing. If either of those legs is knocked out, the tax shelter collapses. Although Congress was unwilling in 1986 to eliminate accelerated depreciation and expensing of certain capital outlays, it did eliminate the investment tax credit and accelerated depreciation of real estate, extending the cost recovery period of real estate as well. Congress also strengthened Code section 465, limiting deductions attributable to nonrecourse debt, but continued to permit third-party nonrecourse debt to support deductions for real estate. In all likelihood, these changes would have significantly reduced the number of new shelters even without the enactment of section 469.

On balance, the tax system would benefit from the repeal of Code section 469 and its replacement with a stronger attack on the two factors that made tax shelters possible in the first place. Accelerated cost recovery deductions should be limited even more than under current law, and Congress should resist the temptation to "fix" the economy by enacting an investment tax credit. Rather, greater effort should be made to level the playing field toward economic depreciation for all assets. Under an income tax, only economic depreciation avoids distortions in investment choices.¹⁶⁰

Section 465 limitations on deductions attributable to nonrecourse debt should be strengthened. The current exception for qualified nonrecourse financing in Code section 465(b)(6) should be repealed. Section 465 should be revised to apply to all nonrecourse debt, with absolutely no exceptions.¹⁶¹ Current rules deeming indebtedness to certain related parties to be nonrecourse should be retained. Coupled with the rules for allocating partnership debt under the section 752 Regulations, these changes reasonably can be expected to have sufficient prophylactic effect to permit repeal of Code section 469. This would treat the problem, not mask its symptoms.

158. See Boris I. Bittker, *Tax Shelters and Tax Capitalization or Does the Early Bird Get a Free Lunch*, 28 NAT'L TAX J. 416 (1975).

159. George Cooper, *The Taming of the Shrewd: Identifying and Controlling Income Tax Avoidance*, 85 COLUM. L. REV. 657, 701, 710-14 (1985).

160. See, e.g., Paul R. Samuelson, *Tax Deductibility of Economic Depreciation to Insure Invariant Valuations*, 72 J. POL. ECON. 604, 606 (1964) (stating only putative decline in economic value provides sensible definition for measuring "true money income").

161. For a thorough discussion of the reasons for limiting depreciation on all debt financed basis, see Martin J. McMahon, Jr., *Reforming Cost Recovery Allowances for Debt Financed Depreciable Property*, 29 ST. LOUIS U. L.J. 1029 (1985).

B. *Disfavored Profit-Seeking Expenses*

Currently, the Tax Code categorically denies full deductibility to certain types of profit seeking expenses. Unreimbursed employee business expenses, investment income expenses (Code section 212 expenses), and investment interest long have been deductible only as itemized deductions under section 63, rather than in computing adjusted gross income.¹⁶² Thus, because the standard deduction does double duty as a low income allowance and an administratively convenient proxy for itemized deductions, nonitemizers who incur unreimbursed employee business expenses and investment expenses effectively are taxed on gross income rather than net income. The legislative history of the Individual Income Tax Act of 1944, which introduced the adjusted gross income concept and standard deduction, acknowledges the different treatment of employee business expenses but does not give any reason for the discrimination.¹⁶³

Since 1986, deductions for unreimbursed employee business expenses and investment expenses other than interest have been even more restricted. These expenses are treated as miscellaneous itemized deductions under Code section 67. As such, they are deductible only to the extent that the total exceeds two percent of the taxpayer's adjusted gross income. Thus, for example, a taxpayer with a salary of \$50,000 who itemizes deductions and has no deductions taken into account in computing adjusted gross income may not deduct the first \$1,000 of unreimbursed employee business expenses.

The stated reasons for subjecting employee business expenses and investment expenses to these limitations are of dubious validity. According to the General Explanation of the Tax Reform Act of 1986, the restrictions were enacted because "the prior-law treatment of employee business expenses, investment expenses, and other miscellaneous itemized deductions fostered significant complexity, and . . . some of these expenses have characteristics of voluntary personal expenditures."¹⁶⁴ Specifically, Congress believed that the record keeping burden was excessive relative to the amount of the expenditures, and the deductibility of these items presented significant administrative and enforcement problems, particularly because taxpayers frequently made mistakes with respect to such deductions. The cited errors included disregarding the restrictions on home office deductions and deductibility of education expenses, deducting costs of a safe deposit box used only to store personal belongings, and deducting the cost of subscriptions without a sufficient business or investment purpose. Congress nevertheless concluded that taxpayers with unusually large employee business or investment expenses should be allowed some deduction, analogizing large amounts

162. Deductions for investment interest also are limited by section 163(d), but that provision defers rather than disallows deductions.

163. H.R. REP. No. 1365, 78th Cong., 2d Sess., pt. 1 (1944), *reprinted in* 1944 C.B. 821, 838-40; S. Rep. No. 885, 78th Cong., 2d Sess., *reprinted in* 1944 C.B. 858, 877-80.

164. STAFF OF THE JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 78 (1987).

of such expenses to medical expenses and casualty losses, which Congress concluded should be deductible only if they significantly affect the individual's disposable income. Finally, Congress also justified the floor on the grounds that it "takes into account that some miscellaneous expenses are sufficiently personal in nature that they would be incurred apart from any business or investment activities of the taxpayer," citing professional association dues, subscriptions to publications, and safe deposit box rentals.¹⁶⁵

While it may be true that allowing deductions for employee business expenses creates an administrative burden, both of record-keeping for taxpayers and auditing by the IRS, and that some unreimbursed employee business expenses and investment expenses have a personal as well as profit seeking motive, these problems are overstated by the legislative history. They are no different than issues arising with respect to self-employed individuals. Code section 67's 2% floor for miscellaneous itemized deductions is an inappropriate response to the purported problems for numerous reasons. The purported taxpayer record keeping burden is minimal. Checking account records, credit card records, and a logbook for travel expenses provide all of the necessary information for all but truly trivial items. If administrative convenience really is an issue, some consideration should be given to a standard allowance equal to a fixed percentage of earnings from wages or self-employment in lieu of claiming actual expenses. Such a system is employed in some other countries, including Canada and France.¹⁶⁶

If the problem is abusive deductions for mixed purpose expenditures, Congress clearly is barking up the wrong tree. Sole proprietors, partners in small partnerships, and corporations controlled by owner-employees are far more likely to deduct personal expenses under the guise of business expenses than are employees.¹⁶⁷

Finally, from the perspective of accurately measuring income, Code section 67 creates a completely arbitrary and unjustified distinction between employees and the self-employed.¹⁶⁸ For example, a sole practitioner or partner in a law firm may deduct American Bar Association dues without question, but an associate in a law firm or a government lawyer in all likelihood will be denied any effective deduction. Section 67 does not apply only to "voluntary" expenses. Its sweep extends to expenses that are "necessary" in a relatively narrow sense of the term: union dues paid by an employee in a closed shop, continuing education expenses necessary to

165. *Id.* at 79.

166. COMPARATIVE TAX SYSTEMS, EUROPE, CANADA, AND JAPAN 155, 344 (Joseph A. Pechman ed., 1987).

167. See HOUSE WAYS AND MEANS COMM., OVERVIEW OF THE FEDERAL TAX SYSTEM 222-27 (1991); Dan Subotnik, *Equity for the Compliers: On Eliminating—or Extending—the Two Percent Rule*, 56 TAX NOTES 809 (Aug. 10, 1992).

168. See 3 REPORT OF THE ROYAL COMMISSION ON TAXATION (Canada) 289-90 (Canada 1966) (recommending repeal of "unfair discrimination against employees" with respect to deductions for business expenses under Canadian tax system).

maintain a professional license or certification, annual registration fees to maintain a professional license, noncommuting transportation between job-sites. Even where the expenses are voluntary, it is manifestly unjust to apply different standards to employees than to self-employed taxpayers.

Code section 67 also creates a distinction in practice between owner-employees of closely held corporations and all non-owner employees. Owners of closely held corporations can and do provide themselves with full reimbursement or direct payment by the corporation, as excludable working condition fringe benefits. These include not just legitimate business expenses, but many mixed purpose expenses, as well as clearly personal expenses. They avoid even raising the issue of deductibility on their own tax returns.

Code section 67 cannot be justified on the grounds that nearly all taxpayers have some such unreimbursed employee business expenses or Code section 212 expenses and that only excessive expenses affect the individual's ability to pay taxes. Under this logic, it would make sense to limit the deduction of business expenses of partnerships and corporations to the amount by which expenses exceeded 2% of gross income. No one seriously would suggest such a rule.

Unreimbursed employee business expenses and investment expenses should be fully deductible. If Code section 67 is repealed and the standard deduction is eliminated, as I have suggested, nothing more need be done. If the standard deduction is retained as an administrative convenience it should be in lieu only of tax expenditure personal deductions. Employee business expenses and investment expenses should be deductible in computing adjusted gross income.¹⁶⁹

V. CONCLUSION

That is my personal list of high priority items for the agenda of reforming personal income taxation within the context of the present system. There is much that I have not discussed because of lack of space and, sometimes, insufficient knowledge. The single most important issue that I have avoided entirely is how to deal with the regressivity of Federal Insurance Contributions Act (FICA) taxes which are imposed only on wages below a ceiling. This tax issue cannot reasonably be analyzed without a thorough examination of the social security benefits distribution system as well. If, however, the criteria of relative importance of subjects for reform are the revenues involved and the number of taxpayers affected, the equitable and economic impact of the FICA tax may alone be more important than all of the items I have discussed. For similar reasons, I have not discussed qualified pension plans. To do so requires a very thorough analysis of income security issues generally.

I have not discussed deductions for medical expenses, charitable contributions, personal casualty losses, and state taxes, because I still vacillate

169. Treating these expenses as deductions in computing adjusted gross income also would negate the effect of section 68 on such deductions.

on whether to some extent these items are proper deductions in determining income or are properly classified as tax expenditures, although, at least for today, I lean toward the latter view. Taxation of financial instruments has been slighted because for all the wonderful complexity of the original issue discount regulations, in the grand scheme of things taxation of financial instruments is a relatively minor issue in individual income taxation. I could go on justifying the items selected or explaining the items not selected, but the rationalizations are of little consequence.

Two general themes run through the proposals discussed in this essay. One is a renewed commitment to progressive taxation to mitigate the growing disparity in incomes and wealth in this country. The other is further refining the tax base to include items that currently are excluded without adequate justification and to allow deductions for all costs of earning an income.

Finally, I close with the universal plea for simplification. To a large extent this is consistent with the general theme of eliminating unjustifiable exclusions and selective investment incentives. If investment incentives, particularly accelerated cost recovery allowances, are eliminated, then the passive activity loss rules and alternative minimum tax, both of which add significant complexity, also could be eliminated.¹⁷⁰ Avoiding the reintroduction of a significant preference for capital gains is another major element of simplification. Special rules and exceptions should be eschewed. Generally speaking, the more nearly taxable income approaches economic income, the simpler the tax system will be. Accordingly, I propose that Congress should abandon its view of the Internal Revenue Code as a means to provide incentives and disincentives, provide taxpayers with a simpler system to voluntarily comply with and let economic growth fend for itself.

170. The alternative minimum tax adds complexities that often are overlooked by policy makers and analysts. For example, because the dependent care credit under Code section 21 is not allowed against alternative minimum tax liability, *see* I.R.C. § 26, many individuals who never actually have any minimum tax liability nevertheless are directed to, and must, complete Form 6251, calculating minimum tax liability, as part of calculating their child care credit. *See* INTERNAL REVENUE SERVICE, INSTRUCTIONS TO FORM 2441 (1992).