

Tax Reform 1985: The Quest for a Fairer, More Efficient and Simpler Income Tax

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Recent reports of the demise of the federal income tax—like earlier reports of Mark Twain's death—have proved to be highly exaggerated. Tax-reform efforts have coalesced over the past year on the goal of restructuring the income tax to promote, as the Treasury has put it, "fairness, simplicity and economic growth,"¹ rather than replacing the income tax with a consumption tax, as had been recommended by many academics² and, in 1977, by the Treasury.³ This bipartisan consensus has generated three similar, yet distinct, proposals for a "modified flat-rate tax"—that is, a tax that imposes a lower and less progressive rate schedule on an income-tax base that has been broadened by the repeal of many of the tax preferences of current law.⁴

These developments should generally be applauded. They reflect an overdue recognition of the problems that have caused the pres-

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1. U.S. TREASURY DEPARTMENT, *TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH: THE TREASURY DEPARTMENT REPORT TO THE PRESIDENT* (3 volumes, 1984) [hereinafter cited as *TREASURY REPORT*].

2. See, e.g., Andrews, *A Consumption-Type or Cash-Flow Personal Income Tax*, 87 *HARV. L. REV.* 1113 (1974) [hereinafter cited as *Andrews*]; INSTITUTE FOR FISCAL STUDIES, *THE STRUCTURE AND REFORM OF DIRECT TAXATION, REPORT OF A COMMITTEE CHAIRED BY PROFESSOR J.E. MEADE* (1978) [hereinafter cited as *MEADE REPORT*]; N. KALDOR, *AN EXPENDITURE TAX* (1955) [hereinafter cited as *KALDOR*].

3. U.S. TREASURY DEPARTMENT, *BLUEPRINTS FOR BASIC TAX REFORM* (1977) [hereinafter cited as *BLUEPRINTS*].

4. The three proposals are the *TREASURY REPORT*, *supra* note 1; The Fair Tax Act of 1985, S. 409 & H.R. 800, 99th Cong., 1st Sess. (1985) (introduced by Sen. Bill Bradley, D-N.J., and Rep. Richard Gephardt, D-Mo.) [hereinafter cited as *Bradley-Gephardt*]; The Fair & Simple Tax Act of 1985, S. 325 & H.R. 777, 99th Cong., 1st Sess. (1985) (introduced by Sen. Robert Kasten, R-Wis., and Rep. Jack Kemp, R-N.Y.) [hereinafter cited as *Kemp-Kasten*]. For a further definition of a "modified flat-rate tax," see Graetz, *The 1982 Minimum Tax Amendments as a First Step in the Transition to a "Flat-Rate" Tax*, 56 *S. CAL. L. REV.* 527, 530-35 (1983) [hereinafter cited as *Graetz, Minimum Tax*]. For a further discussion of the Bradley-Gephardt bill, see Bradley & Gephardt, *Fixing the Income Tax with the Fair Tax*, 3 *YALE L. & POL'Y REV.* 41 (1985).

ent income tax to become widely perceived as unfair, inefficient and unduly complex. Moreover, they constitute an important reaffirmation of the inherent superiority of an income base over a wage or consumption base as the principal mechanism for the collection of federal revenues.

This Article will first offer a brief overview of the three leading proposals for a modified flat-rate tax. This analysis will necessarily be quite general, because the reform proposals are continually being revised and refined. We will next consider why proponents of these tax-reform proposals—including the Reagan Administration, whose tax legislative program had previously focused almost exclusively on capital formation and economic growth—have concluded that an income tax is preferable to a consumption tax for the collection of federal revenues. We will then explore five problems of the current income tax that must be addressed under any comprehensive revision of the Internal Revenue Code: These are the problems of tax expenditures, inflation, the role of the corporate income tax, tax-shelter investments, and compliance. We will conclude by assessing the contributions of the three reform proposals to the quest for a fairer, more efficient and simpler income tax.

I. *The Modified Flat Tax Proposals*

The modified flat-rate income tax has attracted congressional support from “neo-liberal” Democrats such as Senator Bill Bradley as well as from “supply side” Republicans such as Representative Jack Kemp. The tax was also endorsed by the Treasury Department in its comprehensive *Report to the President on Tax Reform* and is the centerpiece of the tax-reform package to be submitted to Congress by the Reagan Administration.

The modified flat tax proposals that have thus far received the greatest attention — the Bradley-Gephardt “Fair Tax,” the Kemp-Kasten “Fair and Simple Tax” (FAST), and the 1984 Treasury proposal — share the goals of broadening the tax base and lowering tax rates. They would cease the practice of regarding the income tax as an all-purpose cure, like chicken soup, for every ill afflicting society. Accordingly, they would repeal many of the exclusions, deductions and credits that populate the current Internal Revenue Code,⁵ so that the same amount of revenues could be raised at significantly lower tax rates. For example, the top marginal rate for individuals

5. See *infra* text accompanying notes 33-49.

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would be 35 percent under the Treasury proposal,⁶ 30 percent under Bradley-Gephardt,⁷ and 24 percent under Kemp-Kasten.⁸ The top marginal rate for corporations would also be reduced under all three proposals.⁹ The Treasury and Bradley-Gephardt proposals provide, in effect, for a three-bracket rate structure to replace the fifteen brackets (fourteen for married couples) of current law;¹⁰ the Kemp-Kasten bill, while imposing a single tax rate, would allow for some progressivity by exempting from tax a certain amount of earned income.¹¹

The modified flat-rate tax, according to its proponents, offers several advantages over the current income tax. The first is greater economic efficiency or economic neutrality.¹² A tax with fewer preferences and lower rates than the current tax is less likely to distort economic decision-making. It is argued that people would be less inclined under such a tax to allocate their labor and capital differently than they would in a world without taxes.

The second advantage attributed to the modified flat tax is horizontal equity,¹³ a widely used criterion that requires people in simi-

6. 1 TREASURY REPORT, *supra* note 1, at 37.

7. Bradley-Gephardt, *supra* note 4, at § 101.

8. Kemp-Kasten, *supra* note 4, at § 101.

9. Corporate income would be taxed at a flat rate of 33% under the Treasury proposal and 30% under Bradley-Gephardt. Kemp-Kasten would tax corporations at graduated rates of 15%, 25% and 35%. 1 TREASURY REPORT, *supra* note 1, at 97; Bradley-Gephardt, *supra* note 4, at § 102; Kemp-Kasten, *supra* note 4, at § 102.

10. 1 TREASURY REPORT, *supra* note 1, at 37; Bradley-Gephardt, *supra* note 4, at § 101.

11. Kemp-Kasten, *supra* note 4, at §§ 102, 134. The Kemp-Kasten bill contains a single statutory rate of 24%; however, the proposal provides for a somewhat graduated rate structure by exempting from tax 20% of earned income up to the Social Security ceiling (\$39,600 in 1985) and then phasing out the exemption as income rises above the ceiling amount.

12. The Treasury further defines economic neutrality as follows:

An ideal tax system would . . . interfere with private decisions as little as possible. That is, it would not unnecessarily distort choices about how income is earned and how it is spent. It would not unduly favor leisure over work, or consumption over saving and investment. It would not needlessly cause business firms to modify their production techniques or their decisions on how to finance their activities. A neutral tax policy would not induce businesses to acquire other firms or to be acquired by them merely for tax considerations. It would not discourage risk-taking or the formation of new businesses. It would not discourage competition by granting special preferences only to one industry or one type of financial institution.

1 TREASURY REPORT, *supra* note 1, at 13.

13. The Treasury, for example, defines horizontal equity as "equal treatment of equals":

A tax that places significantly different burdens on taxpayers in similar economic circumstances is not fair. For example, if two similar families have the same income, they should ordinarily pay roughly the same amount of income tax, regardless of the sources or uses of that income.

Id. at 14.

lar circumstances to pay similar amounts of tax. The tax would repeal current provisions that allow some taxpayers to reduce their tax liability because of the sources of their income or the types of their expenditures. Finally, a modified flat tax is regarded as an opportunity to simplify substantially the operation of the income tax.¹⁴

The proponents of the three tax-reform proposals appear to differ as to the relative priority that they accord the dual goals of base broadening and rate reduction. The authors of the Bradley-Gephardt bill seem to be concerned primarily with the repeal of existing tax preferences, particularly the favorable treatment of capital gains. They appear to have concluded that such broadening of the tax base can win political acceptance only if it is coupled with reducing the top tax rate on all forms of income to a level roughly comparable to the current top rate on capital gains. The authors of the Kemp-Kasten and Treasury proposals, on the other hand, seem to be concerned primarily with lowering tax rates to encourage savings and capital formation. They appear to have recognized that a rate reduction is achievable only if the tax base can be broadened substantially.¹⁵

Attempting to analyze these proposals in detail is like attempting to hit a rapidly moving target. As Treasury Secretary Donald Regan emphasized upon the release of the Treasury plan: "This thing was written on a word processor. It can be changed."¹⁶ Indeed, the proposal reportedly *will* be changed in several significant respects before it is formally submitted to Congress.¹⁷ The Kemp-Kasten and Bradley-Gephardt bills have likewise undergone several revisions since they were originally introduced. Moreover, no flat tax proposal has yet been voted upon by a single congressional commit-

14. The Treasury observes that "though simplicity in taxation may be difficult to define, everyone knows what it is not":

Simplicity is not reflected in a tax system that requires extensive recordkeeping by ordinary citizens. . . . Simplicity is not computing dozens of deductions and credits, and wondering all the while whether other means of saving tax might have been missed through ignorance of the laws. Nor is simplicity being forced to wade through long and complicated instruction booklets or resort to professional assistance, in order to meet the civic responsibility to pay taxes.

Id. at 15-16.

15. Compare B. BRADLEY, *THE FAIR TAX* 90 (1984) ("It is clear that the biggest problem with our income tax is the mass of tax loopholes.") with *Kemp Says Economic Growth Should Be Motive Behind Tax Reform*, 26 *TAX NOTES* 736 (1985) (quoting Rep. Kemp as having said that the purpose of tax reform should be to improve economic growth by encouraging capital investment).

16. Kilborn, *A Bargaining Chip*, N.Y. Times, Nov. 28, 1984, at A1, col. 5.

17. Blustein, *Baker's Tax Proposal Seen Easier Than Regan's Concerning Depreciation, Capital Gains, Fringes*, Wall St. J., Feb. 28, 1985, at 62, col. 1.

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tee, let alone by the full House and Senate. It is highly unlikely that any of the current plans will emerge unaltered from the legislative process.¹⁸

The purpose of this Article is therefore not to compare and contrast one flat tax against another. Instead, it is to explore some general lessons that can be derived from seventy years of experience under the income tax and that will remain important regardless of which tax-reform plan, if any, is ultimately enacted into law. The most important of these lessons is reflected in the bipartisan rejection of a consumption tax as a replacement for the income tax.

II. *The Rejection of the Consumption Tax*

The consumption tax emerged in recent years as the leading contender to replace the income tax as the nation's major revenue source.¹⁹ Such a tax could take one of three forms: a retail sales tax, a value-added tax, or a personal progressive consumption tax (often labeled an expenditure tax).²⁰ Proponents of a consumption tax have chiefly emphasized its supposed superiority to an income tax in providing incentives for savings and investment,²¹ although some have also stressed its greater simplicity²² and ability to cope with inflation.²³ It is therefore particularly significant that even the Rea-

18. For a discussion of the tax legislative process, see Graetz, *To Praise the Estate Tax, Not to Bury It*, 93 YALE L. J. 259, 263-69 (1983) (noting increased influence of special interests in guiding tax policy decisions) [hereinafter cited as Graetz, *Estate Tax*]; Graetz, *Reflections on the Tax Legislative Process: Prelude to Reform*, 58 VA. L. REV. 1389 (1972).

19. See sources cited *supra* note 2. For further analysis of consumption-tax proposals, see Graetz, *Can the Income Tax Continue to Be the Major Revenue Source?*, in *OPTIONS FOR TAX REFORM 39* (J. Pechman ed. 1984) (Brookings Institution) [hereinafter cited as Graetz, *Income Tax*]; J. PECHMAN, *FEDERAL TAX POLICY 183-205* (1983); Warren, *Would a Consumption Tax Be Fairer Than an Income Tax?*, 89 YALE L. J. 1081 (1980); Graetz, *Implementing a Progressive Consumption Tax*, 92 HARV. L. REV. 1575 (1979) [hereinafter cited as Graetz, *Consumption Tax*].

20. A sales tax, such as those commonly imposed by state and local governments, is generally collected only at the retail level; in contrast, a value-added tax, such as those imposed by a number of European countries, is collected at each stage of the manufacturing and distribution process. An expenditure tax could be imposed much like the present income tax; however, the tax base would include amounts borrowed and would exclude amounts saved or invested. See 1 TREASURY REPORT, *supra* note 1, at 213-14.

21. See, e.g., KALDOR, *supra* note 2, at 14 (asserting that an expenditure tax, unlike an income tax, "does not discriminate against either savings or risk bearing"). See also Andrews, *supra* note 2, at 1173 ("it seems to be assumed that the net effect of the shift toward a consumption base would favor saving").

22. See, e.g., Andrews, *supra* note 2, at 165 (asserting that, on balance, a consumption tax "would represent an incomparably simpler tax to administer" than the current income tax).

23. See, e.g., MEADE REPORT, *supra* note 2, at 186-87 (contending that "[o]ne of the main advantages of a [consumption tax] is that it would be immeasurably easier to cope properly with tax problems arising from inflation").

gan Administration, which from the outset has sought to use the tax system to encourage capital formation and economic growth, has rejected the consumption tax in favor of a modified income tax.²⁴

One basic reason to prefer an income tax over a consumption tax is that a broad consumption-tax base is inherently smaller than a broad income-tax base. This fact is made clear by reference to Henry Simons's famous definition of income as consumption plus accretions to wealth:²⁵ An income tax includes income in the base whether spent or saved, while a consumption tax omits accretions from the base and thereby taxes income only if spent. The same point may be illustrated by the equality, under certain conditions, of a consumption base and a wage base.²⁶ The fact that a consumption tax tends to exempt income from capital, while an income tax reaches both income from labor and income from capital, suggests that a consumption tax may produce not only less revenue but also more unfairness than an income tax.

Since an income base is naturally broader than a consumption base, an income tax has the potential to raise more revenue at the same rates or to raise the same revenue at lower rates. This may prove no small advantage to a government confronted with projections of huge current and future deficits. The revenue potential of a consumption tax might also be limited by two other factors: First,

24. The Treasury conceded that a personal consumption tax might prove superior to an income tax in terms of encouraging savings and eliminating the difficulties that currently arise in the measurement of income from business and capital. A consumption tax was nonetheless rejected because of (1) the equity and efficiency costs of excluding all capital income from tax; (2) the disruption of international taxation that would result so long as other nations continued to impose a tax on income rather than consumption; (3) the greater complexity that would arise in the taxation of individuals; (4) transitional difficulties, especially those involving the taxation of consumption from after-tax savings that had been accumulated before the adoption of the consumption tax; and (5) uncertainty over the proper treatment of gifts and bequest under a consumption tax. 1 TREASURY REPORT, *supra* note 1, at 211-12. The Treasury likewise rejected a national retail sales or value-added tax as a full or partial replacement for the current income tax because such a tax would be inherently regressive, would intrude into an area of taxation traditionally reserved for states and localities; would impose high administration and compliance costs; and would be likely to lead to an increase in overall government spending. *Id.* at 226-27.

25. H. SIMONS, *PERSONAL INCOME TAXATION* 50 (1938).

26. See Graetz, *Consumption Tax*, *supra* note 19, at 1598; Warren, *supra* note 19, at 5. This equivalence of a consumption base and a wage base derives from the equivalence of allowing an immediate deduction for the cost of an investment and of imposing tax initially but exempting from tax the income from the investment. This "immediate-deduction/yield-exemption equivalence" was first recognized by E. Cary Brown in the article, *Business-Income Taxation and Investment Incentives*, in *INCOME, EMPLOYMENT AND PUBLIC POLICY: ESSAYS IN HONOR OF ALVIN H. HANSON* 300-16 (1948). See also Committee on Simplification, ABA Section of Taxation, *Complexity and Personal Consumption Tax*, 35 *TAX LAW* 415, 433 (1982) [hereinafter cited as Committee on Simplification].

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under a consumption tax, there would be no justification for any separate corporate tax (other than a withholding tax).²⁷ Second, a consumption tax, unlike an income tax, should be imposed on a tax-exclusive base—in other words, a deduction should be allowed for the tax itself.²⁸ Today's top tax-inclusive income-tax rate of 50 percent is equivalent to a tax-exclusive rate of 100 percent, and the pre-1981 top rate of 70 percent is equivalent to a tax-exclusive rate of 233 1/3 percent. It is unlikely that tax-exclusive rates of 100 percent or greater would be acceptable to the public notwithstanding their equivalence to currently accepted tax-inclusive rates.²⁹

An even more important reason for rejecting the consumption tax as a substitute for the income tax is that it fails to distribute the costs of government fairly based on taxpayers' relative abilities to pay.³⁰ A system that taxes only wages or consumption fails to take into account ability to pay due to the accumulation of capital or income

27. This is because corporations are engaged in production, not consumption. Amounts earned by businesses and retained for investment would be exempt from the consumption tax as would amounts earned and invested by individuals. The tax would be imposed only when corporate earnings were distributed to shareholders and used by them for consumption rather than savings or investment. This poses the transitional problem of whether to tax consumption of wealth accumulated in after-tax dollars under the income tax. See Graetz, *Consumption Tax*, *supra* note 19, at 1634-42; Committee on Simplification, *supra* note 26, at 439.

28. The failure to allow a deduction for the consumption tax itself would create disparities in the amount due depending on the timing of deductible investments as opposed to the timing of estimated or actual tax payments. For example, individuals whose tax was underwithheld could invest the amount that would eventually become due and thereby obtain deductions unavailable to individuals whose tax was overwithheld. See Graetz, *Consumption Tax*, *supra* note 19, at 1582-84.

29. The revenue potential, as well as the fairness, of the consumption tax might be increased by including bequests and gifts in the tax base of the donor. This would be inconsistent with consumption tax principles, however, since the donee rather than the donor would spend the amount of the bequest or gift. Moreover, taxing bequests as consumption would seem to have little practical prospect of enactment. It has been suggested for similar reasons that the replacement of the income tax with a consumption tax be coupled with either the significant strengthening of the the estate and gift tax or the imposition of a periodic low-rate wealth tax. The estate and gift tax is incapable of raising a significant share of federal revenues, however, and is extremely unpopular among many segments of the public. A wealth tax is widely viewed as impractical because of valuation and liquidity problems; moreover, a wealth tax is a "direct" tax that could not be imposed without a constitutional amendment or a constitutionally effective disguise. See Graetz, *Income Tax*, *supra* note 19, at 40-41; Graetz, *Estate Tax*, *supra* note 18, at 284-85. See also Aaron & Galper, *Reforming the Tax Structure* in ECONOMIC CHOICES 1984 87, 94 (Rivlin ed. 1984) (Brookings Institution) (proposal for a consumption tax, which the authors label a "lifetime income tax," that would include gifts and bequests in the tax base).

30. U.S. tax policy has been guided throughout the twentieth century by the fundamental principle that tax burdens should be distributed in accordance with people's ability to pay. See, e.g., Musgrave, *In Defense of an Income Concept*, 81 HARV. L. REV. 44, 45-46 (1967) (ability to pay provides "a general index of economic well-being which broadly measures a person's capacity to contribute or to 'sacrifice' on behalf of government.").

from capital. Indeed, the recognition that fairness requires the taxation of both labor and capital income motivated the adoption of the sixteenth amendment,³¹ which ensured that Congress would possess the same taxing power over investment income as it was already conceded to possess over labor income and business profits.³² The new modified flat tax proposals may therefore be viewed as a reaffirmation of the sixteenth amendment and of the appropriateness of taxing investment income.

Moreover, if the federal income tax were to be replaced with a consumption tax in its most common form—that is, a retail sales tax or a value-added tax—the tax burden on low- and middle-income individuals would increase relative to the burden on upper-income individuals. Finally, whereas the income tax imposes its greatest burden on the taxpayer's high-earning years, typically the middle years, a consumption tax would impose its greatest burden on the low-earning, high-consumption years of youth and old age.

The proponents of a modified flat tax have, by rejecting a consumption base in favor of an income base, implicitly recognized that exempting capital or capital income from tax is neither permitted by considerations of tax equity nor compelled by considerations of economic efficiency or economic growth. Instead, they have sought an income tax that does not distort economic behavior as much as does the present tax but that still imposes a rate of taxation on capital or capital income that exceeds the zero rate that would prevail under a consumption tax. In short, they have correctly recognized that the income tax needs restructuring, not repeal. We will now turn to those aspects of the current income tax that most require such revision.

31. U.S. CONST. amend. XVI.

32. The Supreme Court held in *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429 (1895), that an earlier income tax was unconstitutional to the extent that it taxed income derived from real estate and municipal bonds. On rehearing, the Court found the entire income tax to be unconstitutional because it consisted in too large part of a direct tax on property income that was not apportioned among the states in conformity with the Constitution. *Pollock v. Farmers' Loan & Trust Co.*, 158 U.S. 601 (1895). As Boris Bittker has observed:

The *Pollock* case is often described as a "judicial veto" preventing Congress from taxing income until the Sixteenth Amendment was adopted in 1913. In point of fact, however, the decision intimated that a tax on salaries, wages, and business profits would not be a "direct tax" and hence would not have to be apportioned, thus leaving Congress free to tax income from these sources if it was willing to exempt unearned income.

1 B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 1.2.2 (1981).

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III. *The Problem of Tax Expenditures*

The federal government has since 1974 explicitly recognized the existence of "tax expenditures" that represent departures from the "normal structure" of the individual and corporate income taxes.³³ Tax expenditures are defined generally as provisions of the Internal Revenue Code that allow special exclusions, deductions, deferrals or credits to encourage particular economic activities or to benefit particular categories of taxpayers. Considerable controversy remains, however, over precisely which items should be included in the annual "tax expenditure budget."³⁴

The 104 provisions identified as "tax expenditures" in fiscal 1982 were estimated to constitute about 41 percent of the total federal revenue that would otherwise have been collected and about 8.4 percent of the gross national product.³⁵ Most of these preferential provisions are of long standing. Richard Goode has found, for example, that 83 percent of the estimated revenue cost of tax expenditures in 1982 resulted from provisions at least thirty-five years old and that 95 percent resulted from provisions enacted before 1970.³⁶ The recent increases in the "tax expenditure budget" are therefore attributable not so much to new provisions as to greater use of old provisions.

The three reform plans recognize that the tax base can be broadened, and tax rates can be reduced, only if many of these tax expenditures are eliminated. Consequently, all three plans would, for example, repeal the investment tax credit,³⁷ the percentage deple-

33. The annual accounting for "tax expenditures" was mandated by the Congressional Budget and Impoundment Control Act of 1974, Pub. L. No. 93-344, § 601, 31 U.S.C. § 1105(a)(16) (1982).

34. Compare Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget*, 11 NAT'L TAX J. 244 (1969), with Surrey & Hellmuth, *The Tax Expenditure Budget — Response to Professor Bittker*, 22 NAT'L TAX J. 528 (1969). The issue of whether the Accelerated Cost Recovery System constituted a tax expenditure was debated in the early 1980s by Stanley Surrey and Norman Ture, who was then the Undersecretary of the Treasury. Compare Ture's *Unreleased Testimony*, 13 TAX NOTES 1538 (1981) (Ture contends that "any depreciation method which does not afford instantaneous write-off is a negative tax expenditure") with *1983 Budget Makes Major Changes in Tax Expenditure Budget*, 14 TAX NOTES 420 (1982) (Surrey counters that it would be "theoretically wrong" to exclude ACRS from the tax expenditure budget).

35. Goode, *Lessons from Seven Decades of Income Taxation*, in *OPTIONS FOR TAX REFORM* 13, 19 (J. Pechman ed. 1984) (Brookings Institution). In contrast, tax expenditures constituted only 25% of federal revenues and 4.6% of GNP in 1971. *Id.*

36. *Id.* at 19-20.

37. 2 TREASURY REPORT, *supra* note 1, at 173-75; Bradley-Gephardt, *supra* note 4, at § 201; Kemp-Kasten, *supra* note 4, at § 201.

tion allowances for oil, gas and mineral resources,³⁸ and the tax exemption for private-purpose bonds issued by state and local governments.³⁹ The plans differ concerning the elimination of other provisions that have often been characterized as tax expenditures. For example, each plan would impose different restrictions on the deductibility of charitable contributions,⁴⁰ state and local taxes,⁴¹ and non-business interest expense.⁴² The proposals likewise differ with respect to the treatment of various employee fringe benefits that are exempt from the current income tax.⁴³

It is particularly noteworthy that the Treasury and Bradley-Gephardt proposals would eliminate the preferential treatment of all capital gains.⁴⁴ The Kemp-Kasten bill would retain a reduced

38. 2 TREASURY REPORT, *supra* note 1, at 229-31; Bradley-Gephardt, *supra* note 4, at § 311; Kemp-Kasten, *supra* note 4, at § 311.

39. 2 TREASURY REPORT, *supra* note 1, at 289-92; Bradley-Gephardt, *supra* note 4, at § 215; Kemp-Kasten, *supra* note 4, at § 215.

40. The Treasury would retain the deduction only for charitable contributions in excess of 2% of gross income, limit the deduction to the indexed basis of appreciated property, repeal the 50% and 30% limits on individual contributions, and repeal the deduction for non-itemizers. 2 TREASURY REPORT, *supra* note 1, at 69-80. Bradley-Gephardt would allow charitable deductions, like other personal deductions, only to offset income taxable at the 14% rate; corporations would be allowed to deduct only 50% of their charitable contributions. Bradley-Gephardt, *supra* note 4, at §§ 202, 234. Kemp-Kasten would retain the charitable deduction provisions of current law.

41. The Treasury would repeal the itemized deduction for state and local taxes; such taxes could continue to be deducted, however, if they were incurred in business or other income-producing activity. 2 TREASURY REPORT, *supra* note 1, at 62-65. Bradley-Gephardt would retain the deduction for state and local income and real property taxes, but would repeal the deduction for state and local personal property and general sales taxes. Bradley-Gephardt, *supra* note 4, at § 233. Kemp-Kasten would retain the deduction for state and local taxes on real property, but would repeal the deduction for state and local income, sales and personal property taxes. Kemp-Kasten, *supra* note 4, at § 226.

42. The Treasury would allow the deduction of non-business interest expense only to the extent that it did not exceed the sum of home-mortgage interest, investment income and \$5,000. 2 TREASURY REPORT, *supra* note 1, at 331-33. Bradley-Gephardt would allow the deduction of home mortgage interest and other non-business interest to the extent of net investment income. Bradley-Gephardt, *supra* note 4, at § 232. Kemp-Kasten would allow the deduction for interest on home mortgages and student loans but not on other consumer debt. Kemp-Kasten, *supra* note 4, at § 228.

43. For example, the Treasury would limit to a specified amount the exclusion of health insurance premiums paid by an employer on behalf of an employee and would repeal the exclusion of employer-provided dependent care, transportation, educational assistance, legal services, death benefits, group-term life insurance and the special treatment of cafeteria plans. 2 TREASURY REPORT, *supra* note 1, at 23-40. The Bradley-Gephardt and Kemp-Kasten bills would repeal only some of these provisions. *See* Bradley-Gephardt, *supra* note 4, at §§ 211, 212, 216 (repeal of exclusions for employer-provided transportation, cafeteria plans, dependent care assistance, group-term life insurance; limitations on exclusion of employer contributions to accident and health plans); Kemp-Kasten, *supra* note 4, at § 211 (repeal of exclusions for employer-provided compensation for injuries and sickness, group legal service plans, transportation).

44. 2 TREASURY REPORT, *supra* note 1, at 178-88; Bradley-Gephardt, *supra* note 4, at § 241.

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capital-gains rate for corporations and for individuals who elected not to index the basis of their assets.⁴⁵ The Treasury, in calling for the repeal of the capital-gains preference, recited the concerns for economic neutrality that are embodied in the concept of tax expenditures:

Along with other provisions that establish special tax treatment for particular sources and uses of income, the preferential tax rate for capital gains is one of an elaborate series of tax incentives for particular businesses and investments. These incentives impede the efficiency of an economy based on free market principles. This undeclared government industrial policy largely escapes public scrutiny, yet it increasingly controls the form and content of business and investment activity.⁴⁶

It is also significant that the three plans retain the preferential tax treatment of retirement savings through the deferred pension and profit-sharing plans and individual retirement accounts that together constitute the principal form of savings for many middle-income taxpayers.⁴⁷ The income earned on these investments should, as a theoretical matter, be taxed currently under a comprehensive income tax.⁴⁸ There are good reasons, however, for allowing the tax-free accumulation of a substantial amount of such income until retirement, even though the current law in this area could be somewhat improved. The deferral of tax provides a useful lifetime averaging effect and mitigates significantly the natural preference of the income tax for current over deferred consumption.

In sum, the three reform proposals point in the proper direction with respect to the longstanding problem of tax expenditures. To recognize the need to repeal many tax expenditures is one thing, however, and to overcome the political and transitional obstacles to doing so is quite another. Many tax expenditures that serve useful social functions could probably not be replaced by direct expendi-

45. Kemp-Kasten, *supra* note 4, at § 232. Kemp-Kasten would allow individual taxpayers either to exclude from gross income 40% of their net capital gain or to adjust the basis of their capital assets upward to compensate for inflation.

46. 2 TREASURY REPORT, *supra* note 1, at 180-81.

47. See 1 TREASURY REPORT, *supra* note 1, at 161 (observing that all three proposals leave essentially intact the present tax treatment of individual retirement accounts, Keogh plans, qualified pension plans and profit-sharing plans). Many of the current provisions governing such plans are contained in I.R.C. §§ 219, 401-418E (1982).

48. For example, the Treasury proposed in 1977 that, under a comprehensive income tax, the earnings of pension plans should be taxed as they accrued, either to the employer or to the employee. The proposal would have continued to exclude employers' contributions to pension plans from employees' tax bases until received, however, and to allow employees a deduction for their own contributions. See BLUEPRINTS, *supra* note 3, at 56.

tures in the current political and fiscal climate. This inhibition may well prove fatal to a variety of specific base-broadening proposals.

Moreover, it remains to be seen whether Congress can muster the political courage to eliminate even those tax-expenditure provisions that are widely conceded to have outlived their usefulness; any attempt to do so would most likely encounter strong opposition from their beneficiaries, who have come to regard certain tax expenditures almost as their vested right. A compromise solution might be to delay or to phase-in the termination of those tax-expenditure provisions whose repeal would impose particularly large losses on particularly vulnerable categories of taxpayers.⁴⁹

IV. *Inflation and the Income Tax*

The current income tax was designed for a world of stable prices. The income tax, while perhaps able to withstand inflation that occurs at a low, regular or predictable rate, has been undermined by the high, fluctuating and unpredictable inflation rates of recent years.⁵⁰ It has consequently produced bizarre patterns of undertaxation and overtaxation that have affected most borrowers and lenders as well as most owners of capital assets.

There are three ways in which the income tax has been seriously affected by fluctuating and unpredictable rates of inflation. These are the problems of "bracket creep," the mismeasurement of income from capital, and the increased importance of timing.

Inflation has distorted the dollar amounts specified in the progressive rate schedules and elsewhere in the Internal Revenue Code. As a result, workers experienced bracket creep throughout the 1970s whenever they received cost-of-living raises that did not increase their real spending power but that pushed them into higher tax brackets. Congress dealt with this problem in 1981 by enacting indexing provisions that, beginning in 1985, adjust the personal exemptions, zero bracket amount and rate schedules annually to reflect increases in the consumer price index.⁵¹

49. For further discussion of transitional issues, see *infra* text accompanying note 147.

50. For further discussion of the effects of inflation on the income tax, see J. PECHMAN, *supra* note 19, at 107-09. See also 1 TREASURY REPORT, *supra* note 1, at 17; INFLATION AND THE INCOME TAX (H. Aaron ed. 1976); Von Furstenberg, *Individual Income Taxation and Inflation*, 28 NAT'L TAX J. 117 (1975); Note, *Inflation and the Federal Income Tax*, 82 YALE L. J. 716 (1973). See generally 1 B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 3.5.4 (1981).

51. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 104, I.R.C. §§ 151(f), 1(f), *amending* § 63(d) (1982).

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The failure of Congress to respond earlier to the problem of bracket creep, however, may have taken a lasting toll on the income tax. Many citizens came to question the fairness of a tax that each year claimed a larger share of the same amount of real income.⁵² Moreover, bracket creep, by subjecting more and more of the population to higher marginal rates, encouraged investment in tax shelters by increasing the value of tax preferences and structural distortions in the measurement of income.

The second way in which inflation has affected the income tax has been in distorting the measurement of income from capital. Net income is mismeasured whenever an amount spent or incurred in an earlier year's dollars must be offset against an amount received or earned in a later year's inflated dollars. These distortions affect the size of capital gains and losses, depreciation allowances, accounting for inventories, and the tax treatment of debt, particularly misallocations between interest and principal.

Congress has generally responded to this mismeasurement of capital income not with systematic solutions but instead with ad hoc "tinkering" such as the 1978 increase in the capital-gains exclusion⁵³ and the 1981 acceleration of depreciation deductions.⁵⁴ Provisions such as these have served, in effect, to impose a zero rate of tax on income from important categories of assets; these include equipment, which essentially enjoys the equivalent of immediate expensing through a combination of accelerated cost recovery deductions and the investment tax credit; natural resources exploration and development, where immediate expensing is generally permitted; and real estate, which often produces negative income-tax rates.⁵⁵ These rules have produced tax burdens that vary widely

52. See Goode, *supra* note 35, at 18-19. The author observes:

Only recently did the unfavorable view of the income tax become the opinion of a plurality of citizens. . . . A likely cause of the abrupt decline in the public opinion rating of the individual income tax after 1972 was its interaction with inflation. Over the years 1972-83, the consumer price index rose by 138 percent, more than it had increased from the end of World War II up to 1972. With personal exemptions and nominal rates in the federal income tax unchanged in 1972-78, the decline in the real value of the exemptions and bracket creep caused the taxes of many persons to increase faster than their real income.

Id. at 18. See also Henry, *Noncompliance with U.S. Tax Law—Evidence on Size, Growth, and Composition*, 37 TAX LAW. 1, 53 (1983).

53. Revenue Act of 1978, Pub. L. No. 95-600, § 402, amending I.R.C. § 1202. (1982).

54. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 201, I.R.C. § 168 (1982).

55. It has been estimated that as much as 80% of the \$10.5 trillion of assets held by individuals qualifies for preferential treatment under the current income tax. See Galper & Steuerle, *Tax Incentives for Savings*, 2 BROOKINGS REV. 1, 19-20 (1983).

both among industries and among companies within the same industry and have thereby produced inequities and encouraged the inefficient allocation of resources.

Meanwhile, Congress has failed to address, even in a piecemeal fashion, the problems of inflation with respect to debt. Interest income and expense are overstated in inflationary periods because interest rates often include an inflation premium to compensate lenders for the anticipated decline in the value of their principal. Consequently, taxable lenders tend to be overtaxed, because some of their nominal interest income represents principal rather than interest, while borrowers tend to be undertaxed, because their deductible interest expense includes the inflation premium as well as real interest.

Congress seems to have rationalized its neglect of this problem on the simplistic ground that the undertaxation of debtors will somehow in the aggregate be compensated for by the overtaxation of creditors. In fact, taxable institutional lenders, such as banks and insurance companies, can shelter much of their overstated income, while tax-exempt lenders, such as pension funds and university endowment funds, are indifferent to income overstatement. The reluctance of Congress to adjust the taxation of debt to account for inflation undoubtedly reflects the political reality that borrowers are far more numerous than lenders in every legislative district. It may also reflect the position of influential economists that the overtaxation of assets, because of its inhibiting effect on capital formation, should be given priority over the overtaxation and undertaxation of debt.⁵⁶

The failure of Congress to adopt a systematic solution to the mismeasurement of capital income during periods of inflation has given rise to an income tax that is incapable of measuring the income of asset owners, debtors or creditors. Indeed, the wrong tax burden has been imposed on virtually every individual and corporation in a society that has universally ignored Polonius' admonition to refrain from both borrowing and lending. The current income tax thus provides great incentives for undertaxed assets to be held by taxpayers subject to the highest marginal rates and for overtaxed assets (such as loans that produce taxable interest) to be held by low-

56. See, e.g., INFLATION AND THE INCOME TAX, *supra* note 50, at 328 (economist Martin Feldstein was reported to have remarked that, while he would prefer the indexing of both assets and debt, the indexing of depreciation alone would be better than no indexing at all).

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bracket taxpayers and tax-exempt entities.⁵⁷ It has also encouraged the same taxpayer simultaneously to engage in debt and asset transactions where the asset is eligible for favored tax treatment.

The opportunities for taxpayers to engage in such “tax arbitrage” have been enhanced by structural provisions of the Internal Revenue Code. A number of these provisions were enacted in a simpler era to distinguish owners from borrowers, for example, and to distinguish one form of legal entity from another. The innovative use of these provisions has resulted in the formation of large and even publicly owned limited partnerships that can “pass through” their tax losses to offset their investors’ unrelated income,⁵⁸ the issuing of zero-coupon bonds by taxable borrowers to tax-exempt lenders,⁵⁹ equipment and real estate leasing by loss corporations and tax-exempt entities,⁶⁰ family sale-leaseback transactions,⁶¹ and the spin-off

57. For a further discussion of such tax arbitrage, see Steuerle, *Tax Arbitrage, Inflation, and the Taxation of Interest Payments and Receipts*, 30 WAYNE L. REV. 991 (1984).

58. For a discussion of the tax treatment of limited partnerships and the problems that have resulted from such treatment, see 2 TREASURY REPORT, *supra* note 1, at 146-48. The Treasury contends that the current law is inadequate in distinguishing corporations, which are usually taxed as separate entities, from large limited partnerships, which can pass through items of income and loss to their partners.

59. Zero-coupon bonds are bonds that pay no stated interest; the investor purchases the bond at a discount and redeems it for its face value at maturity. The Internal Revenue Code requires that a portion of this discount be treated as interest income or expense each year even though no interest is actually paid until maturity. Prior to 1982, such interest income and expense was allocated ratably over the life of the indebtedness; now this interest is subject to an “economic accrual” method that reflects the compounding of interest. The earlier treatment was advantageous to taxable issuers, who could obtain overstated deductions long before they had to make payments on the bonds, but disadvantageous to taxable investors, who had to pay tax on overstated income that they had not yet received. Tax-exempt entities and Individual Retirement Accounts, which are indifferent to these rules, have consequently become the leading purchasers of zero-coupon bonds. See I.R.C. §§ 1271-75 (West Supp. 1984). See also M. GRAETZ, *FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES*, ch. 6 (1985).

60. Leasing transactions have often been designed to permit highly taxed corporations essentially to purchase the tax benefits—especially the accelerated depreciation deductions and the investment tax credits—of tax-exempt entities and loss corporations. See, e.g., *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978) (real-estate sale-leaseback). Congress facilitated such transactions with respect to equipment leasing by enacting the “safe-harbor” lease provisions of the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 201(f)(8), I.R.C. § 168(f)(8) (1982). New restrictions were imposed on such transactions in 1982, however, as a result of concern at the sizable tax savings realized by profitable corporations such as General Electric and Occidental Petroleum as a result of safe-harbor leasing. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, §§ 208, 209, I.R.C. § 168(i) (1982). In addition, the benefits of engaging in sale-leasebacks with tax-exempt entities were significantly reduced by the Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 31(a), I.R.C. § 168(j) (West Supp. 1984). See M. GRAETZ, *supra* note 59, at ch. 4. See also Warren & Auerbach, *Tax Policy and Equipment Leasing after TEFRA*, 96 HARV. L. REV. 1579 (1983); Warren & Auerbach, *Transferability of Tax Incentives and the Fiction of Safe Harbor Leasing*, 95 HARV. L. REV. 1752 (1982).

61. The purpose of family sale-leasebacks and gift-leasebacks is primarily to shift income-producing property from family members in high tax brackets to family mem-

of corporate assets into royalty trusts.⁶²

The third important effect of inflation on the income tax is to magnify dramatically the significance of timing issues. High interest rates, which have been correlated with inflation, and high effective tax rates have raised substantially the tax stakes of allocating deductions to earlier taxable years and income to later taxable years. In labeling issues of income tax timing as trivial in 1938, Henry Simons clearly marked himself as a man before our time.⁶³ Even in more recent years, however, Congress has seemed to concur in that judgment, routinely justifying decisions to accelerate deductions or to delay income recognition as “*only* a matter of timing.” The distinction between life and death is also “*only* a matter of timing.”

The belated nature of concern for issues of income-tax timing is amply evidenced by the fact that it was not until 1982 that Congress discovered compound interest. The Tax Equity and Fiscal Responsibility Act of 1982 required, for the first time, the use of compound interest in measuring interest income on bonds originally issued at a discount⁶⁴ and in calculating interest on tax underpayments.⁶⁵ Tax planners have been aware for some time of the dramatic impact on

bers in lower tax brackets. These transactions may also create deductions for highly taxed transferors; for example, a taxpayer who transfers fully depreciated office equipment to his daughter might seek to obtain rental deductions when he leases it back from her. *See, e.g.,* *Hudspeth v. Commissioner*, 509 F.2d 1224 (9th Cir. 1975) (upholding sale-leaseback of farmland between farm couple and their children); *Rosenfeld v. Commissioner*, 706 F.2d 1277 (2d Cir. 1983) (allowing gift-leaseback of office building between doctor and his children). *See also* M. GRAETZ, *supra* note 59, at ch. 4.

62. The primary motive behind spin-offs of corporate assets is to transfer to shareholders future income to be earned by the assets and thereby to avoid tax on the income at the corporate level. *See, e.g.,* *Hineman, Oil and Gas Investments*, 1 *TAX. OF INVESTMENTS* 250 (1984) (oil and gas royalty trusts); Cole, *Mobil Asks U.S. Ruling on a Trust*, N.Y. Times, Jan. 17, 1984, at D1, col. 6 (request for IRS ruling on plan to give stockholders \$1.5 billion in future royalties from oil-producing properties).

63. H. SIMONS, *supra* note 25, at 168-69. Simons observed, in defense of generally taxing capital gains only when realized, that

[e]njoying large gains, realizable but unrealized, one could in effect borrow from the treasury without interest, sometimes for many years. While this possibility indicates a significant difference between the “ideal” method of calculating taxable income and the modified realization procedure, there would seem to be no serious inequities involved in adherence to the methods which practical considerations so strongly dictate. . . . Moreover, the treasury is protected in most cases against abuse of the postponement opportunities, for . . . [w]hat a man may gain by postponing realization will ordinarily be offset, or more than offset, under progressive rates, by the piling-up of taxable income in his later years or in the hands of his estate.

Id.

64. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 231 (codified as amended at I.R.C. § 1272 (West Supp. 1984)).

65. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 344, I.R.C. § 6622 (1982).

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tax liabilities of compound, as opposed to simple, interest, especially in periods of high interest rates; for example, \$10,000 grows in thirty years to \$55,000 at 15 percent simple interest but to \$662,100 when the interest is compounded.⁶⁶

The Treasury proposal is the first to recognize that the income tax must correct systematically for the mismeasurement of income that results from the fluctuating and unpredictable inflation rates that have become a fact of economic life in the United States. In contrast, the Bradley-Gephardt and Kemp-Kasten bills offer half-way solutions that fail to address the problem of inflation comprehensively.

Bracket creep would become a less significant problem under the flattened rate structures provided by the three reform plans. Consequently, the Bradley-Gephardt bill would not adjust tax brackets for inflation,⁶⁷ while the Treasury and Kemp-Kasten proposals would continue to do so.⁶⁸ The benefits to be obtained from shifting income to lower-bracket taxpayers, and deductions to higher-bracket taxpayers, would also be reduced under a flatter rate structure. The Treasury would further discourage income shifting by taxing children's unearned income at their parents' marginal rate⁶⁹ and by taxing trust income either to the grantor, to the beneficiaries, to the trust at the grantor's marginal rate or to the trust at the highest individual rate.⁷⁰

The Treasury would reduce the overstatement (or, in the case of borrowers, the understatement) of net income in periods of inflation by indexing the basis of capital assets,⁷¹ inventories,⁷² depreciation deductions⁷³ and indebtedness.⁷⁴ The Treasury has concluded that such indexing would permit the accurate measurement of income regardless of the inflation rate and therefore would eliminate the need for "ad hoc" inflation adjustments such as the Accelerated Cost Recovery System and the preferential treatment of capital gains.⁷⁵ The repeal of ACRS would, in turn, eliminate many timing

66. This example is adapted from Canellos & Kleinbard, *The Miracle of Compound Interest: Interest Deferral and Discount After 1982*, 38 TAX L. REV. 565, 565 (1983).

67. Bradley-Gephardt, *supra* note 4, at § 121.

68. 1 TREASURY REPORT, *supra* note 1, at 155; Kemp-Kasten, *supra* note 4, at §§ 112, 121.

69. 2 TREASURY REPORT, *supra* note 1, at 92-95.

70. *Id.* at 96-106.

71. *Id.* at 178-88.

72. *Id.* at 189-92.

73. *Id.* at 152-72.

74. *Id.* at 193-200.

75. *Id.* at 181.

advantages associated with taking depreciation deductions in years before they are economically appropriate.

The indexing of both assets and debt presents many technical difficulties that policymakers have only begun to consider. The Treasury would attempt to avoid the inherent complexity of annually indexing the basis of assets and debt, for example, by instead indexing the basis of assets only at the time of sale and by reducing interest income and expense each year by a fraction based upon the inflation rate. These shortcuts would produce unintended distortions in the measurement of income. For example, financial institutions, which can fully protect themselves against inflation by holding assets equal to debt and by charging higher interest rates than they pay to their depositors, would enjoy an enormous unwarranted tax reduction under the Treasury's proposal.

Indexing interest income but not other forms of passive income would also produce new pressures on the need to distinguish interest from rent or dividends—that is, loans from leases and debt from equity. Moreover, the Treasury's indexing proposal is described at such a level of generality that it is difficult to know how it would affect many common occurrences, including corporate distributions, international transactions, installment sales and annuities.

It may prove necessary under any comprehensive indexing scheme to require annual inflation adjustments to the basis of both assets and debt. Most of these adjustments would probably have to be reflected in current income, while others might be possible to postpone until the disposition of the asset or indebtedness. The Treasury's indexing proposal thus appears to contain too many difficulties and uncertainties to be workable without extensive revision and refinement. Even if the details of this proposal prove too problematic to implement in the current round of tax reform, however, the Treasury is to be commended for recognizing the conceptually appropriate solution to the mismeasurement of capital income and expenses during periods of inflation and for beginning a serious discussion on problems of its implementation.

The Treasury proposal, to a far greater extent than the Bradley-Gephardt and Kemp-Kaſten bills, addresses the timing problems that result from the mismatching of income and deductions. The Treasury would respond to these problems by moving toward a system of economic depreciation,⁷⁶ by requiring that most businesses

76. *Id.* at 152-72.

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use the accrual method of accounting for tax purposes,⁷⁷ and by repealing a number of provisions that allow the accelerated amortization, or the immediate deduction, of special categories of expenditures (such as the costs of oil, gas and mineral exploration and development).⁷⁸

Other timing issues remain unresolved even under the Treasury proposal. For example, the Treasury would continue to “step-up” to fair market value the basis of assets held at death.⁷⁹ This rule exempts permanently from income tax any appreciation that occurred while the property was held by the decedent and therefore may encourage elderly taxpayers to retain property that could be put to more productive use elsewhere in the economy. The solution to this problem might be either to require the new owner of the asset to “carry over” the basis of the decedent⁸⁰ or, better still, to tax any unrealized appreciation at the time of the owner’s death.⁸¹ Indeed, this may be an appropriate time to reconsider more generally the current rule that subjects to tax only those gains and losses that have been realized.⁸²

77. *Id.* at 215-17. The Bradley-Gephardt and Kemp-Kasten proposals would likewise limit the use of the cash method of accounting. Bradley-Gephardt, *supra* note 4, at § 413; Kemp-Kasten, *supra* note 4, at § 411.

78. *See, e.g.*, 2 TREASURY REPORT, *supra* note 1, at 232-33 (repeal of expensing of intangible drilling costs); 234-35 (repeal of expensing of hard mineral exploration and development costs); 236-37 (repeal of expensing of qualified tertiary injectant expenses); 240-41 (repeal of mining and solid waste reclamation and closing cost deduction); 299-313 (repeal of rapid amortization for trademark and trade name expenditures, pollution-control facilities, child-care facilities, rehabilitation of low-income housing, railroad rolling stock, railroad grading and tunnel bores, soil and water conservation expenditures, fertilizer and soil conditioning expenditures, land clearing expenditures and reforestation expenditures).

79. *See* I.R.C. § 1014 (1982).

80. In 1976, Congress applied the carryover-basis rules to appreciated property transferred at death. The complexities and technical difficulties that haunted this provision from the outset delayed its effective date and ultimately helped to bring about its demise in 1980. It seems unlikely that Congress would attempt to re-enact a carryover-basis rule so soon after this unhappy experience. *See* Tax Reform Act of 1976, Pub. L. No. 94-455, § 2005, 90 Stat. 1520, 1872, *deferred by* Revenue Act of 1978, Pub. L. No. 95-600, § 515, 92 Stat. 1763, 1883, *repealed by* Crude Oil Windfall Profits Tax Act of 1980, Pub. L. No. 96-223, § 401, 94 Stat. 229, 299.

81. *See* Graetz, *Taxation of Unrealized Gains at Death—An Evaluation of the Current Proposals*, 59 VA. L. REV. 830 (1973). *Cf.* Covey, *Possible Changes in the Basis Rule for Property Transferred by Gift or at Death*, 50 TAXES 831 (1972) (proposal by American Bankers Association Trust Division for additional estate tax on appreciation).

82. The realization requirement has already been abandoned with respect to the treatment of certain commodity-straddle arrangements and hedging transactions with stock options. *See* I.R.C. §§ 1092, 1256 (West Supp. 1984). Indeed, even Henry Simons recognized in 1938 that

[s]ometimes it may become feasible to place even less reliance on the realization criterion. Perhaps taxpayers might be required decennially to report their taxable

IV. *The Corporate Income Tax*

A few years ago, Lily Tomlin played the leading role in an abominable movie called *The Incredible Shrinking Woman*.⁸³ In terms of national tax policy, the corporate income tax has been playing a similar role in an equally bad entertainment. In 1953, the corporate income tax accounted for 28.4 percent of federal revenue and 5.4 percent of the gross national product.⁸⁴ In 1983, after the most recent liberalization of depreciation allowances, the corporate tax was estimated to account for only 6.6 percent of federal revenues and 1.3 percent of GNP.⁸⁵ The current corporate tax has not been projected to produce more than about 10 percent of federal revenues in any future year.⁸⁶ The individual income tax, by contrast, has accounted for a relatively steady percentage of federal revenue and GNP over the past thirty years—45.2 percent of federal revenues and 8.6 percent of GNP in 1953, as compared to 47.2 percent of revenues and 8.9 percent of GNP in 1983.⁸⁷

The tax-reform proposals may portend an enlarged role for the corporate income tax. For example, the Treasury projected that under its original proposal, which was designed to be revenue-neutral overall, individual income-tax receipts would eventually be 8.5 percent lower than they would have been under current law while corporate receipts would be about 24 percent higher.⁸⁸ A further increase in the corporate tax burden may become particularly appealing to the Reagan Administration, notwithstanding its philosophical aversion to taxing corporations, as it increasingly finds itself caught between its need to reduce soaring federal deficits and its campaign promises not to raise individual income taxes.

Another modern trend in corporate taxation has been the wide

incomes as though all property were disposed of at estimated fair market values as of that year. Ultimately, this reconciliation might be made annually. . . .

H. SIMONS, *supra* note 25, at 167.

83. THE INCREDIBLE SHRINKING WOMAN (Universal 1981). See also THE INCREDIBLE SHRINKING MAN (Universal-International 1957).

84. U.S. TREASURY DEPARTMENT, ANNUAL REPORT OF THE SECRETARY OF THE TREASURY ON THE STATE OF THE FINANCES FOR 1953, at 616-17 (1954).

85. U.S. OFFICE OF MANAGEMENT AND BUDGET, BUDGET OF THE U.S. GOVERNMENT FISCAL YEAR 1985, at 9-5, 9-60 (1984).

86. *Id.*

87. Compare U.S. TREASURY DEPARTMENT, *supra* note 84, at 616-17, with U.S. OFFICE OF MANAGEMENT AND BUDGET, *supra* note 85, at 9-47, 9-60.

88. 1 TREASURY REPORT, *supra* note 1, at 44. The Administration has since acknowledged even more explicitly that its final tax proposal will increase the total amount of taxes collected from corporations in order to finance the lowering of tax rates for individuals. See Birnbaum, *Baker Says Corporations Will Pay More So That Individual Tax Rates Can Fall*, Wall St. J., Feb. 28, 1985, at 64, col. 1.

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variation in effective tax rates both among industries and among companies within the same industry. Alan Auerbach recently estimated, for example, that the effective rate of corporate tax ranged from a low of negative 20.2 percent for the water transportation industry to a high of 37.1 percent for the industry composed of water supply, sanitary services and certain utilities.⁸⁹ Wholesale trade corporations were subject to an estimated 8.3 percent rate of corporate tax, while retail trade corporations were subject to a rate of 23.5 percent.⁹⁰ There are similar disparities in effective tax rates among members of the same industry that have different investment, financing or accounting practices.

The disparities among industries are largely attributable to the combination of accelerated depreciation⁹¹ and the investment tax credit⁹² and to the extent of debt financing within the industry. Accelerated depreciation and the investment credit, designed in large part to ameliorate the effects of inflation, have reduced the corporate tax burden on capital-intensive industries relative to labor-intensive industries. Tax burdens may also vary depending upon the mix of property used by the industry; for example, industries that invest primarily in equipment are often taxed at a lower effective rate than are industries that invest primarily in buildings or inventory.⁹³

Disparate tax rates at the company level, as opposed to the industry level, result in part from variations in each company's history of gains and losses. This history depends, in turn, on whether the company has been able to take advantage of accelerated depreciation and the investment credit. Several unintegrated companies may have the same combined taxable income as a single conglomerate but pay a higher corporate income tax; that is because the conglomerate may elect to file a consolidated return, which permits the tax losses of one subsidiary to offset the tax gains of another.⁹⁴ This disparate treatment may encourage economically inefficient mergers

89. Auerbach, *The Corporation Income Tax*, in *THE PROMISE OF TAX REFORM*, ch. 3, at 12 (J. Pechman ed. 1985). See also Reich, *Reflections on Boundaries: A Reply to Charles Reich*, 2 *YALE L. & POL'Y REV.* 204, 205-06 (1984) (citing disparate tax rates among industries).

90. Auerbach, *supra* note 89.

91. See I.R.C. § 168 (1982).

92. See I.R.C. §§ 38, 46 (West Supp. 1984).

93. See 2 *TREASURY REPORT*, *supra* note 1, at 156 ("ACRS disproportionately benefits capital-intensive industries and methods of production. Income from sectors of the economy without significant investment in depreciable property typically face higher effective tax rates.").

94. See I.R.C. §§ 1501-04 (1982).

and acquisitions as well as economically inefficient transactions, such as leasing, among unaffiliated companies.

Variations in financing patterns among companies—especially in their use of debt versus equity financing—also produce variations in their relative tax burdens. The corporate income tax traditionally has favored debt over equity financing by providing that interest paid on indebtedness is deductible to the company⁹⁵ while dividends paid on equity are not. This preference has been exacerbated by the asymmetrical taxation of assets and loans that has resulted from the failure of the income tax to respond systematically to inflation.⁹⁶ Meanwhile, the government has repeatedly proved incapable of imposing clear rules to distinguish between debt and equity.⁹⁷

The disparate tax burdens among industries, and among companies within a single industry, have produced enormous misallocations of resources that cannot be explained as any sort of coherent national industrial policy. Instead, investment capital has been shifted from industry to industry, from company to company, for little purpose but to achieve the greatest tax benefits. As the Treasury has observed, these “tax-induced distortions in the use of labor and capital and in consumer choices have severe costs in terms of lower productivity, lost production and reduced consumer satisfaction.”⁹⁸ Indeed, Auerbach has calculated that differential corporate taxation resulted in 1984 in the waste of 3.25 percent of the nation’s

95. See I.R.C. § 163 (1982).

96. See *supra* text accompanying notes 53-62. It is probably not surprising that economists differ widely in their estimates of the extent to which the tax on corporate capital income is distorted by inflation. This divergence of views results from their varying assumptions about the marginal tax rates applicable to recipients of corporate interest payments. In terms of aggregate impact, for example, Feldstein and Summers, who assume high marginal rates on creditors, have estimated a 3.3% increase in the total effective corporate tax rate for each 1 percent rise in the inflation rate. See Feldstein & Summers, *Inflation and the Taxation of Capital Income in the Corporate Sector*, Nat'l Bureau of Econ. Research Working Paper No. 312 (1979). King and Fullerton, who assumed a lower tax on creditors, estimated only a 0.4% increase in the total effective corporate tax rate for each 1% rise in the inflation rate. See *THE TAXATION OF INCOME FROM CAPITAL: A COMPARATIVE STUDY OF THE UNITED STATES, UNITED KINGDOM, SWEDEN, AND WEST GERMANY* 296 (M. King & D. Fullerton eds. 1984).

97. See J. EUSTICE, BITTKER AND EUSTICE'S *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 4.05 (Supp. No. 2 1984) (detailing difficulties in promulgating regulations under I.R.C. § 385 to distinguish stock from debt). The proposed regulations were first issued in March 1980 (some 11 years after enactment of section 385) and were then revised and reissued in December 1981; the effective date of the regulations was repeatedly delayed, and the regulations ultimately were withdrawn in July 1983. The author concludes that “it seems most likely that the entire project will be scrapped, and that the Treasury will recommend repeal of § 385 (thus returning the definitional problem to the place from whence it came—the courts).” *Id.*

98. 1 TREASURY REPORT, *supra* note 1, at 4.

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capital stock for a one-time “social loss” of roughly \$75 billion.⁹⁹

The Treasury would reduce these inefficiencies by replacing the current Accelerated Cost Recovery System, investment tax credit and capital gains preference with systematic inflation adjustments of assets,¹⁰⁰ inventories¹⁰¹ and debt¹⁰² and with a “Real Cost Recovery System” intended to more nearly reflect economic depreciation.¹⁰³ The Kemp-Kasten and the Bradley-Gephardt bills would likewise require a more gradual recovery of the costs of depreciable property than is permitted by current law; Kemp-Kasten would index depreciation deductions, while Bradley-Gephardt would not.¹⁰⁴

The adoption of a system of economic depreciation, including appropriate adjustments for inflation, and the repeal of the investment credit would reduce the tax benefits of investing in capital instead of labor, or in one category of asset instead of another. These changes would thereby reduce the influence of the corporate tax on economic decision-making as well as the disparities among industries in the taxation of corporate income.

The reform proposals have been somewhat less ambitious in attacking the structural provisions that may produce disparate tax burdens at the company level. For example, the proposals fail to consider the inequities and inefficiencies that may result from allowing consolidated companies to offset their losses from one business against their income from another. These problems could be addressed either by preventing or limiting the use of consolidated returns, so that each company would be taxed separately regardless

99. Auerbach, *supra* note 89, at 14.

100. 2 TREASURY REPORT, *supra* note 1, at 178-88.

101. *Id.* at 189-92.

102. *Id.* at 193-200.

103. The Real Cost Recovery System would assign assets to one of seven classes for depreciation purposes. Each RCRS class would be given a fixed percentage—ranging from 32% to 3%—that would be applied each year to the inflation-adjusted basis of the asset. *Id.* at 152-72.

104. The Bradley-Gephardt “Simplified Cost Recovery System” would apply 250% declining balance depreciation to six classes of property with recovery periods ranging from four years to 40 years. The deductions would not be adjusted for inflation. Bradley-Gephardt, *supra* note 4, at § 301. The Kemp-Kasten “Neutral Cost Recovery System” would apply straight-line depreciation (with only a partial deduction allowed in the year that the property is placed in service) to the five existing classes of ACRS property; however, what is currently three-year recovery property would be depreciable over four years; five-year property would be depreciable over six years, 10-year property over 15 years, 15-year public utility property over 20 years, and 18-year real property over 25 years. The amount of the deduction would be adjusted for inflation annually. Kemp-Kasten, *supra* note 4, at § 301. NCRS is intended to be the equivalent of expensing assuming a 3.5% rate of inflation; however, the system would produce less revenue loss than ACRS because deductions are not “front-loaded.” Timberlake, *Congressional Tax Reform Leaders Reintroduce Reform Bills*, 26 TAX NOTES 400, 401 (1985).

of the identity of its controlling shareholders, or, as some have proposed, by allowing the refund or transfer of tax losses, so that unaffiliated companies would not be induced to engage in unproductive mergers or other activity to obtain the same tax advantages available to members of consolidated groups.¹⁰⁵ It has also been proposed that new restrictions be imposed on the carryover of net operating losses following a corporate acquisition.¹⁰⁶

The disparate treatment of debt and equity that exists under current law—and that persists to a varying degree under each of the reform proposals—may reflect some continuing uncertainty about the role of the corporate income tax. One view is that corporations should be treated as separate taxpaying entities with an ability to pay taxes that is independent of the collective taxpaying ability of their shareholders. The other view is that corporations should be treated as mere conduits through which income flows to their shareholders; the sole purpose of the corporate income tax, according to this view, is to prevent undistributed corporate earnings from escaping taxation under the individual income tax.¹⁰⁷

Those who subscribe to the conduit theory find it theoretically inappropriate to tax corporations on earnings that are distributed to shareholders as dividends. That is because dividends, when subject to tax once at the corporate level and again at the shareholder level, are taxed more heavily than other kinds of individual income. By the same token, undistributed corporate earnings are improperly taxed whenever the corporation's effective tax rate differs from the collective rate of its shareholders. The theoretically proper reform from this perspective would be to repeal the separate corporate tax and to attribute undistributed corporate income directly to shareholders for taxation at their marginal rates. Any remaining corporate tax would be only a withholding tax that would be credited to shareholders as corporate income was distributed or attributed to

105. See, e.g. Campisano & Romano, *Recouping Losses: The Case for Full Loss Offsets*, 76 NW. U. L. REV. 709 (1981). Proposals for the transfer or refund of tax losses would, of course, pose additional costs for the government and inefficiencies for the national economy (such as enabling unprofitable corporations to remain in business for longer periods).

106. Congress amended section 382 in 1976 to impose a strict continuity-of-ownership test on loss carryovers in acquisitions but has not yet permitted the amendment to take effect. Tax Reform Act of 1976, Pub. L. No. 94-455, § 806, 90 Stat. 1520, 1598, amending I.R.C. §§ 382 and 383. For discussion of later developments, see *ABA Tax Section Resolves to Broaden Tax Base, Limit NOL Carryovers*, 26 TAX NOTES 512, 513-14 (1985).

107. These two perspectives are described in J. PECHMAN, *supra* note 19, at 129-30. See also R. MUSGRAVE & P. MUSGRAVE, *PUBLIC FINANCE IN THEORY AND PRACTICE* 270-71 (1973).

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them.¹⁰⁸

There are both political and practical obstacles, however, to such “full integration” of the individual and corporate income taxes. The repeal of the corporate income tax might prove unacceptable to the large segment of the public that believes that a portion of the federal tax burden should be borne by corporations as entities.¹⁰⁹ Moreover, many commentators consider it impractical to impute and tax retained corporate earnings to shareholders. They have urged, as a second-best solution, the repeal of the corporate tax on earnings distributed to shareholders as dividends.¹¹⁰ This could be accomplished by either a corporate deduction for dividends distributed or a shareholder credit for corporate taxes paid.¹¹¹

These proposals have heretofore encountered considerable resistance among corporate managers, who prefer that any corporate tax reductions be focused on retained earnings rather than distributed earnings. They have therefore advanced, with the concurrence of the economics profession, various bang-for-the-buck arguments regarding the likely impact of corporate tax reductions as an investment stimulus.¹¹² This has previously resulted in the rejection of both dividend relief and general corporate rate reductions in favor of investment credits and liberalized depreciation allowances.

The Treasury blames the “double taxation” of dividends for skewing corporate financing decisions away from equity and in favor of riskier debt, inducing the retention of earnings in marginally productive activities, discouraging investment in the corporate sector as

108. See BLUEPRINTS, *supra* note 3, at 69; C. McLURE, MUST CORPORATE INCOME BE TAXED TWICE? 146-84 (1979); Warren, *The Relation and Integration of the Individual and Corporate Income Taxes*, 94 HARV. L. REV. 719, 739-41 (1981).

109. See Goode, *supra* note 35, at 26. The author observes:

For most people, corporations are real entities, not legal fictions or veils. It follows that the majority think that corporations should pay their “fair” share of taxes, though that is not precisely defined. . . . Popular attitudes do not necessarily oppose some alleviation of the tax burden on dividends or other distributions.

Id. See also N.Y. Times, March 31, 1985, § 4, at 2, col. 1 (quoting Rep. Dan Rostenkowski, chairman of the House Ways and Means Committee, as remarking that “[w]hen corporations can be viewed as enjoying a profit in the neighborhood of \$2 or \$3 billion and not paying taxes, that is when the revolution comes in”).

110. See, e.g., C. McLURE, *supra* note 108, at 42-44.

111. The various proposals are described in Graetz, *Dividend Relief Via Shareholder Credits*, 7 TAX NOTES 667 (1978). *Cf.* American Law Institute, Federal Income Tax Project: Tentative Draft No. 2, at 48 (1979) (proposal for dividend relief limited to new equity).

112. Similar arguments have been advanced by the National Association of Manufacturers with respect to the 1984 Treasury proposal. See *Tax Reform: Economists Applaud Long-Term Impact of Treasury Plan; Business Groups Disagree*, Daily Tax Rep. (BNA), March 29, 1985, at G-7.

well as savings generally, and encouraging participation in tax-shelter partnerships.¹¹³ The Treasury therefore has proposed a half-way solution that would allow corporations a deduction equal to 50 percent of all dividends distributed to their shareholders.¹¹⁴ The decision not to provide full relief from double taxation was reportedly motivated by considerations of revenue loss.¹¹⁵

An alternative to allowing the deduction of corporate dividends would be to restrict the deduction of corporate interest expenses. This approach would address many of the problems at which the dividend deduction is directed at a lower cost to the federal fisc.

VI. *Tax Shelters and Tax Arbitrage*

The steady rise of tax-shelter activity since the 1960s has placed great stress upon the current income tax. The Treasury has noted, for example, that the number of taxpayers claiming losses from partnerships, the most common vehicle for tax-shelter investments, increased almost five-fold, to 2.1 million, between 1963 and 1982.¹¹⁶

Tax-shelter investments typically have at least one of four elements that contribute to tax reduction: (1) *deferral* of tax through acceleration of deductions or postponement of income;¹¹⁷ (2) *conversion*, which occurs when the costs of an investment are deductible from ordinary income while the gain, if taxable at all, is taxed at lower rates (typically capital-gain rates);¹¹⁸ (3) *leverage*, which increases deferral and conversion by increasing deductible amounts;¹¹⁹ and (4) *income shifting*, which involves structuring trans-

113. 1 TREASURY REPORT, *supra* note 1, at 118-19.

114. *Id.* See also 2 TREASURY REPORT, *supra* note 1, at 134-4.

115. 1 TREASURY REPORT, *supra* note 1, at 119.

116. *Id.* at 138.

117. Examples of the provisions of the current income tax that allow deferral include the immediate deduction for the intangible oil and gas drilling costs that should more appropriately be capitalized and recovered over a number of years; the Accelerated Cost Recovery System, which permits depreciation deductions in excess of true economic depreciation; and current deductions for the costs of earning farm income that will not be reported until a later taxable year. See I.R.C. §§ 263(c) (intangible drilling expenses), 168 (Accelerated Cost Recovery System); 180 (expenditures by farmers for fertilizer, etc.); 182 (expenditures by farmers for clearing land) (1982).

118. The current income tax contains rules requiring that some gains on the sale of capital assets be treated as ordinary income rather than capital gain to the extent of prior depreciation deductions taken against ordinary income. However, these "recapture" rules do not prevent all conversion of ordinary income into capital gain, especially on investments in real estate. Compare I.R.C. § 1245 (recapture rules for depreciable personal property and some real property) with I.R.C. § 1250 (recapture rules for certain depreciable real property) (1982).

119. The use of borrowed funds to obtain increased deductions arises in part from

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actions to ensure that income, deductions or credits will be allocated among taxpayers in the manner that produces the lowest net tax liability.¹²⁰

The failure of the tax law to respond systematically to inflation has contributed to this proliferation of tax shelters. Congress's ad hoc solutions to the overtaxation of assets in inflationary periods, combined with its neglect of the undertaxation of debt, have enabled taxpayers to achieve negative tax rates by combining borrowing with accelerated deductions or income postponements or exclusions. As a result, taxpayers have been encouraged to engage in certain categories of investments, regardless of whether they are economically viable, and have received after-tax profits on investments that produced little or no profit before tax.

Tax-shelter investments are typically associated with a form of *tax arbitrage* whereby an individual simultaneously engages in debt and asset transactions where the asset is eligible for favorable tax treatment. This occurs not only when taxpayers invest in what are commonly perceived to be tax shelters but also when they buy homes financed by mortgages or hold a combination of debt and tax-preferred retirement savings. As noted above, a different form of tax arbitrage occurs where undertaxed assets are held by taxpayers subject to high marginal rates, while overtaxed assets (such as loans that produce taxable interest) are held by low-bracket taxpayers and tax-exempt entities.¹²¹

Some commentators believe that the growth of tax shelters in recent years may be attributable not only to the provisions of the Internal Revenue Code but also to the increased unpopularity of the income tax that resulted from bracket creep and other effects of in-

the rule of *Crane v. Commissioner*, 331 U.S. 1 (1947) (amount realized on sale of property includes mortgage as well as equity). Some inroads have recently been made on the *Crane* doctrine, such as the disallowance of deductions where loans are nonrecourse, where loans exceed the value of the related assets, and where repayment is considered unduly contingent. See I.R.C. § 465 (1982) (taxpayers cannot deduct losses on non-real estate investments in excess of amount by which they are "at risk" with respect to the activity); *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976) (basis does not include mortgage where loan is significantly in excess of fair market value of the property); *Gibson Products Co. v. United States*, 637 F.2d 101 (5th Cir. 1981) (contingent nature of obligation prevents inclusion in basis of oil and gas leases of nonrecourse debt secured by leases, drilling equipment and percentage of future production).

120. Leasing transactions, *see supra* note 60, are one form of income-shifting that has often been used in tax shelters. Another is the special allocation of partnership losses among partners in different tax brackets. See M. GRAETZ, *supra* note 59, at ch. 4; McKee, Nelson & Whitmire, *Allocating Tax Benefits: An Analysis of the Proposed Section 704(b) Regulations*, 36 MAJOR TAX PLAN. 25-1 (1984).

121. *See supra* text accompanying notes 57-62.

flation.¹²² The problem has been exacerbated by the difficulties of the Internal Revenue Service in policing even those tax shelters that have no adequate basis in law or fact. The IRS has conducted too few audits and has only recently acquired the computer capability to identify potentially abusive tax shelters.¹²³

Until the 1982 legislation, even those taxpayers whose tax-shelter deductions were ultimately disallowed by the IRS could enjoy in the interim the equivalent of a below-market government loan with none of the financial-statement impact or the time-consuming paperwork demanded by other institutional lenders. It was necessary only that they avoid a fraud penalty. Many attorneys routinely provided such taxpayers with "fraud insurance" in the form of tax-shelter opinion letters.

The 1982 Act contained new compliance provisions that were expected to account for a substantial share of the total revenue to be raised by this largest peacetime tax increase in the nation's history.¹²⁴ The 1984 tax legislation strengthened some of these provisions and adopted additional ones.¹²⁵ It is still too early to ascertain how significant will be the impact of this legislation on tax-shelter activity.

The elimination of tax shelters is a major goal of the three tax-reform proposals. All three proposals seem to assume that reducing marginal rates will reduce incentives to invest in tax shelters.¹²⁶

122. See *supra* text accompanying note 52.

123. See Murray, *IRS Is Losing Battle Against Tax Evaders Despite Its New Gear*, Wall St. J., April 10, 1984, at 1, col. 6. The article observes that

IRS audits, which many tax experts consider the most effective weapon against tax cheating, will decline this year to 1.36% of all returns from 1.5% last year. The agency's stagnant budgets have taken a heavy toll on IRS manpower in recent years, and audit coverage has dwindled steadily from a rate of about 5% in the 1960s.

Id.

124. See, e.g., Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, §§ 611 (penalty for promoting abusive tax shelters), 612 (action to enjoin promoters of abusive tax shelters), 613 (penalty for substantial understatement of tax liability), 615 (penalty for aiding and abetting understatement of tax liability), 616 (fraud penalty), I.R.C. §§ 6700, 7408, 6661, 6701, 6653 (1982). The compliance provisions were expected to generate \$3.4 billion of an anticipated total of \$18.0 billion in 1983, \$8.9 billion of an anticipated \$37.7 billion in 1984, and \$8.7 billion of an anticipated \$42.7 billion in 1985. H.R. CON. REP. NO. 97-760, 97th Cong., 2d Sess. 691, reprinted in 1982 U.S. CODE CONG. & AD. NEWS 781, 1454.

125. See, e.g., Deficit Reduction Act of 1984, Pub. L. No. 98-369, §§ 141 (registration of tax shelters) 142 (originator of tax shelter must keep list of investors), 143 (increased penalty for promoting tax shelters), 144 (increased interest rate on substantial underpayments attributable to certain tax-motivated transactions), I.R.C. §§ 6111, 6112, 6700 (as amended), 6621 (as amended) (West Supp. 1984).

126. See, e.g., 1 TREASURY REPORT, *supra* note 1, at 64 ("rate reduction . . . will reduce the attraction of both tax avoidance through legitimate tax shelters and illegal underreporting of income.").

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There is little empirical support for this proposition, however. A rate reduction may not reduce the number of individuals who participate in tax shelters although it will reduce the benefits that each individual can derive from such activity. Recall, for example, that investment in tax shelters continued to increase after the 1969 and 1981 reductions in the top marginal rate¹²⁷ and after the enactment of the "at risk" rules of Section 465, which substantially reduced the ratio of tax savings to cash investment that could be obtained from most tax shelters other than real estate.¹²⁸

The tax-reform proposals contain a number of specific provisions for reducing the benefits of tax shelters. For example, all three proposals would eliminate conversion advantages by taxing the capital gains of individual at the same rate as ordinary income.¹²⁹ All would also reduce many deferral opportunities by requiring the costs of depreciable property to be recovered at a less accelerated rate¹³⁰ and by repealing the particularly favorable treatment provided under current law for oil, gas and mineral exploration and development.¹³¹

In addition, the proposals would reduce the advantages of leverage and tax arbitrage by limiting the amount of non-business interest expense that could be used to offset unrelated income.¹³² For example, the Treasury would allow individual taxpayers to deduct only mortgage interest on a principal residence plus investment and

127. The top marginal rate was reduced to 50% on earned income in 1969 (effective in 1971) and to 50% on all income in 1981. See Tax Reform Act of 1969, Pub. L. No. 91-172, § 804, 83 Stat. 509, 752; Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 101, 95 Stat. 172, 176-85, I.R.C. § 1 (1982).

128. Section 465 allows the taxpayer to deduct non-business losses only to the extent that he is "at risk" with respect to the activity in which the losses were incurred. A taxpayer is considered "at risk" with respect to his cash investment and indebtedness on which he is personally liable; he is not considered "at risk" with respect to nonrecourse indebtedness, which permits the lender to recover against the mortgaged property but not against the borrower personally. In the absence of section 465, a taxpayer could, for example, acquire depreciable property by paying \$100 in cash and taking out a \$900 mortgage on the property. He could then recover the entire \$1,000 purchase price through depreciation deductions; under section 465, however, the taxpayer could recover only \$100. Thus, it has been said that section 465 reduces to one-to-one the ratio of tax benefit to cash outlay for most investments other than real estate. I.R.C. § 465 (1982).

129. 2 TREASURY REPORT, *supra* note 1, at 181; Bradley-Gephardt, *supra* note 4, at § 241; Kemp-Kasten, *supra* note 4, at § 232.

130. 2 TREASURY REPORT, *supra* note 1, at 152-72; Bradley-Gephardt, *supra* note 4, at § 301; Kemp-Kasten, *supra* note 4, at § 301.

131. 2 TREASURY REPORT, *supra* note 1, at 223-42; Bradley-Gephardt, *supra* note 4, at § 311; Kemp-Kasten, *supra* note 4, at § 311.

132. 2 TREASURY REPORT, *supra* note 1, at 331-33; Bradley-Gephardt, *supra* note 4, at § 232; Kemp-Kasten, *supra* note 4, at § 228.

other personal interest expenses to the extent of their net investment income plus \$5,000.

The Treasury proposal goes beyond the Bradley-Gephardt and Kemp-Kasten bills in imposing additional restrictions on tax-shelter activity. For example, Treasury would close a large loophole in Section 465 by extending the "at risk" rules for loss deductions to all investments, including real estate.¹³³ The Treasury would also limit the ability of limited partnerships to "pass through" their tax losses to shelter their investors' income from other sources. Large limited partnerships (defined as those with more than 35 limited partners) would be taxed as corporations so that their gains and losses would have to be taken into account at the entity level.¹³⁴

To assume that the foregoing provisions would be sufficient to eliminate all tax shelters, however, would be to underestimate the ingenuity of taxpayers and their attorneys. It is inevitable that the enactment of these provisions would be followed by new forms of tax avoidance. For example, the Treasury has recognized that, if home-mortgage interest was deductible but other non-business interest was not, taxpayers would attempt to mortgage their homes to the maximum extent possible in order to obtain funds whose repayment would give rise to interest deductions. The Treasury has consequently proposed to limit the amount of a taxpayer's mortgage for purposes of interest deduction to the fair market value of his home and to trace debt to insure that it is not the result of mortgage overstatement.¹³⁵ These rules are likely to prove difficult for the IRS to enforce, however.

The reform plans fail to consider a more comprehensive response to the tax-shelter problem that was first advanced in 1973 by Treasury Secretary George P. Shultz. This "limitation on artificial losses" proposal would prevent taxpayers from using their deductions from tax-shelter investments to offset their income from salaries, business profits and other unrelated activities.¹³⁶ This approach now is

133. 2 TREASURY REPORT, *supra* note 1, at 334-35.

134. *Id.* at 146-50.

135. *Id.* at 332.

136. See *Hearings on General Tax Reform before the House Comm. on Ways and Means*, 93rd Cong., 1st Sess. 6985-86 (1973) (testimony of Treasury Secretary George P. Shultz). The proposal would have limited the deduction of "artificial accounting losses"—that is, losses attributable to an accelerated deduction that "clearly relates to some future expected profit and has little or no relation to income reported in the current year"—to the associated net related income for the taxable year. Losses that could not be deducted in one year could be carried over to succeeding years.

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found in the minimum tax rules that limit interest deductions¹³⁷ and in rules for so-called hobby losses¹³⁸ and vacation homes.¹³⁹

VII. *Tax Compliance Problems*

No effort to discuss the income tax today would be complete without at least a cursory examination of compliance problems. A large revenue gap, estimated to be in the range of \$100 billion and growing, has resulted from a combination of unreported income and overstated deductions.¹⁴⁰

Unreported taxable income has averaged an estimated 10 to 15 percent of total taxable income in recent years, and IRS commissioners seem convinced that the rate of noncompliance has been growing dramatically. For example, Commissioner Roscoe L. Egger, Jr., has reported that the "income tax gap" created by revenues lost from legal sources of income grew from \$29 billion in 1973 to \$87 billion in 1981 and, without the 1982 legislation, was expected to grow to \$120 billion in 1985.¹⁴¹ Shocking estimates are also offered of income tax evasion in the illegal sector.¹⁴²

It is surprising in light of the prevailing sanction and detection structure that *anyone* who behaved strategically would have paid income tax during the past decade so long as they could have avoided fraud penalties. The most rudimentary cost-benefit analysis of a decision whether to under-report taxable income suggests that, if a sanction structure is to have any deterrent effect, either the probability of punishment must approach 100 percent or the penalty must be greater than the cheater's benefit. During the past decade, while aggregate audit probabilities were typically closer to 2 percent than 100 percent,¹⁴³ interest rates on understated tax liabilities were often less than market rates. The income tax can still be viewed—even after recent efforts to strengthen the sanction and de-

137. I.R.C. § 55(e)(4) (1982) (limiting interest deduction to interest incurred in financing the taxpayer's home plus an amount equal to net investment income).

138. I.R.C. § 183 (1982) (activity not engaged in for profit can give rise to deductions only to the extent that it generates income).

139. I.R.C. § 280A (1982) (extending hobby-loss rules to deduction of expenses associated with residences used for both personal and rental purposes).

140. *Tax Compliance Act of 1982 and Related Legislation: Hearings Before the House Comm. on Ways and Means, 97th Cong., 2d Sess. 3* (1982) (statement of Rep. Rostenkowski) [hereinafter cited as *Tax Compliance Hearings*].

141. *Id.* at 5 (statement of Commissioner Egger).

142. Illegal-sector noncompliance was estimated to account for \$8 billion in lost tax revenues in 1981. *Id.*

143. See note 123, *supra*.

tection structure—as a game that favors significantly those who underreport their taxable income.

The compliance gap has become a justification not only for new enforcement measures but also for major substantive proposals such as the reduction of tax rates and the replacement of the income tax with a consumption tax. It is difficult to analyze the compliance implications of these proposals because relatively little theoretical and empirical knowledge is currently available concerning the nature and extent of the compliance problem.¹⁴⁴ What knowledge we do have suggests, however, that this problem will not be solved by merely lowering tax rates or modifying the tax base without addressing the structural issues of detection and punishment. Yet, the three tax-reform proposals contain no new provisions to encourage citizens to meet their tax obligations fully and promptly.

The notion that lowering tax rates will induce greater compliance stems, at least in part, from the notion that underreporting will produce lesser benefits at lower rates of tax. However, lower tax rates will also reduce the costs of underreporting—at least where the fraud penalty is not applicable—so that the taxpayer's cost-benefit calculation may remain unchanged. It seems important that favorably taxed capital gains, which are subject to a top rate of 20 percent, currently account for a significant portion of unreported income from legal sources.¹⁴⁵

The costs of auditing tax returns and collecting unpaid taxes would probably remain the same after the rate reduction,¹⁴⁶ so the government would have to expend the same resources to collect fewer unpaid taxes (or to expend more resources to collect the same amount of taxes). The government might conclude that these resources would be used more productively elsewhere. The rate re-

144. The economics-based literature on crime and punishment has made little progress since the basic theoretical structure was established nearly two decades ago by Gary S. Becker. See Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968). In this framework, criminal activity is treated as a rational decision based upon probabilities of detection and conviction and levels of punishment. For an application of these models to tax evasion and avoidance, see, e.g., Allingham & Sandmo, *Income Tax Evasion: A Theoretical Analysis*, 1 J. PUB. ECON. 323 (1972).

145. See *Tax Compliance Hearings*, *supra* note 140, at 14 (capital gains estimated by Commissioner Egger to account for more than 10% of the compliance gap). This estimate is consistent with Henry's finding that "the overwhelming share of noncompliance with respect to legal source income appears to involve business and property income" and to involve upper-bracket taxpayers. Henry, *supra* note 52, at 6.

146. See Graetz, Reinganum & Wilde, *An Equilibrium Model of Tax Compliance with a Bayesian Auditor and Some "Honest" Taxpayers* (forthcoming); Graetz, Reinganum & Wilde, *A Model of Tax Compliance Under Budget-Constrained Auditors* (forthcoming).

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duction might therefore lead to fewer enforcement activities and therefore to greater, rather than lesser, noncompliance.

In summary, it is clear that compliance is a serious problem under the current income tax. This problem demands attention, both at the level of theory and the level of fact, in order to design better compliance mechanisms and to improve those that already exist. The notion embodied in the three reform proposals that compliance problems will disappear if we but lower tax rates does not withstand even this introductory analysis.

VIII. *Conclusions*

There is much cause for encouragement in the emerging consensus for a modified flat-rate tax. This new interest in comprehensive tax reform will have to be more than a passing political fad, however, for many obstacles remain to be surmounted before any broad-based, low-rate income tax can be enacted into law.

Several important considerations should be borne in mind by those who will participate in the debate over these tax-reform plans. The first is that all three proposals, regardless of the political affiliations of their authors, are more alike than they are different. They all reject the view of some flat-tax proponents that income-tax reform should serve as a camouflage for shifting the tax burden from higher- to lower-income taxpayers. They agree that the income tax should be restructured rather than replaced by a consumption tax; they recognize that the taxation of capital as well as labor is essential to tax equity and is not unduly burdensome to economic efficiency or economic growth.

The three proposals likewise agree on the necessity of repealing or revising many of the tax preferences and structural provisions that contribute to the complexity, unfairness and inefficiency of the present Internal Revenue Code. They also agree that the current income tax has failed to compensate appropriately for the effects of inflation. The Treasury plan, in fact, offers a comprehensive alternative to the ad hoc responses to inflation that currently distort economic decision-making and cause tax burdens to vary widely among taxpayers with similar before-tax income.

None of these proposals, however, attempts to cure every ill afflicting the current income tax. For example, none of the proposals addresses the problem of unrealized appreciation of assets transferred at death. In addition, the proposals largely ignore those rules that encourage companies to alter their financing patterns, or to en-

gage in mergers and acquisitions, purely for tax reasons; only the Treasury would even begin the important task of integrating the corporate and individual income taxes. The proposals address the growing compliance gap merely by hoping that it will somehow go away once tax rates are lowered; they offer no new provisions that would significantly increase the costs incurred by taxpayers in playing the "audit lottery."

Each of these tax-reform proposals should be examined not only as a package but also section by section. Thus, one should evaluate whether each new provision would enhance the simplicity, fairness or economic neutrality of the income tax for particular groups of taxpayers. This analysis may suggest that some of these provisions should be enacted immediately, others should be rejected, and still others should be delayed pending further study.

The relative importance of the three goals of simplicity, equity and economic neutrality may vary for each of these provisions depending on the category of taxpayers that would primarily be affected by the change in the tax law. For example, simplicity may be most desirable and most achievable in those provisions that would affect the vast majority of working-class and middle-class taxpayers whose incomes derive largely from wages, salaries, interest and dividends. These concerns for simplicity may therefore justify, for example, the elimination or reduction of deductions for state and local taxes and for relatively small charitable contributions.

The goal of equity may take on greater importance with respect to high-income individuals whose earnings derive from investments as well as from labor. The tax law should attempt to ensure that these individuals pay similar taxes regardless of the sources of their income and that they pay appropriately greater taxes than those with lower incomes. Considerations of fairness may therefore help to justify, for example, the repeal of the capital-gains preference, the limitations on the deduction of non-business interest expense, and the elimination of the exemption for interest on private-purpose bonds issued by state and local governments.

The goal of economic neutrality may be of paramount importance with respect to the taxation of businesses, whose tax-motivated decisions to enter into particular investments, transactions or relationships otherwise may reverberate throughout the national economy. These concerns may support, for example, the repeal of the investment tax credit, the use of depreciation schedules more closely

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linked to economic depreciation, and the indexing for inflation of assets, inventories and debt.

The tax law cannot often promote simplicity, fairness and economic neutrality within a single provision. It may be necessary for simplicity to give way to equity and neutrality, for example, in taxing those businesses and individual investors who hold different types of property whose costs may be recovered according to different schedules. It may be necessary at other times to give simplicity priority over equity, for example, by continuing to exempt from tax certain *de minimis* fringe benefits that are provided to some working people but not to others.

These tax-reform proposals must be evaluated in light of the political and economic realities of the 1980s. One of these realities is the existence of powerful special interests who have already descended on Washington to protest many of the proposed changes. Another is the projection of large federal deficits that are unlikely to be reduced significantly by spending cuts alone. It is therefore more difficult now than in the past to combine tax reduction with tax reform in order to make the entire package more appealing to Congress.

This is not to suggest that tax reform should be abandoned merely because it is difficult to accomplish. Rather, it is to emphasize the importance of identifying and neutralizing the opposition to tax reform. One approach might be expressly to combine tax reform with deficit reduction and to emphasize that all taxpayers are being called upon to give up their own tax benefits for the greater public benefit. A vote for tax reform would then become a vote for a more balanced federal budget rather than a vote against charities, oil producers or capital-intensive industries.

A second approach might be to delay or to phase in those provisions of a modified flat-rate tax that are expected to cause particularly large losses for particularly vulnerable categories of taxpayers. The transition to a modified flat-rate tax might be eased by expanding upon the minimum-tax provisions of current law.¹⁴⁷ The minimum tax has already satisfactorily resolved such major potential

147. For a more extensive discussion of how such a transition might be effected, see Graetz, *Minimum Tax*, *supra* note 4. Cf. Fuerbringer, *Minimum Tax Level Proposal*, N.Y. Times, April 2, 1985, at D1, col. 3 (announcement by House Democrats of "fair share minimum tax" proposal that would place "a minimum tax of 25 percent on individuals and corporations with taxable income of \$100,000 or more, even if their deductions would reduce their tax to zero or less"). For a general discussion of alternative transition rules in the tax law, see Graetz, *Legal Transitions: The Case of Retroactivity in Income Tax Revision*, 126 U. PA. L. REV. 47 (1977).

controversies as the treatment of capital gains, itemized deductions and tax credits, and has partially resolved other important issues, such as depletion and depreciation. The next step in the transition might involve further broadening of the minimum-tax base by, for example, the addition of interest on state and local bonds and life insurance reserves, unrealized gains on assets transferred by death and gift, and the excess of allowable depreciation over economic depreciation.

Finally, one must bear in mind that that tax reform is necessarily a continuing process. It is probably impossible to construct any modified flat tax that could correct all of the problems of the current income tax and that would not at the same time create new problems of its own. It is nonetheless important to begin today—while the interest of policymakers and taxpayers in comprehensive tax reform stands at its highest level in more than a decade—to strengthen and restructure the federal income tax in ways that will promote fairness, simplicity and economic efficiency.

Fortunately, this tax-reform effort will be able to build upon the foundation of an income tax that, despite its flaws, has proved for some seventy years to be a reasonably fair and efficient means of financing the world's largest democratic government. Indeed, the modified flat tax proposals recognize the essential soundness of the income tax by proposing that it be reformed rather than replaced. For, as Joe E. Brown said to Tony Curtis in *Some Like It Hot*,¹⁴⁸ after learning to his great dismay that Curtis was a man pretending to be a woman: "Well, nobody's perfect."

148. *SOME LIKE IT HOT* (United Artists/Mirisch 1959).