

# THE 1982 MINIMUM TAX AMENDMENTS AS A FIRST STEP IN THE TRANSITION TO A “FLAT-RATE” TAX

MICHAEL J. GRAETZ\*

The massive body of tax legislation enacted in the first two years of the Reagan Administration offers little guidance for predicting the future direction of United States tax policy. Dramatically different Congressional coalitions—each led by the President—passed by very narrow margins the nation’s largest tax reduction (the Economic Recovery Tax Act of 1981)<sup>1</sup> and then the next year enacted the largest peacetime tax increase (the Tax Equity and Fiscal Responsibility Act of 1982).<sup>2</sup> In each case, short-term political and fiscal concerns dominated the debates. The 1981 legislation reduced taxes in an effort to stimulate economic activity and investment by according substantial tax relief to businesses and high income individuals; the 1982 legislation requires significant additional taxes from these same sources to reduce triple-digit deficits, a reduction also deemed necessary for economic recovery. Although the two Acts together provide for an overall reduction in business taxes and a phased-in decrease in marginal tax rates applicable to individuals, they impart the overwhelming impression that uncertainty, confusion, and inconsistency currently dominate the tax legislative process.

Despite the contradictory aspects of recent tax legislation, however, despair at the prospect of coherent revision of the federal income tax may be premature. During the last Congress, twelve bills were introduced by legislators ranging across the political spectrum,<sup>3</sup> that pro-

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\* Professor of Law, University of Southern California, and Professor of Law and Social Sciences, California Institute of Technology; B.B.A. 1966, Emory University; LL.B. 1969, University of Virginia. I would like to thank Jerry Mashaw and Alan Schwartz for their helpful comments on an earlier draft.

1. Pub. L. No. 97-34, 95 Stat. 172 (1981).

2. Pub. L. No. 97-248, 51 U.S.L.W. 10 (Sept. 14, 1982).

3. S. 2887, 97th Cong., 2d Sess. (1982) (introduced Sept. 9, 1982, by Sen. Mitchell, D-Me.);

posed study or enactment of a so-called flat-rate income tax.<sup>4</sup> The Monetary and Fiscal Policy Subcommittee of the Joint Economic Committee held hearings on the flat-rate tax in July and August of 1982,<sup>5</sup> the tax writing committees directed staff to begin work, and the Senate Finance Committee held hearings on the idea in September of 1982.<sup>6</sup> President Reagan voiced his tentative support of the basic concept, calling it "very tempting,"<sup>7</sup> and press commentary has been both widespread and favorable. As a result, the "flat-rate tax" has become the focus of current tax revision efforts.

This Article addresses the problem of the transition to a flat-rate tax. Assuming that Congress wants to enact such a tax, how do we move from an income tax riddled with special exclusions, deductions, and credits to a broad-based income or consumption tax? Both political actors and professional groups, including Senate Finance Committee Chairman Robert Dole, Office of Management and Budget Director David Stockman, Assistant Secretary of the Treasury John Chapoton,

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H.R. 6944 & S. 2817, 97th Cong., 2d Sess. (1982) (introduced Aug. 5, 1982, by Rep. Gephardt, D-Mo. and Sen. Bradley, D-N.J.) [hereinafter cited as Bradley-Gephardt]; H.R. 6741, 97th Cong., 2d Sess. (1982) (introduced July 13, 1982, by Rep. Dreier, R-Cal.); H.R. 6628, 97th Cong., 2d Sess. (1982) (introduced June 17, 1982, by Rep. Dannemeyer, R-Cal.); H.R. 6352, 97th Cong., 2d Sess. (1982) (introduced May 11, 1982, by Rep. Paul, R-Tex.); S. 2376, 97th Cong., 2d Sess. (1982) (introduced Apr. 15, 1982, by Sen. Grassley, R-Iowa); H.R. 6070, 97th Cong., 2d Sess. (1982) (introduced Apr. 5, 1982, by Rep. Panetta, D-Cal.); H.R. 5868, 97th Cong., 2d Sess. (1982) (introduced Mar. 17, 1982, by Rep. Hance, D-Tex.); S. 2200, 97th Cong., 2d Sess. (1982) (introduced Mar. 15, 1982, by Sen. Helms, R-N.C. (companion bill to H.R. 5513)); S. 2147, 97th Cong., 2d Sess. (1982) (introduced Mar. 1, 1982, by Sen. DeConcini, R-Ariz.); H.R. 5513, 97th Cong., 2d Sess. (1982) (introduced Feb. 10, 1982, by Rep. Crane, R-Ill.); H.R. 4821, 97th Cong., 1st Sess. (1981) (introduced Oct. 22, 1981, by Rep. Hansen, R-Idaho). See STAFF OF THE JOINT COMM. ON TAXATION, 97TH CONG., 2D SESS., PAMPHLET ANALYZING FLAT-TAX PROPOSALS CONSIDERED AT SENATE FINANCE COMMITTEE HEARINGS ON SEPT. 28, 1982, reprinted in DAILY TAX REP. (BNA) No. 188, at J-1 (Sept. 28, 1982) [hereinafter cited as JOINT COMMITTEE] (discussing current flat-tax proposals). For a synopsis of all of these bills except H.R. 6944 and S. 2817, see 16 TAX NOTES 951 app. (June 21, 1982). See also R. Hall & A. Rubushka, A Simple Income Tax with Low Marginal Rates (Jan. 1982, revised July 1982) (unpublished manuscript prepared for the Hoover Institute, Stanford University) (proposing a flat-rate tax, similar to an expenditure tax in its exclusion of savings from the tax base, but with a tax base different from a broad-based expenditure tax because consumption from borrowed funds is not taxed).

4. The term flat-rate tax means different things to different people and is a misnomer since it is commonly applied to comprehensive tax reform proposals incorporating a broadened tax base and a flattened rate schedule regardless of progressivity.

5. *Flat-Rate Tax, Hearings Before the Subcomm. on Monetary and Fiscal Policy of the Joint Economic Comm.*, 97th Cong., 2d Sess. (1982).

6. *Flat-Rate, Broad-Based Income Taxation, Hearings Before the Senate Finance Committee*, 97th Cong., 2d Sess. (1982).

7. See Reagan, Dole, Stockman, Long Contribute to Flat-Rate Tax Debate [hereinafter cited as *Flat-Rate Tax Debate*] and *Flat-Rate Tax Discussion Continues on the Sidelines*, 16 TAX NOTES 266, 267 (July 19, 1982).

the Staff of the Joint Committee on Taxation, and the Tax Section of the American Bar Association, have expressed particular concern with transitional problems, citing the need to protect people who have made economic decisions "in reliance" on the continued existence of special tax provisions.<sup>8</sup>

I argue here that the minimum tax amendments of the Tax Equity and Fiscal Responsibility Act of 1982 placed into the Internal Revenue Code a transitional mechanism that can be regarded as a first step to phasing in a broad-based tax. I then outline a series of future amendments to the minimum tax and other changes necessary to complete the path to a broad-based income tax. Before proceeding to these observations, however, I first describe the flat-rate tax concept and make some general comments on the nature of the transitional problems involved in moving from current law to a broad-based tax with lowered rates. I then trace the intellectual and political origins of the minimum tax provision, describe the 1982 amendments to the minimum tax, and indicate why the minimum tax provides an appropriate vehicle for transition to a flat-rate tax. After illustrating the additional amendments required to move the minimum tax from its current secondary status to center stage as the vehicle for transition to a broad-based income tax, I demonstrate why the 1982 minimum tax amendments will not serve an identical purpose if a broad-based consumption, rather than income, tax were the ultimate goal.

This Article assumes that a move to a broad-based low-rate tax is both feasible and desirable and accepts the rather convincing case that has been made that a broad-based income tax could be superior to present law on economic efficiency, horizontal equity, and simplicity grounds.<sup>9</sup> I have also generally accepted, at least for present purposes,

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8. See Statement of M. Bernard Aidinoff, Chairman, 1982-83 ABA Section of Taxation, *Flat-Rate, Broad-Based Income Taxation, Hearings Before the Senate Finance Committee*, 97th Cong., 2d Sess. (1982), at 10-11 (copy on file with *Southern California Law Review*) [hereinafter cited as Aidinoff Testimony]; Statement of John Chapoton, Assistant Treasury Secretary for Tax Policy, *Flat-Rate, Broad-Based Income Taxation, Hearings Before the Senate Finance Committee*, 97th Cong., 2d Sess. (1982), reprinted in DAILY TAX REP., *supra* note 3, at J-10, J-15 [hereinafter cited as Chapoton Testimony]; JOINT COMMITTEE, *supra* note 3, at J-8 to -9; *Flat-Rate Tax Debate*, *supra* note 7, at 266.

9. For examples of the ongoing debate about the merits of a broad-based tax, see Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925 (1967); Musgrave, *In Defense of An Income Concept*, 81 HARV. L. REV. 44 (1967); Pechman, *Comprehensive Income Taxation: A Comment*, 81 HARV. L. REV. 63 (1967); Galvin, *More on Boris Bittker and the Comprehensive Tax Base: The Practicalities of Tax Reform and the ABA's CSTR*, 81 HARV. L. REV. 1016 (1968); Bittker, *Comprehensive Income Taxation: A Response*, 81 HARV. L. REV. 1032 (1968). Much of the foregoing debate is collected in B. BITTKER, C. GALVIN, R. MUSGRAVE & J.

the view that these goals are more likely to be realized with as uniform and as broad a tax base and low rates as is practical. By limiting my concern here to the problem of transition, I avoid detailed consideration of the merits of particular base broadening issues. Therefore, this Article only briefly addresses some of the many difficult and controversial issues which will arise in the move to a low-rate broad-based income or consumption tax. I attempt here merely to demonstrate that the problems of transition to such a regime, while important, are not insurmountable; that in fact Congress has taken an important first step in this direction in its 1982 amendments to the minimum tax; and suggest a general outline of subsequent steps to complete the path by building on that first step.

### I. A "FLAT-TAX" DEFINED

The unifying theme of all flat-tax proposals is a substantial broadening of the tax base coupled with a significant reduction of marginal tax rates. The principles underlying this theme are simple: cease the practice of regarding the income tax as chicken soup, as a potential cure for every ill affecting society; eliminate the many exclusions, deductions, and credits that populate the income tax; and thereby broaden the tax base to such an extent that revenues at least equivalent to present amounts can be raised with significantly lower tax rates.

Several justifications have been advanced for implementing a flat-rate tax. Proponents of such a tax reform contend that greater economic efficiency can be achieved through the greater neutrality that would result from broadening the overall tax base and lowering marginal rates. This greater neutrality would reduce the interference that taxes have on the allocation of resources and mitigate the adverse impact of taxes on incentives to engage in productive economic activity.<sup>10</sup>

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PECHMAN, A COMPREHENSIVE INCOME TAX BASE? A DEBATE (Federal Tax Press 1968). See also COMMISSION TO REVISE THE TAX STRUCTURE, REFORMING THE FEDERAL TAX STRUCTURE (Fund for Public Policy Research 1973); COMPREHENSIVE INCOME TAXATION (J. Pechman ed., Brookings Institution 1977); UNITED STATES TREASURY DEPARTMENT, BLUEPRINTS FOR BASIC TAX REFORM (1977) [hereinafter cited as BLUEPRINTS]; Special Committee on Simplification, Section of Taxation, American Bar Association, *Evaluation of the Proposed Model Comprehensive Income Tax*, 32 TAX LAW. 563 (1979) [hereinafter cited as Simplification Committee].

10. See Chapoton Testimony, *supra* note 8, at J-12; Statement of Alice M. Rivlin, Director, Congressional Budget Office, *Flat-Rate, Broad-Based Income Taxation, Hearings Before the Senate Finance Committee*, 97th Cong., 2d Sess. (1982), reprinted in DAILY TAX REP., *supra* note 3, at J-24, J-24 [hereinafter cited as Rivlin Testimony]; JOINT COMMITTEE, *supra* note 3, at J-3. See generally Graetz, *Legal Transitions: The Case of Retroactivity in Income Tax Revision*, 126 U. PA. L. REV. 47, 64-73 (1977) [hereinafter cited as *Legal Transitions*] (discussion of efficiency considerations in tax law).

By the same token, a broad-based tax with lower rates could improve horizontal equity—a widely used criterion that requires persons in similar circumstances to pay similar amounts of tax—by eliminating provisions which allow some taxpayers to reduce their taxes because of either the source of their income or the type of expenditure.<sup>11</sup> The impact of a broad-based low-rate tax revision on vertical equity—the distribution of the tax burden by income classes—will ultimately depend on both the tax base selected and the rate schedule that emerges.<sup>12</sup> Finally, proponents of broad-based low-rate taxes regard such a change as a special opportunity to simplify greatly the operation of the income tax.<sup>13</sup>

Although there seems to be widespread agreement that broadening the tax base and lowering rates is an appropriate general direction for comprehensive tax reform, fundamental issues, as well as specific details, remain extremely controversial. When the time comes to adopt legislation, differences over several issues will undoubtedly divide flat-tax proponents. While this Article adopts an optimistic attitude as to both the feasibility and desirability of the adoption of a flat-rate tax, a brief summary of these controversies is necessary to comprehend the issues involved in adopting a flat-rate tax.

First, the details of base broadening will prove extremely controversial as evinced by the disparity among the twelve flat tax bills introduced in the Congress. Some of these bills would repeal all exemptions, exclusions from income, deductions, and credits other than personal exemptions, which in many instances would be increased.<sup>14</sup> Other bills would retain a limited number of deductions, exclusions,

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11. See JOINT COMMITTEE, *supra* note 3, at J-1; *Legal Transitions*, *supra* note 10, at 79-81.

12. See JOINT COMMITTEE, *supra* note 3, at J-1; *Legal Transitions*, *supra* note 10, at 81-83. As will be developed below in greater detail, it is the apparent goal of many flat-tax proposals to dramatically shift the distribution of tax burdens by decreasing taxes of upper income individuals and increasing taxes of middle and lower income individuals. Such a change in vertical equity is not, however, a necessary aspect of broad-based tax revision proposals, but is rather a matter of choice. See *infra* text accompanying notes 16-28.

13. Aidinoff Testimony, *supra* note 8, at 2-5; JOINT COMMITTEE, *supra* note 3, at J-2. Although a true flat-rate tax would provide some marginal simplification advantages over progressive rates, substantial simplification should result from a broadened, more uniform tax base with lower progressive rates and perhaps fewer brackets. See generally BLUEPRINTS, *supra* note 9, at 42-48 (analysis of simplification resulting from broad tax base); Simplification Committee, *supra* note 9, *passim* (same).

14. H.R. 6741, 97th Cong., 2d Sess. 2-3 (1982) (Rep. Drier); H.R. 6352, 97th Cong., 2d Sess. 2 (1982) (Rep. Paul); S. 2200, 97th Cong., 2d Sess. 2 (1982) (Sen. Helms); H.R. 5513, 97th Cong., 2d Sess. 1-3 (1982) (Rep. Crane). See also JOINT COMMITTEE, *supra* note 3, at J-9 to -10 (describing the features of the current proposals).

and credits.<sup>15</sup> The items selected for retention, however, vary widely among these bills.

Second, while each of the bills would substantially reduce tax rates, a variety of rate structures have been proposed that would have extremely different impacts on the distribution of the tax burden.<sup>16</sup> None of the bills recently introduced would increase the progressivity of the tax burden compared to the present income tax, although certain bills have been designed to achieve a distribution of the tax burden by income class which approximates that of present law.<sup>17</sup> The bill introduced by Senator Bradley and Representative Gephardt, for example, would achieve such a result by applying rates ranging from fourteen to twenty-eight percent to a substantially broadened income tax base.<sup>18</sup> Maintaining a distribution of the tax burden by income class similar to that of present law necessarily requires that the top tax rate be reduced no lower than the average rate now applicable to high bracket taxpayers—estimated to be roughly twenty-five to thirty-three percent.<sup>19</sup> The Treasury Department has indicated that approximately the same degree of current progressivity could be retained by taxing a broad income base at rates of ten percent on the first \$19,500 of income; twenty-five percent on amounts from \$19,500 to \$75,000; and thirty-nine percent on amounts over \$75,000, with an exemption of \$3,000 per return and \$1,000 for each dependent.<sup>20</sup>

On the other hand, many flat-tax proposals would dramatically redistribute the tax burden by substantially increasing the burden of

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15. See, e.g., H.R. 4821, 97th Cong., 1st Sess. 2-4 (1981) (Rep. Hansen) (retaining exclusions for life insurance proceeds at death, gifts and inheritances, income from discharge of indebtedness, income from recovery of bad debts, and contributions to aid construction, as well as several deductions).

16. See generally Esenwein, *An Overview of the Issues Concerning A Flat-Rate Income Tax*, 16 TAX NOTES 947 (June 21, 1982) (determination of appropriate rate depends upon selection of the base); Pechman & Scholz, *Comprehensive Income Taxation and Rate Reduction*, 17 TAX NOTES 63, 86-89 (Oct. 11, 1982) (discussion of variety of rate schedules); Talley, *Estimates of Flat Income Tax Rates Using Various Tax Bases*, 16 TAX NOTES 952, 956 (June 21, 1982) (flat rate will greatly shift tax burdens without proper exemptions).

17. See JOINT COMMITTEE, *supra* note 3, at J-9 to -10.

18. Bradley-Gephardt, *supra* note 3, at 2, 4.

19. *Hearings Before the Subcomm. on Monetary and Fiscal Policy of the Joint Economic Comm.*, 97th Cong., 2d Sess. 6 (1982) (testimony of David Bradford) [hereinafter cited as Bradford Testimony]; Chapoton Testimony, *supra* note 8, at Tables 1-4, at J-19 to -22; Pechman & Scholtz, *supra* note 18, at 84.

20. Chapoton Testimony, *supra* note 8, at J-11. Fifty percent of all taxpayers, however, would experience a tax increase, under such a schedule as a result of broadening the tax base. See also Pechman & Scholtz, *supra* note 16, at 88-89 (possible to achieve a similar result with a variety of rate schedules with a maximum 30% rate).

middle and lower income classes and significantly reducing the tax share of upper income groups.<sup>21</sup> Replacing progressive tax rates with a flat rate would necessarily cause such a shift. The Assistant Treasury Secretary for Tax Policy has testified that a flat sixteen percent rate applied to a broad-based income tax (with a \$5,000 exemption for a family of four) would produce roughly the same revenues as present law, but would result in a shift of about \$32 billion in taxes from individuals with more than \$50,000 of income to those with income less than \$50,000.<sup>22</sup> Increasing the exemption to \$10,000 would reduce the amount of redistribution, but would still result in a tax reduction of \$22 billion for persons with income above \$50,000 and a tax increase of \$27 billion for those in the \$5,000-\$50,000 income classes.<sup>23</sup> It seems reasonably certain that a top rate of approximately twenty-five to thirty percent will be required to maintain a distribution of the tax burden reasonably close to that of present law.<sup>24</sup>

Disposition of the progressivity issue with regard to a broad-based tax requires a judgment which Henry Simons aptly characterized as "ethical-aesthetic,"<sup>25</sup> and must necessarily be resolved through political debate, not scholarly analysis. My own ethical-aesthetic judgment demands that broad-based tax reform not become an occasion for redistributing the tax burden from upper income classes to middle and lower income classes.<sup>26</sup> Professors Blum and Kalven thirty years ago labelled the case for progressive taxation "uneasy,"<sup>27</sup> but the cases for proportional or regressive taxation will no doubt prove equally uneasy. In this Article, I therefore assume that a distribution of the tax burden among income classes at least as progressive as under present law should be retained in the move to a broader tax base with substantially reduced rates.<sup>28</sup> My concern for maintaining a distribution of a tax

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21. Chapoton Testimony, *supra* note 8, at J-11; Pechman & Scholz, *supra* note 16, at 84; Talley, *supra* note 16, at 956.

22. Chapoton Testimony, *supra* note 8, at J-10 to -11.

23. *Id.* at J-11.

24. *See id.* (top rate ranges from 25.5 to 33.6%); Pechman & Scholz, *supra* note 16, at 86-89 (top rate of 30%).

25. H. SIMONS, PERSONAL INCOME TAXATION 18-19 (1938).

26. Plato's assertion that no one in society should be more than four times as wealthy as the poorest member probably commands as much (or as little) support as John Rawls' difference principle which provides that "social and economic inequalities are to be arranged so that they are both (a) to the greatest benefit of the least advantaged and (b) attached to offices and positions opened to all under conditions of fair equality of opportunity." J. RAWLS, A THEORY OF JUSTICE 83 (1971). *See generally* Graetz, *Commentary*, in WEALTH REDISTRIBUTION AND THE INCOME TAX 45, 45-50, 53 (A. Leibowitz ed. 1978).

27. W. BLUM & H. KALVEN, JR., THE UNEASY CASE FOR PROGRESSIVE TAXATION (1953).

28. *See supra* text accompanying notes 21-24. My earlier assumption that a flat-rate tax is

burden which is not markedly less progressive than that of current law necessarily influences my choices in detailing the transition to a broad-based low-rate income tax.

The third difficulty of a flat-tax proposals is that there is considerable controversy about how to tax business income, especially the income of large corporations. Many of the broad-based tax revision bills do not address the question of corporate income taxation at all.<sup>29</sup> The Bradley-Gephardt bill, on the other hand, makes no changes in the corporate income tax, and explicitly maintains current rates, special deductions, and credits.<sup>30</sup> Other proposals apply the current corporate income tax rules, but with substantially lower rates.<sup>31</sup> Still others would broaden the corporate tax base, lower the rates, and eliminate individual income taxes on dividends, interest, or gains from the sale of a business.<sup>32</sup> Finally, some of the proposals attempt to conform corporate taxation to flat-rate proposals for wage or consumption taxation, rather than to individual income taxation.<sup>33</sup>

Coordination of corporate and other business taxation with the fundamental base-broadening changes in individual taxation seems essential to avoid creation of new tax planning opportunities which could defeat the purpose of base-broadening. Coordination of corporate and individual tax rates is similarly necessary. A detailed discussion of the changes in corporate taxation appropriate to a broad-based tax reform is beyond the scope of this Article. Integration of corporate and individual income taxes and the appropriate treatment of corporate income

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desirable presumes that considerations of efficiency, fairness, and simplicity are the motivating force behind the flat-rate proposals—perhaps a questionable conclusion in light of the fact that eight of the twelve current legislative proposals significantly reduce the progressivity of the rate structure and would result in a massive shift of the tax burden. I would be against any flat-rate proposal that substantially shifted the tax burden, and both the Staff of the Joint Committee on Taxation and the Treasury seem to share my concern over the distributional effects implicit in several of the current proposals. See Chapoton Testimony, *supra* note 8, at J-11; JOINT COMMITTEE, *supra* note 3, at J-1. Moreover a shift in the tax burden of the magnitude estimated to result from a flat-rate tax with a rate of 16%—calculated to be as high as \$33 billion—renders the disposition of many transitional questions of the sort discussed here insignificant. See *supra* text accompanying note 22.

29. *E.g.*, H.R. 5513, 97th Cong., 2d Sess. (1982); H.R. 5520.

30. Bradley-Gephardt, *supra* note 3. Senator Bradley and Representative Gephardt have subsequently indicated that another bill dealing with corporate taxation will be introduced in the Ninety Eighth Congress. Telephone interview with Leslie Devlin, Assistant Press Secretary to Senator Bradley (Jan. 10, 1983).

31. *E.g.*, H.R. 6070, 97th Cong., 2d Sess. (1982).

32. *E.g.*, S. 2557, 97th Cong., 2d Sess. (1982).

33. *E.g.*, S. 2147, 97th Cong., 2d Sess. (1982). See also R. Hall & A. Rabushka, *supra* note 3, at 5-12.

and distributions in the context of consumption taxes at the individual level have been recently explored in considerable detail in the literature.<sup>34</sup> I will, however, very briefly examine issues of business and corporate taxation.

Finally, flat-tax proposals have raised the question of whether income or consumption is the appropriate broad tax base.<sup>35</sup> The advantages and disadvantages of an income tax versus a personal tax on consumption and the problems of implementing such a tax have received great scholarly attention in the literature in the past several years,<sup>36</sup> and I do not intend to review those debates here. I do, however, discuss the choice between consumption and income taxes in Section VII insofar as transitional issues are at stake.

## II. PROBLEMS OF TRANSITION TO A FLAT-RATE TAX

Changing the current income tax to a broad-based low-rate income tax would constitute a major revision of the tax system, and as the Chairman of the Tax Section of the American Bar Association has noted, this change "would create unusually significant [transition] problems."<sup>37</sup> He was undoubtedly correct when he stated:

[I]t is not enough to consider fundamental tax reform in the abstract.

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34. In the context of income taxation, see, e.g., BLUEPRINTS, *supra* note 9, at 69-72; C. McLURE, MUST CORPORATE INCOME BE TAXED TWICE? (Brookings Institution 1979); Graetz, *Dividend Relief via Shareholder Credits: Tax Preferences Under Chairman Ullman's Proposal*, 7 TAX NOTES 667 (Dec. 11, 1978); Nolan, *Integration of Corporate and Individual Income Taxes*, 30 U.S.C. TAX INST. 899 (1978); Warren, *The Relation and Integration of the Individual and Corporate Income Taxes*, 94 HARV. L. REV. 719 (1981). For discussions of corporate taxation with consumption taxation of individuals, see e.g., J. KAY & M. KING, THE BRITISH TAX SYSTEM 175-200 (1978); INSTITUTE FOR FISCAL STUDIES, THE STRUCTURE AND THE REFORM OF DIRECT TAXATION 233-49 (1978) [hereinafter cited as MEADE REPORT]; Graetz, *Implementing a Progressive Consumption Tax*, 92 HARV. L. REV. 1575, 1634-42 (1979) [hereinafter cited as *Consumption Tax Implementation*].

35. See Chapoton Testimony, *supra* note 8, at J-15 to -18; Rivlin Testimony, *supra* note 10, at J-26 to -27; JOINT COMMITTEE, *supra* note 3, at J-1.

36. E.g., ADVISORY COMM'N ON INTER-GOVERNMENTAL RELATIONS, THE EXPENDITURE TAX (Information Report M-84 1974); BLUEPRINTS, *supra* note 9, at 21-52, 113-44; S. LODIN, PROGRESSIVE EXPENDITURE TAX—AN ALTERNATIVE? (1978) (report of the 1972 Swedish government commission on taxation) (translated into English in 1978); MEADE REPORT, *supra* note 34, at 28-40, 150-74, 187-92; WHAT SHOULD BE TAXED: INCOME OR EXPENDITURE? (J. Pechman ed., Brookings Institution 1980); Andrews, *Fairness and the Personal Income Tax: A Reply to Professor Warren*, 88 HARV. L. REV. 947 (1975); Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974) [hereinafter cited as *Consumption-Type Tax*]; *Consumption Tax Implementation*, *supra* note 34; Mieszkowski, *The Choice of Tax Base: Consumption versus Income Taxation*, in FEDERAL TAX REFORM: MYTHS AND REALITIES 27 (M. Boskin ed. 1978); Warren, *Fairness and a Consumption-Type or Cash Flow Personal Income Tax*, 88 HARV. L. REV. 947 (1975).

37. Aidinoff Testimony, *supra* note 8, at 10.

Rather, any far-reaching change in a tax system as complex as ours, on which taxpayers have relied in making decisions, will necessarily involve considerable complexities in the transition. Needless difficulties will be avoided if such transitional questions are considered from the beginning as part of the basic tax reform itself.<sup>38</sup>

Transitional problems were also emphasized by the Assistant Secretary of the Treasury for Tax Policy<sup>39</sup> and the Director of the Congressional Budget Office<sup>40</sup> in their recent testimony before the Senate Finance Committee and in a pamphlet analyzing flat-tax proposals prepared by the Staff of the Joint Committee on Taxation for that same Committee.<sup>41</sup> None of the broad-base low-rate tax bills which have been introduced address transitional issues, although some contain delayed effective dates.<sup>42</sup>

In general, there are two basic attitudes regarding transitions in the tax law.<sup>43</sup> The politically dominant approach to significant changes in the tax law has been to protect the expectations of taxpayers who have "relied" on existing law; such protection typically takes the form of "grandfathered" effective dates.<sup>44</sup> The Treasury, for example, has in the past argued for "grandfathering" in the case of a move either to a broad-based income or consumption tax.<sup>45</sup> An alternative perspective on tax law transitions, which I have advanced in greater detail elsewhere, is that neither fairness nor efficiency demands grandfathered effective dates. Rather, when the magnitude of change is large, its impact should be reduced through delayed or phased-in effective dates rather than grandfathering.<sup>46</sup> This approach to transitions has been generally endorsed by the Special Committee on Simplification of the

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38. *Id.* at 11.

39. Chapoton Testimony, *supra* note 8, at J-15.

40. Rivlin Testimony, *supra* note 10, at J-24.

41. JOINT COMMITTEE, *supra* note 3, at J-8 to -9.

42. *See id.* at J-9 to -10 (discussing the various proposals).

43. The paragraphs which follow summarize a point made at greater length in *Legal Transitions*, *supra* note 10, at 60-87.

44. A grandfather rule exempts from any change in law certain transactions entered into prior to the date of enactment. For a general discussion of grandfather rules, see *id.* at 60-63.

45. *See BLUEPRINTS*, *supra* note 9, at 181-315. *See generally* S. LODIN, *supra* note 36, at 123-27 (transitional rules in tax system changes); MEADE REPORT, *supra* note 34, at 187-92, 198-200 (transitional effects on equity and the capital market); Committee on Tax Policy, New York State Bar Association, *Retroactivity of Tax Legislation*, 29 TAX LAW. 21, 21 (1975) (problems in retroactive legislation); Note, *Setting of Effective Dates for Tax Legislation: A Rule of Prospectivity*, 84 HARV. L. REV. 436, 436-55 (1970) (rule of prospectivity ensures protection of taxpayer reliance).

46. *See Legal Transitions*, *supra* note 10 (discussing the impact of delayed, phased-in, and grandfathered effective dates).

Tax Section of the American Bar Association.<sup>47</sup>

The principal cause for concern by proponents of grandfathering is the loss in wealth by persons who made decisions with the expectation that the old law would remain in effect.<sup>48</sup> In particular, "price changes" would occur in investments that received preferential treatment under the current income tax, but would not receive such favored treatment under a broad-based tax. The price of such assets would decline because potential buyers would no longer be attracted by a tax-favored yield.<sup>49</sup> Proponents of grandfathering have urged that such rules protect against the alleged inequities resulting from frustration of taxpayers' expectations that their assets would continue to receive tax-favored treatment.<sup>50</sup>

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47. Simplification Committee, *supra* note 9, at 686.

48. See sources cited *supra* note 45. It is not the change in tax liabilities which occasions such concerns. It has been estimated, for example, that under a variety of rate schedules designed to approximate the distribution of the current income tax, the move to a low-rate broad-based tax would produce tax increases or reductions of less than \$100. This figure is less than 10% of the tax liability for 75 to 80% of all taxpayers. Pechman & Scholz, *supra* note 6, at 89. A move to a flat-rate tax would have substantially greater impact, however, on tax liabilities. See *supra* text accompanying notes 16-24.

49. Subsidizing the production of specified goods, through favored tax treatment or otherwise, will typically decrease the price of the subsidized goods and increase their output. The effect of the subsidy on price and quantity would depend upon the supply and demand elasticities of the good. If the subsidy were repealed, *ceteris paribus*, the output and price would be expected to return to presubsidy equilibrium. But if certain firms were grandfathered so that the subsidies would be continued, those firms would enjoy economic rents (in this case increased relative value).

For example, upon the introduction of a broad-based income (or consumption) tax, holders of assets whose proceeds will not receive tax-favored treatment would tend to suffer a decline in value as uniform unfavorable (or uniform favorable) tax treatment is extended to investments generally. This effect will be explored with reference to state and local bonds, on the assumption that interest on such bonds would be included in receipts under a broad-based income tax and therefore treated similarly to the return on other investment assets.

If state and local bonds were not protected through a grandfathered effective date rule, the value of the bonds would decline relative to other investment assets. There would then be no difference in the value of state and local bonds and, for example, corporate bonds of similar risk. Protecting holders of tax-favored assets by a grandfathered effective date, however, may result in an increase in value of the asset. For example, if the income tax exclusion of interest on municipal bonds were repealed only for bonds issued after the date of enactment, interest on previously issued bonds would remain exempt from taxation. Because bonds are not perpetual obligations, once the bonds outstanding as of the enactment date reach maturity all interest would be subject to tax. The maximum supply of tax-exempt bonds would be fixed as of the date of enactment. Since maturity dates for the bonds outstanding at that time vary, the supply of tax-exempt bonds would subsequently shrink until all of the bonds had matured. With a grandfathered effective date, the value of outstanding municipal bonds would rise as higher bracket taxpayers purchased these bonds from lower bracket taxpayers. See *Legal Transitions*, *supra* note 10, at 60-63.

50. See BLUEPRINTS, *supra* note 9, at 182-83; See *Legal Transitions*, *supra* note 10, at 50-52. See also sources cited *supra* note 45 (analysis of transition problems especially with regard to protection of taxpayer expectations).

The argument, however, that reliance on existing law should be protected as a matter of fairness is problematical and suffers from circularity. This argument, in effect, would treat recipients of tax benefits as if they had entered into a contract with the government that precluded the government from changing the law. The argument is often little more than an assertion that the status quo should be shielded from normal legislative changes. But the existence of expectations cannot be used at the same time to justify those expectations. Rights would be created, and thus fairness defined, because certain expectations have come into being. An empirical finding that expectations of no legal changes exist would constitute both the necessary and sufficient condition for the holder of such expectations to be protected from economic loss caused by a change in law. The existence of expectations would thus form the entire circle.

As the Supreme Court has recognized in a different context, "Not only are existing laws read into contracts in order to fix obligations as between parties, but the reservation of essential attributes of sovereign power is also read into contracts as a postulate of the legal order."<sup>51</sup> To be reasonable, expectations in the tax law context should be tempered by the subjective probability that the law will be altered. Tastes and social conditions change, and such changes are often reflected in the political process as changes in law. Individual reliance on the status quo simply does not suffice as a basis for either compensation or grandfathered effective dates.

Moreover, to the extent that people regard fairness to require some protection of expectations that are upset by a change in law, grandfathered effective date rules will typically be inadequate to the task.<sup>52</sup> Nothing short of perfect stability of legal rules seems likely to suffice since uncertainty necessarily will produce winners and losers. Furthermore, a requirement that once a law is enacted it must remain unchanged raises fairness problems itself, particularly in the context of

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51. *Home Bldg. Ass'n v. Blaisdell*, 290 U.S. 398, 435 (1934).

52. Fairness arguments based upon an individual's reliance on the status quo tend to concentrate on protecting only those individuals who are nominally affected by a change in law. For example, in the case of the exemption of state and local bond interest, advocates of protecting losers would only protect the holders of tax exempt bonds. It has not been suggested, however, that issuers of these same bonds, who may well have structured their financing plans on the expectation of continued tax exemption, are entitled to continuation of the exemption because of their "reliance" interest. Nor has it been argued that individuals who demanded or supplied substitutes, with the assumption that the exemption would continue, should also be protected. If fairness depends upon individual reliance, all persons who might alter their behavior because of a tax rule must be protected.

law produced in a system such as ours with representative democratic and political institutions subject to periodic changes in representation and leadership.

Protecting reliance on the status quo seems particularly inappropriate in the context of a move from present law to a low-rate broad-based income tax. This is because a significant portion of the wealth reductions due to the change in law will arise indirectly as a result of the rate-reduction component. In such a move, the owners of assets which received preferential treatment under the present income tax law would suffer a decrease in wealth attributable, in substantial part, to the reduction (or in the case of a move to a consumption tax, the termination<sup>53</sup>) of the income tax on other investments. In other words, even if favored treatment were retained for tax-preferred assets, the significant reduction in tax rates alone would reduce the relative advantage of tax favoritism and would induce price reductions of assets in many instances. It is a unique quality of "tax expenditure" or "tax preference" provisions that, unlike direct expenditures, there are two ways to reduce them—either directly by reduction or repeal of the tax preference, or indirectly by reduction or repeal of the tax. If, for example, both the individual and corporate income taxes were repealed, the "Tax Expenditure Budget"<sup>54</sup> would be reduced to zero. Repeal (or reduction) of only the individual income tax would have the effect of making only individual tax preferences valueless (or less valuable).

One might argue, I suppose, that the individual income tax should not be repealed or reduced, because repeal or reduction would disadvantage individuals who, because of tax preferences, now pay little or no tax relative to individuals who pay substantial amounts of tax and would reduce the value of assets held by persons in the former category. But it seems odd indeed to suggest that the income tax should not be repealed because it would make worthless provisions such as the exclusion of capital gains or the investment tax credit which originally were enacted to reduce taxes. Under such circumstances, the arguments for protecting those who hold tax-favored investments seem even less compelling than in the narrower context of income tax repeal of a particular type of tax-favored treatment, even though their disappointment (and the decline in the value of their assets) would be identical.<sup>55</sup>

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53. See generally *Consumption Tax Implementation*, *supra* note 34, at 1649-59 (discussing transitional problems with consumption tax).

54. OFFICE OF MANAGEMENT AND BUDGET, SPECIAL ANALYSIS G (Federal Budget for 1982).

55. In the context of a move to an expenditure tax, there would be the additional problem of

Another significant criterion for evaluating transitional mechanisms is the simplicity of the transitional rule.<sup>56</sup> Tax simplification, after all, has provided much of the original impetus for flat-tax proposals.<sup>57</sup> It is therefore essential to avoid adopting a program for transition to a flat-rate tax that will threaten the opportunity for simplification that base-broadening with lowered rates accords. For example, it has been suggested that capital gains which have accrued but remain unrealized prior to the date of enactment might be grandfathered so that the new rules would apply only to appreciation occurring after the effective date.<sup>58</sup> Such rules, however, would create an inordinate amount of complexity by requiring segregation of assets acquired prior to the change in law and valuation of those assets on the date of enactment. For reasons of complexity alone, grandfathered effective dates should be eschewed under such circumstances.

In the current context, therefore, I would hold to my earlier conclusion that grandfathered effective dates should not be enacted to protect individual assets that receive favored treatment under present income tax law. The relevant criterion for assessing the efficiency and equity aspects of a change in law is the magnitude of the effects occasioned by such a change. Where the magnitude of a change and its impact on wealth is large, concerns for efficiency and fairness may suggest that phase-in or delayed effective dates be used to mitigate that impact.<sup>59</sup> The Staff of the Joint Committee on Taxation has also recognized that phased-in effective dates can be used to "moderate wealth changes on existing assets and provide taxpayers time to adjust."<sup>60</sup> A phased-in effective date can be effective in achieving a desired moderation of wealth effects and can provide taxpayers time to adjust to the new regime.<sup>61</sup> Phased-in effective dates should be selected, however, in a way that does not create "perverse incentives for taxpayers to make

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taxing consumption from wealth accumulated after the payment of income taxes. *Consumption Tax Implementation*, *supra* note 34, at 1153-62.

56. See, e.g., JOINT COMMITTEE, *supra* note 3, at J-8.

57. *Id.* at J-2; Aidinoff Testimony, *supra* note 8, at 2-5; Chapoton Testimony, *supra* note 8, at J-12 to -13; Rivlin Testimony, *supra* note 10, at J-24.

58. JOINT COMMITTEE, *supra* note 3, at J-8. A similar rule was used when the original income tax was enacted in 1913 and when the carryover rule for the basis of assets transferred at death was enacted in 1976. Tax Reform Act of 1976, I.R.C. § 1023 (repealed 1980). Another example of special complex grandfather provisions can be found in the depreciation recapture provisions of § 1250 of the Internal Revenue Code. I.R.C. § 1250 (1970 & Supp. V 1975) (as amended by Tax Reform Act of 1976, Pub. L. No. 94-455, § 202, 90 Stat. 1520).

59. *Legal Transitions*, *supra* note 10, at 52-60, 64-87.

60. JOINT COMMITTEE, *supra* note 3, at J-8.

61. *Legal Transitions*, *supra* note 10, at 54-60.

non-economic, tax-motivated investments during the transition period."<sup>62</sup>

Although delayed or phased-in effective dates may be used to mitigate the magnitude of a wealth change resulting from a significant change in the tax law, these techniques are not without certain drawbacks. Termination dates of tax preference provisions, a relatively recent phenomenon, have routinely been extended by subsequent Congresses, thereby further delaying changes in substantive rules. The tax treatment of vacation pay, for example, was often postponed year-by-year.<sup>63</sup> Tax reductions enacted with a future effective date have also sometimes been repealed as the crucial date approaches. This latter phenomenon occurred most recently when the Tax Equity and Fiscal Responsibility Act of 1982 repealed substantial business tax reductions scheduled to become effective in 1985 and 1986 through further liberalization of depreciation allowances adopted in the Economic Recovery Act of 1981. Congress took back \$11.4 billion in scheduled tax reductions on the grounds that economic performance and fiscal policy concerns which had emerged in the short interval between the two Acts justified repeal.<sup>64</sup>

The inability of Congress to bind future Congresses through the use of delayed effective dates may in some cases render this device unsuitable as a means of insuring an orderly and predictable transition to a new state of law. In the instant case, unless the delay were sufficiently

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62. JOINT COMMITTEE, *supra* note 3, at J-8.

63. The vacation pay rule was originally made applicable to tax years after June 30, 1955. Congress subsequently delayed the effective date of vacation pay accrual for two years in the Technical Amendment Act of 1958, Pub. L. No. 8-85-866, § 8, 72 Stat. 1608 (1958). Subsequently, Congress on five other occasions postponed the effective date of vacation pay accrual. Pub. L. No. 86-496, § 2, 74 Stat. 164 (1960) (extended to Jan. 1, 1963); Pub. L. No. 88-153, § 1, 77 Stat. 272 (1963) (extended to Jan. 1, 1965); Pub. L. No. 88-554, 78 Stat. 761 (1964) (extended to Jan. 1, 1967); Pub. L. No. 89-692, 80 Stat. 1025 (1966) (extended to Jan. 1, 1969); Pub. L. No. 91-172, § 903, 83 Stat. 711 (1969) (extended to Jan. 1, 1971). Congress finally codified the vacation pay rule in Pub. L. No. 93-625, § 4, 88 Stat. 2108 (1974) (codified at I.R.C. § 463). Congress has similarly extended many other deadlines. *See, e.g.*, Tax Reform Act of 1976, Pub. L. No. 94-455, § 203(b), 90 Stat. 1520 (amending I.R.C. § 167(k) (1970 & Supp. V 1975)) (extension of the tax incentive for rehabilitation of low-income rental housing); *id.* § 802(a) (amending I.R.C. § 46 (1970 & Supp. V 1975)) (extension of 10% investment credit); *id.* § 2107(b) (amending I.R.C. § 501(B) (Supp. V 1975)) (extension of welfare employment incentives).

64. The precise tax increases estimated to result from the repeal of the accelerated depreciation provisions which would have been effective under the Economic Recovery Tax Act of 1981 are \$1.5 billion in 1985 and \$9.9 billion in 1986. An estimated \$18.4 billion in increased taxes is expected to be paid in 1987. STAFF OF THE JOINT COMM. ON TAXATION, SUMMARY OF REVENUE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982, *reprinted in* 16 TAX NOTES 811, 836 (Aug. 30, 1982).

short and reversal sufficiently unlikely because of extant and expected political conditions (the continuation in office through the delay of the crucial political actors might be one such example), a delayed effective date probably will not work. Because of the necessary elimination of tax-favored treatment of a broad range of assets and the ability of currently benefited special interest groups to mobilize their arguments for continuation of favored treatment during the delay, the practical likelihood of moving to a broad-based income tax via a delayed effective date provision seems slight.

If both grandfathered effective dates and a delayed effective date are to be eschewed for the reasons set forth above, a phase-in of the move to a broad-based tax with lowered rates seems to be the only available course. A phase-in could be targeted rather precisely to achieve the desired magnitude of wealth effects and to occasion appropriate movement to a new regime.<sup>65</sup> The principal objection to a phased-in effective date is its complexity.<sup>66</sup> A phase-in, of course, is also subject to the objection that a subsequent Congress might deflect the law from its targeted course, but because a phase-in involves taking immediate steps toward the ultimate goal, this objection would have less force than against a delayed effective date. When, as here, a fundamental change in law is at stake, the greater the immediate movement in the new direction, the greater the likelihood that the ultimate goal will be realized as scheduled.

The task involved in phasing-in either a broad-based income or consumption tax with lower rates—a so-called flat tax—is to find a means of enacting the phase-in without an inordinate increase in tax complexity, inefficiency, unfairness, or arbitrariness. Fortunately, the tax increase on higher income taxpayers occasioned by the 1982 amendments to the minimum tax has (no doubt inadvertently) put into place a minimum tax almost ideally suited to the function of phasing-in

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65. See *Legal Transitions*, *supra* note 10, at 52-60.

66. For example, the Treasury considered a ten-year phase-in to be an appropriate transitional mechanism in moving from income to consumption taxation. BLUEPRINTS, *supra* note 9, at 205, 209-11; MEADE REPORT, *supra* note 34, at 188. To minimize "inequitable distribution effects," the Treasury recommended that taxpayers be required to compute both income and expenditure tax liability and to pay the greater amount for a ten-year period. Both the Treasury and the Meade Commission suggestions would involve a ten-year phase-in during which individuals would be required either to compute both income and expenditure tax or to make fractional "expenditure tax adjustments" to income tax calculations. The Treasury did, however, suggest that this requirement might be limited to wealthier taxpayers. BLUEPRINTS, *supra* note 9, at 214 n.12. See *infra* text accompanying notes 173-88.

a transition to a broad-based income tax with significantly reduced rates.

### III. THE EVOLUTION OF THE MINIMUM TAX

The minimum tax concept has been a tax reform showpiece for leaders of both political parties over the past thirteen years, and, as a somewhat distant offspring of the "comprehensive tax base" debates,<sup>67</sup> originated in concerns virtually identical to those now inspiring political leaders to call for a flat-rate tax. It is therefore fitting that the 1982 amendments to the minimum tax provision, the third major revision since its enactment in 1969, have not only restored much of the original concept of the provision itself but have also restructured the minimum tax so that it is an appropriate vehicle for transition to a broad-based income tax with low rates.

Nearly twenty years ago, in 1964, Senator Russell Long called for the enactment of what he described as an "optional simplified tax," perhaps the closest prior political analogue to the comprehensive tax base and to current flat-tax proposals.<sup>68</sup> In general, Senator Long's proposal would have given taxpayers an election either to compute taxable income in the normal manner and apply the regular rates or to apply a lower rate schedule to an expanded tax base. The expanded base was to be computed by starting (as does the 1982 minimum tax) with adjusted gross income as defined in section 62 of the Internal Revenue Code—generally gross income less trade and business expenses, certain losses, and capital gains and capital loss deductions—and adding certain items now either excluded from gross income or deducted in arriving at adjusted gross income. This tax base would have included many items now excluded from income, such as interest on state and local debt, the excluded portion of capital gains, employees' pension and death benefits, two-thirds of Social Security and Railroad Retirement benefits,<sup>69</sup> and scholarships and fellowships. In addition, it would have disallowed many of the deductions now available, including medical expenses, charitable contributions, certain state and local

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67. See *supra* note 9 and accompanying text.

68. See S. 3250, 88th Cong., 2d Sess. (1964). The proposal was reintroduced in 1966. See S. 2760, 89th Cong., 2d Sess. (1966). See generally Bittker, *An Optional-Simplified Income Tax?*, 21 TAX L. REV. 1 (1965) (critical analysis of Senator Long's proposal); Dodyk, *Tax Simplification: The Long Amendment and the Mills Proposal*, 25 INST. ON FED. TAX. 1443 (1967) (discussion of simplification aspects of the Long proposal).

69. Presumably the one-third of these benefits excluded from Senator Long's expanded tax base was a rough approximation of the return of employees' contributions. See Dodyk, *supra* note 68, at 1449 n.14.

taxes, and nonbusiness interest expenses. Even this bill, however, would have excluded from the optional tax base many items that would be included by proponents of a comprehensive tax base—for example, unrealized appreciation of property transferred by gift or at death, interest earned on life insurance reserves, and imputed rent on owner-occupied homes.<sup>70</sup> Notwithstanding Senator Long's claim that his proposal would achieve substantial simplification of the law and would "reduce the premium enjoyed by the taxpayer who has tax lawyers and accountants to show him ways to avoid paying taxes," the elective nature of the proposal would have required persons to compute tax using both this method and the regular computation and would thereby have contributed to greater income tax complexity.<sup>71</sup>

Senator Long's "optional simplified tax method" seems, however, to have been the precursor of the minimum tax recommendation of the 1968 Treasury *Tax Reform Studies* of the Johnson Administration.<sup>72</sup> Under this minimum tax proposal, an individual would have computed tax liability under the general rules and also would have made a special tax computation by applying tax rates equal to one-half the applicable regular income tax rates to an expanded income base. If the special computation resulted in a greater tax liability, the larger amount would have been required to be paid. The expanded tax base under this minimum tax proposal would have been taxable income increased by the following four items of tax preference: (1) tax-exempt interest on state and local bonds; (2) the appreciation in value of property donated to charity; (3) the excluded one-half of capital gains; and (4) percentage depletion after the cost of the property had been recovered. A special \$10,000 standard deduction in lieu of the itemized deductions would have been allowed in computing minimum taxable income. As a complement to its minimum tax proposal, the *Tax Reform Studies* included a proposal for an allocation of itemized deductions between taxed income and exempt income with disallowance of deductions allocated to exempt income.<sup>73</sup>

President Nixon's 1969 tax reform proposals included a "limit on

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70. For a criticism of the tax base of this proposal, see Bittker, *supra* note 68, at 12-19.

71. 110 CONG. REC. 23,087-98 (1964); 109 CONG. REC. 19,706 (1963). For a criticism of the additional complexity this bill would have required, see Bittker, *supra* note 68.

72. UNITED STATES DEPT OF TREASURY, TAX REFORM STUDIES AND PROPOSALS, 132 (Comm. Print 1969) [hereinafter cited as TAX REFORM STUDIES]. See Graetz, *The Evolution of the Tax Shelter Provisions of the Tax Reform Act of 1976: Fewer Than Fifty Ways to Limit Your Losses*, 29 U.S.C. TAX INST. 1, 28-39 (1977).

73. TAX REFORM STUDIES, *supra* note 72, at 132.

tax preferences" and an allocation of deductions similar in effect to those proposed by the *Tax Reform Studies*.<sup>74</sup> The House of Representatives' version of the 1969 Tax Reform Act adopted the limit on tax preferences and allocation of deductions proposals but modified the list of preference items.<sup>75</sup> The Senate Finance Committee eliminated both of these provisions and substituted a new provision which it labeled a minimum tax. This provision, however, was really an additional tax of five percent on certain preference items applicable to both individuals and corporations.<sup>76</sup> The five percent additional "minimum" tax was amended on the Senate floor: the rate of tax was increased to ten percent to be applied to the excess of the sum of tax preferences over the amount of federal income tax otherwise imposed for the taxable year.<sup>77</sup> The Conference Committee accepted the Senate version with only minor modifications,<sup>78</sup> and this provision remained effective without major change until the Tax Reform Act of 1976.

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74. *Hearings before the House Comm. on Ways and Means on the Subject of Tax Reform*, 91st Cong., 1st Sess. 5060-63, 5504-05 (1969). The first \$10,000 of preferences would have been exempt under the Limitation on Tax Preference (LTP) proposal. A five-year averaging provision was also included, and the proposal was to become fully effective after a three-year transitional period. The following items were included as tax preferences under the LTP proposal: (1) the appreciation element in the value of property donated to charity; (2) intangible drilling expenses; (3) the excess of accelerated over straight-line depreciation on real estate; and (4) farm losses generated because of the use of special accounting rules. The preference items under the allocation of deductions proposals were the four items included under the LTP proposal plus tax-exempt interest and the excluded one-half of capital gains.

75. H.R. Rep. No. 413, 91st Cong., 1st Sess. 2, reprinted in 1969 U.S. CODE CONG. & AD. NEWS 1646.

76. S. Rep. No. 552, 91st Cong., 1st Sess. 7, reprinted in 1969 U.S. CODE CONG. & AD. NEWS 2041. The revenue estimated to be derived from the Senate Finance Committee minimum tax was approximately the same as that anticipated from the House limit on tax preferences and allocation of deductions provisions. However, the Senate version applied to both individuals and corporations while the House version and the Treasury proposal would have applied only to individuals.

77. See 115 CONG. REC. 38,297-300 (1969) (remarks of Senator Miller). The following nine items of tax preference were included under the Senate bill: (1) the excess of accelerated depreciation over straight-line on real estate; (2) the excess of accelerated depreciation over straight-line on personal property subject to a net lease; (3) the excess of the deduction for amortization of pollution control facilities over accelerated depreciation; (4) the excess of amortization of railroad rolling stock over accelerated depreciation; (5) the "bargain element" in qualified employee stock options, i.e., the excess of the fair market value of the optioned shares at the time of exercise over the option price; (6) the excess of the bad debt deduction allowed to financial institutions over the amount that would have been allowable on the basis of actual experience; (7) percentage depletion in excess of the adjusted basis of the property; (8) the excluded one-half of capital gains; and (9) intangible drilling expenses.

78. Tax Reform Act of 1969, Pub. L. No. 91-172, § 301, 83 Stat. 487 (codified as amended at I.R.C. §§ 56-58 (1982)). The Conference Committee eliminated intangible drilling expenses from the list of preferences. A seven-year carry-forward of regular income taxes was added in 1970, and the Revenue Act of 1971 added rapid amortization of job-training and child-care facilities in excess of straight-line depreciation as a tax preference item.

In 1973, the Nixon Administration selected, as it had in 1969, an alternative minimum tax as the fulcrum of its tax reform package. This tax would have been payable only if it exceeded the regular tax liability.<sup>79</sup> Once again, however, the alternative minimum tax approach was rejected by the Congress, which instead opted for substantial increases in the additional "minimum" tax provisions enacted in 1969.<sup>80</sup> The minimum tax was revised in 1976 by increasing the rate from ten to fifteen percent and replacing the \$30,000 exemption and the deduction for regular income taxes with an exemption of the greater of \$10,000 or one-half of the regular income tax liability.<sup>81</sup> The 1976 Act also added

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79. In 1973, the Treasury proposed that the minimum tax provisions of section 56, as they applied to individuals, be replaced by the following proposal:

The [Minimum Taxable Income] ("MTI") proposal is designed to assure that every individual will pay a reasonable amount of federal income tax relative to the size of his income. This will be accomplished by requiring that every individual's taxable income, to which the present graduated tax rates are applied, be no less than his "minimum taxable income," which is approximately one-half of his adjusted gross income expanded to include specified tax preferences which represent exclusions from income under present law.

The minimum taxable income will be determined as follows:

(i) By adding to present law adjusted gross income the total percentage depletion in excess of basis, the excluded one-half of net long-term capital gains, exempt earned income from foreign sources, and the non-taxable bargain element in certain stock options to arrive at Expanded Adjusted Gross Income (EAGI);

(ii) By subtracting from EAGI, the deductions for personal exemptions, a \$10,000 floor, extraordinary medical expenses, extraordinary casualty losses and investment interest (and investment expenses) to the extent of investment income to arrive at the MTI Base; and

(iii) By dividing the resulting MTI Base by two to arrive at "minimum taxable income."

Every individual will be required to pay tax on the greater of his minimum taxable income or his normal taxable income computed in the usual manner.

The specified exclusions and all itemized deductions will be permitted to operate freely within the area of up to one-half of income, but in all events the other one-half of income will be subject to income tax. Because of the \$10,000 floor, the adjustments for extraordinary medical expenses and casualty losses and other reasons, MTI will have little or no impact on taxpayers in income brackets below \$50,000.

MTI is not a form of a "minimum tax" like the provision in present law which imposes a flat 10 percent tax on specified "tax preferences." Instead, MTI will be part of the regular income tax structure in which the rates of tax range from 14 to 70 percent. MTI will be a more effective solution, consistent with our graduated tax rate system, to the problem to which both MTI and the present Minimum Tax are directed.

*Limitation on Artificial Accounting Losses, 1973: Hearings on General Tax Reform Before House Comm. on Ways and Means, 93d Cong., 1st Sess. 6985-86 (1973) (footnote omitted) (testimony of George P. Schultz, Secretary of the Treasury) [hereinafter cited as Schultz Testimony].*

80. In 1974, an influential group of Congressmen joined forces to endorse increases in the 1969 minimum tax as the major tax reform item on their agenda. These proposals took an entirely different approach from the Treasury MTI proposal and formed the basis for the 1976 amendments. In general, they would have revised the minimum tax provisions by: (a) eliminating the deduction for regular income taxes; (b) reducing the exemption from \$30,000 to \$10,000; and (c) replacing the 10% rate with a graduated scale of rates, for example, from 10% to 20%.

81. Pub. L. No. 94-455, § 301, 90 Stat. 1549, 1550 (1976) (amending I.R.C. §§ 56-58).

certain new items to the list of tax preferences, including itemized deductions (other than medical expenses and casualty losses) in excess of sixty percent of the taxpayer's adjusted gross income for the year.<sup>82</sup> The 1976 reduction in the minimum tax exemption had the effect of substantially increasing the number of persons who were required to pay minimum tax and, in combination with the rate increase and reduction of the offset for regular income taxes, of significantly increasing the total amount of minimum tax collected. The principal effect of adding "excess itemized deductions" as a tax preference was the imposition of an additional tax on individuals who had a high amount of adjusted gross income but low taxable income due to large itemized deductions, principally for interest, taxes, and charitable contributions.

The most significant effect of the minimum tax was the increase in the tax on capital gains due to the inclusion of capital gains otherwise excluded from income. From 1969 to 1976, the minimum tax had the effect of increasing the maximum rate applicable to long-term capital gains from 35 to 36.5 percent.<sup>83</sup> The 1976 amendments produced a maximum long-term capital gains rate of 39.9 percent.<sup>84</sup> Moreover, a "tax preference offset" provision of the maximum tax on earned income, adopted in 1969 as a complement to the minimum tax provisions, had the potential to increase further the maximum rate on capital gains to 49.9 percent, compared to a 50 percent maximum on earned income.<sup>85</sup> (Unearned income was subject to a 70 percent maximum

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82. *Id.*

83. See I.R.C. § 56 (1969) (amended 1982).

84. See I.R.C. § 56 (1976) (amended 1982).

85. See Graetz, *supra* note 72, at 9. In 1969, § 1348 was added to the Internal Revenue Code, providing (effective in 1971) a maximum 50% rate of tax on earned income. The purpose of the maximum tax on earned income was to reduce the incentives for individuals with substantial earned income to engage in tax shelter activities or other forms of tax planning. This was supposed to be accomplished not only by a direct reduction in the maximum rate of tax on earnings but also by a so-called preference offset, which had the effect of reducing the amount of earned income eligible for the maximum tax by the individual's tax preferences for the current year. Tax preferences for this purpose were the same as under the minimum tax of § 56, and thus, until the Revenue Act of 1978, an individual might pay increased taxes on earned income because of the realization of long-term capital gains. Since the deduction under § 1202 for one-half of long-term capital gains was a preference which reduced the amount of earned income eligible for the special 50% rate, an individual eligible for the 50% maximum rate might, for example, find that his earned income was taxed at 70 rather than 50%. If the tax preference offset for capital gains was viewed as an additional tax on capital gains, it could have had the effect of increasing the individual's effective rate of tax on capital gains by as much as 10%. (In certain rare cases, under the 1969 Act, because of the treatment of tax preferences under the maximum tax, the maximum rate on capital gains could reach 54.5%. This was changed by the 1976 legislation). The Revenue Act of 1978, however, removed the capital gains tax preference as an offset to the amount of earned income otherwise eligible for the 50% maximum tax rate. Thus, the 50% rate applied to earned income

rate during this period.)

By 1978, however, Congressional concern had shifted away from taxing high-income taxpayers who paid little tax to increasing "capital formation."<sup>86</sup> To a Congress concerned with increasing investment and capital formation, the tax burden on capital gains was unacceptable, and the Revenue Act of 1978 lowered the top capital gains rate to twenty-eight percent in two steps: first, by increasing the capital gains exclusion from fifty to sixty percent of long-term gains, and second, by eliminating capital gains as an item of tax preference subject to the additional minimum tax.<sup>87</sup> To insure that "capital formation will be facilitated, and every individual will pay at least a reasonable minimum amount of tax with respect to large capital gains,"<sup>88</sup> Congress substituted for the additional minimum tax an alternative minimum tax which applied to capital gains and adjusted itemized deductions.<sup>89</sup> The additional minimum tax was retained only for the other items of tax preference.

The new alternative minimum tax was computed by applying an independent rate schedule to a new minimum tax base which included capital gains in full. The minimum tax was payable only if the alternative tax exceeded the taxpayer's regular income tax plus the additional preference tax (which had been somewhat revised). The new alternative minimum tax had a \$20,000 exemption and rates ranging from ten percent to a maximum of twenty-five percent on relevant income in excess of \$100,000.<sup>90</sup>

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regardless of the individual's capital gains for the year. Other tax preferences, however, continued to reduce the amount of earned income eligible for the special maximum rate.

86. STAFF OF THE JOINT COMM. ON TAXATION, 96TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE REVENUE ACT OF 1978, at 15-17, 251-57 (Comm. Print 1978) [hereinafter cited as EXPLANATION OF 1978 ACT].

87. I.R.C. §§ 57, 1202 (amended by the Revenue Act of 1978). A 70% tax rate — the top rate then applicable to ordinary income — applied to 40% of long-term capital gain is equivalent to a tax of 28% of the entire gain.

88. EXPLANATION OF 1978 ACT, *supra* note 86, at 262.

89. I.R.C. § 55 (added by the Revenue Act of 1978). See generally EXPLANATION OF 1978 ACT, *supra* note 86, at 262-67 (tax reform designed to curtail deductions and exclusions by high-income taxpayers); Coven, *The Alternative Minimum Tax: Proving Again that Two Wrongs Do Not Make A Right*, 68 CALIF. L. REV. 1093 (1980) (arguing that the alternative tax is inherently inequitable and unduly complicated).

90. The Staff of the Joint Committee on Taxation described the provision as follows:

The alternative minimum tax is based on the sum of a noncorporate taxpayer's gross income reduced by deductions allowed for the year (including deductions in excess of gross income, if any), and by amounts included in income under section 667 (relating to accumulation distributions from trusts), and increased by the amount of the taxpayer's adjusted itemized deductions, and capital gains deduction. This amount then is subject to the following alternative minimum tax rates:

The Economic Recovery Tax Act of 1981 reduced the maximum alternative minimum tax rate to twenty percent to conform to the reduction of the maximum regular tax rate on capital gains, which had been reduced to twenty percent by lowering the top rate on ordinary income from seventy percent to fifty percent.<sup>91</sup>

The Tax Equity and Fiscal Responsibility Tax Act of 1982 substantially increased total minimum tax revenues by repealing the "additional minimum tax" provisions and broadening the tax base of the alternative minimum tax. This base-broadening was accomplished by adding to the alternative minimum tax base items of tax preference that had been subject to the additional minimum tax, as well as certain

<u>Alternative minimum taxable income</u>	<u>Percent</u>
\$0 to \$20,000 . . . . .	0
\$20,000 to 60,000 . . . . .	10
\$60,000 to 100,000 . . . . .	20
Over \$100,000 . . . . .	25

The resulting amount then is compared to regular tax liability, as increased by the add-on minimum tax. \* \* \* If alternative minimum tax liability exceeds regular income tax liability, as increased by the add-on minimum tax, the greater amount is payable.

Thus, although the tax is in effect a true alternative tax, in the sense that it is paid only when it exceeds regular tax (including any add-on minimum tax liability), as a technical matter, the taxpayer's regular and add-on minimum taxes continue to be imposed and the amount of alternative minimum tax is the excess of the amount computed under the alternative minimum tax rate table over the amount of the regular and add-on minimum taxes.

For purposes of the alternative minimum tax there are two preferences. The capital gains preference is the amount of a taxpayer's section 1202 capital gains deduction, but does not include any deduction which is attributable to the gain from sale of a taxpayer's principal residence.

The other alternative minimum tax preference is adjusted itemized deductions. This preference excludes medical and casualty deductions, state and local tax deductions and, in the case of income in respect of a decedent, amounts deducted (under § 691(c)) for estate taxes. . . . The remaining itemized deductions are preferences only to the extent they exceed 60 percent of adjusted gross income minus the medical and casualty deductions, State and local tax deductions, and the deduction for estate taxes attributable to the inclusion of income in respect of a decedent in a decedent's gross estate.

The foreign tax credit and refundable credits are the only tax credits which are allowed against any alternative minimum tax liability. Thus, taxpayers paying the alternative minimum tax do not obtain the benefit of nonrefundable credits, other than the foreign tax credit, to the extent of the minimum tax. However, in the case of the investment tax credit, the jobs credit, and the WIN credit, the Act provides that any credit carryover or carryback from a year in which the taxpayer is liable for some amount of alternative minimum tax, is not to be reduced to the extent of the taxpayer's alternative minimum tax liability.

EXPLANATION OF 1978 ACT, *supra* note 86, at 262-67 (footnotes omitted).

The alternative minimum tax of section 55 was amended in 1980 to permit nonrefundable tax credits, other than the foreign tax credit, to offset alternative minimum tax liability, except to the extent attributable to capital gains or adjusted itemized deductions. Pub. L. No. 96-222, § 104(a)(4), 94 Stat. 215 (1980).

91. Pub. L. No. 97-34, §§ 101, 102, 95 Stat. 176 (1981). Under the 1981 Act, the alternative minimum tax rates were 10% on amounts from \$20,000 to \$60,000 and 20% on amounts over \$60,000. The special 50% maximum rate on earned income was repealed by the 1981 legislation in connection with the reduction of the overall top rate from 70% to 50%.

other new preference items. The 1982 Act allows a minimum tax exemption of \$30,000 and imposes a flat-rate tax of twenty percent on the amount of the tax base in excess of the exemption.<sup>92</sup>

#### IV. WHY THE 1982 MINIMUM TAX AMENDMENTS MAY BE REGARDED AS A FIRST STEP TO A FLAT-RATE INCOME TAX

The new minimum tax imposes a flat twenty percent tax on a broadened income tax base, and is required to be paid whenever it exceeds the regular income tax. Merely describing the 1982 minimum tax should make it apparent that this provision might well serve as the first step in moving toward a flat-rate (or low graduated rate) tax on a broadened tax base, and closer examination confirms this view.<sup>93</sup>

The disengagement of the minimum tax rates from the regular rate schedule, which originated in 1978 with the enactment of a three-bracket alternative minimum tax with a maximum twenty-five percent rate on a limited alternative tax base, created several conceptual difficulties for a minimum tax designed only as a complement to the existing income tax. When the minimum tax is evaluated as a mechanism of transition to a broad-based low-rate income tax, however, the independent rate structure becomes an advantage. By happenstance, the twenty percent minimum tax rate—no doubt selected because it is the maximum rate applicable to capital gains under present law—is perfectly apt as an approximation of a flat tax rate. If the twenty percent rate were made generally applicable it would raise revenues in the neighborhood of those presently produced by the individual income tax.<sup>94</sup> The massive shift in distribution of the tax burden from high income to low and middle income taxpayers that such a generally applicable flat rate would produce, however, is precluded under the minimum tax by the combination of its \$30,000 exemption and the requirement that the minimum tax be paid only when it exceeds the tax due under the regular rules.

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92. Pub. L. No. 97-248, § 201, 51 U.S.L.W. 10 (Sept. 14, 1982). See I.R.C. § 55 (amended by the Tax Equity and Fiscal Responsibility Tax Act of 1982). The exemption of \$30,000 applies to unmarried individuals; a \$40,000 exemption is applicable to married couples filing joint returns.

93. For an article that shares the premise that the minimum tax provision provides a satisfactory transitional mechanism to broad-based tax reform, see Hobbet, *Transitional Mechanisms to Facilitate Tax Reform*, 34 LAW & CONTEMP. PROBS. 818 (1969).

94. See Bradford Testimony, *supra* note 19, at 5-7; Clapoton Testimony, *supra* note 8, at J-10; Pechman & Scholz, *supra* note 16, at 83. For a discussion of some of the problems resulting from the rate structure of the alternative minimum tax, see Coven, *supra* note 89, at 1097.

The primary emphasis of the minimum tax is the broadening of the income tax base to increase taxes of high income individuals who Congress has concluded currently avoid paying their fair share of taxes under the regular income tax rules. Using the minimum tax as the first step in the transition to flat-rate tax should therefore foreclose the prospect of Congress using the flat-rate tax idea as a smokescreen for eliminating progressivity in the income tax, even though a broad-based income tax would ultimately require top rates in the range of twenty-five to thirty percent if a major shift in the distribution of the tax burden is to be avoided. Using the minimum tax as a transitional vehicle will provide a means for identifying those flat-rate proponents who are not interested in broadening the tax base, but are merely engaged in an effort to find a politically acceptable means of substantially shifting the tax burden from upper to middle income persons. Without any change in rate, the minimum tax is well-positioned to serve as the testing ground of Congressional will to enact the base-broadening provisions necessary to complete the move to a more comprehensive tax base.

Moreover, the base-broadening aspects of the minimum tax resolve in a satisfactory manner a number of the thorniest political issues which will arise in consideration of broad-base tax reform. The extent to which a broad-based, low-rate tax achieves the advantages of simplification, economic efficiency, and horizontal equity will largely depend on the comprehensiveness of the base-broadening revisions. A more comprehensive base implies greater neutrality in treatment both of sources of income and of expenditures, permits lower tax rates to produce equivalent revenues, and lessens both the opportunities and incentives for complex tax planning efforts. The ultimate goal, therefore, of such revision should be as broad and uniform a tax base as is practical coupled with minimal rates necessary to meet revenue demands and distributional preferences.

The 1982 minimum tax takes substantial steps in the direction of a significantly broadened tax base, and its greatest advantage as a transitional mechanism is that it satisfactorily resolves many difficult issues inherent in base-broadening tax reform. By viewing the current minimum tax as a first-step toward a low-rate broad-based income tax, Congress may avoid reconsideration of many important issues simply by accepting their treatment under the minimum tax. A detailed discussion of the base-broadening issues which will arise in the move to a flat-rate income tax is beyond the scope of this Article, but the materials which follow highlight some of the more critical issues.

Perhaps the most significant advantage of the minimum tax as a transitional mechanism is its equal treatment of capital gains and ordinary income. As the history of the minimum tax set forth in the prior section of this Article indicates, during the period between 1969-1976, Congress took substantial steps to reduce the disparity in rates between ordinary income and capital gains, but in 1978 this trend was reversed.<sup>95</sup> At the same time, however, Congress has indicated its willingness to accept uniform taxation so long as the rate is low enough (in the twenty to twenty-five percent range) by enacting an alternative minimum tax which imposes an identical tax rate on ordinary income and capital gains. Under the minimum tax provisions, such uniform treatment has been accomplished without substantial revision of restrictions on deductibility of capital losses<sup>96</sup> and without any "fresh start" rule which would grandfather gains which have accrued prior to the date of enactment. Certain important aspects of capital gains taxation await further consideration in the context of a move to a broad-based income tax—notably the treatment of gains accrued at death and indexation—but the fundamental step of taxing capital gains and ordinary income at the same rate is accomplished under the minimum tax.

As with capital gains, the new minimum tax provisions treat itemized deductions in a manner generally consistent with broad-based income tax principles. Rather than denying all itemized deductions, as some proponents of comprehensive income taxation have suggested, the minimum tax rules allow certain deductions, often with new limitations, and disallow others; but in all cases the marginal tax reduction of itemized deductions is significantly lessened. Charitable contributions, for example, are allowed as under the regular tax computation, but a dollar contributed to charity will save only twenty cents of tax under the minimum tax, as compared with a maximum of fifty cents under the regular computation.<sup>97</sup> Casualty losses and medical expenses are also allowed as under the regular income tax, but, in addition to having a reduced value under the minimum tax, allowance of those deductions

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95. See *supra* text accompanying notes 83-89.

96. At the time when the broad base is made generally applicable, some restriction on the deductibility of capital losses will have to be considered if individuals with portfolios containing gains and losses are to be precluded from eliminating their tax liability by realizing losses only and offsetting them against ordinary income. This problem does not arise under the minimum tax because it applies only when the tax exceeds the regular tax which limits deduction of capital losses against ordinary income.

97. I.R.C. § 55(e)(1)(B) (1982).

is substantially restricted under other provisions of the 1982 Act.<sup>98</sup> State and local taxes are not deductible under the minimum tax, and the interest deduction is limited to interest incurred in financing the taxpayer's home plus an amount equal to net investment income.<sup>99</sup> The minimum tax thereby allows a deduction for interest on preenactment home mortgage loans and interest incurred in acquiring or substantially renovating or remodeling future dwellings, but does not permit deduction of interest on other consumer loans or on borrowing for investments which do not yield currently taxable investment income.<sup>100</sup> In so doing, it strikes a reasonable balance between the two extremes of flat-tax proposals with regard to interest: total disallowance and full deduction.

In addition, the treatment of tax credits under the minimum tax is very restrictive. All nonrefundable tax credits, other than the foreign tax credit, are denied. This rule eliminates tax reductions due to the research and experimental tax credit,<sup>101</sup> the alcohol fuels credit,<sup>102</sup> the residential energy credit,<sup>103</sup> the targeted jobs credit,<sup>104</sup> the WIN credit,<sup>105</sup> the child-care credit,<sup>106</sup> the retirement income credit,<sup>107</sup> and the investment tax credit.<sup>108</sup> No doubt, some proponents of broad-based income taxation will argue that only a deduction, not a credit, should be allowed for foreign taxes, but this debate can await subsequent stages of the move to a flat-rate tax. Therefore, with regard to credits, the new minimum tax rules are a significant first step indeed, leaving only one controversy for subsequent resolution as the tax base is further broadened.

Finally, the list of preferences under the new minimum tax rules adds a number of other important tax deductions and exclusions avail-

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98. I.R.C. §§ 55(e)(1)(A), (C), 165, 213 (1982). These latter provisions limit deductions for medical expenses and casualty losses to the excess over 10% of adjusted gross income.

99. I.R.C. § 55(e)(3), (4) (1982). No deduction is allowed for interest on loans made after July 1, 1982 for refinancing the taxpayer's home. *Id.*

100. The limitation to net investment income is modeled after § 163(d) of the Internal Revenue Code, originally enacted in 1969. For a discussion of the original reasons for this provision, see Halperin, *Capital Gains and Ordinary Deductions: Negative Income Tax for the Wealthy*, 12 B. C. INDUS. & COM. L. REV. 387, 388-90 (1971).

101. I.R.C. § 44(F) (1982).

102. I.R.C. § 44(E) (1982).

103. I.R.C. § 44(C) (1982).

104. I.R.C. § 44(B) (1982).

105. I.R.C. § 40 (1982).

106. I.R.C. § 44(A) (1982).

107. I.R.C. § 37 (1982).

108. I.R.C. § 38 (1982).

able under present law to the base.<sup>109</sup> For example, by including percentage depletion and intangible drilling expenses<sup>110</sup> in the minimum tax base, Congress has crossed an important political hurdle. Using the minimum tax as the vehicle for transition to a flat-rate tax might therefore forestall effective pleading for favorable treatment by historically effective lobbying groups, such as representatives of the oil and natural resources industries.

In addition, the minimum tax base includes certain items which produce tax deferral advantages under the regular income tax rules, such as mining exploration expenses and the excess of accelerated depreciation over straight and development line depreciation (with longer lives) on real estate.<sup>111</sup> By including such items the minimum tax now has the effect of requiring individuals who will be subject to its provisions to forego certain tax deferral incentive provisions which would provide more rapid deductions than would be allowed under a measure of economic income.<sup>112</sup>

Upon relatively brief examination, it becomes apparent that the 1982 minimum tax rules have appropriately resolved a number of important issues which might otherwise become stumbling blocks in a move to a broad income tax base subject to low tax rates: capital gains, itemized deductions, tax credits, natural resources, and certain other tax preferences have all been addressed by the minimum tax in a satisfactory inanner. The comprehensiveness of this list is demonstrated by its inclusion of every issue separately discussed by the Joint Committee on Taxation in its treatment of transitional problems in moving to a broad-based income tax.<sup>113</sup> Moreover, the minimum tax base does not include any items which are not reasonable candidates for inclusion in a broad income tax base.<sup>114</sup>

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109. See I.R.C. § 57 (1982). The following items of preference are addressed by the code's provisions: (1) exclusions from gross income for dividends and interest; (2) accelerated depreciation on real property; (3) accelerated depreciation on leased personal property; (4) amortization of certified pollution control facilities; (5) deductions for mining exploration and development costs; (6) deductions for circulation and research and experimental expenditures; (7) depletion; (8) capital gains; (9) the bargain element of incentive stock options; (10) intangible drilling costs; and (11) accelerated cost recovery deductions in excess of specified allowances.

110. I.R.C. § 57(a)(8), (11) (1982).

111. I.R.C. § 57(a)(2), (5) (1982).

112. The impact of the minimum tax on such deferral items is typically so severe when it applies that taxpayers would be better off foregoing the deferral provision altogether.

113. See JOINT COMMITTEE, *supra* note 3, at J-8 to -9.

114. This is not true if a flat-rate consumption, rather than income, tax were desired. See *infra* text accompanying notes 173-88.

## V. ADDITIONAL STEPS NECESSARY TO MOVE FROM THE CURRENT MINIMUM TAX TO A FLAT-RATE TAX

A comprehensive consideration of the steps needed to complete the move from the 1982 minimum tax to a broad-based income tax with low rates would require an exhaustive review of the issues taken up in the comprehensive income tax literature, a task which I have explicitly eschewed here. I do, however, provide a general outline of the necessary direction and note some of the most significant issues.<sup>115</sup> My choices in outlining subsequent steps necessary to achieve a generally applicable broad-based income tax with low rates are influenced by my concern for maintaining a distribution of the tax burden that is not markedly less progressive than that of current law, and I have attempted to identify issues which are important both in terms of revenue and in terms of establishing neutral treatment of income.<sup>116</sup>

Given my choice of the minimum tax as the principal transitional mechanism, there are two types of issues that must be considered: (1) the addition of certain currently excluded items to the minimum tax base, and (2) the resolution of existing problems which must occur independent of the minimum tax. The primary consideration in both of these areas is the establishment of a sufficiently broad tax base. Although the minimum tax base is considerably broader than that of the regular income tax, it remains insufficiently comprehensive. Further broadening is therefore essential; additional sources of both capital and labor income must be added to the base.

### A. ADDITIONS TO THE MINIMUM TAX BASE

#### 1. *Exclusions from Income*

Although certain statutory exclusions of capital income are included in the minimum tax base—for example, the exclusions of dividends and interest, capital gains, and percentage depletion—some significant omissions remain. Of these omissions, the exclusion of interest on state and local bonds is the most notable.<sup>117</sup> From the inception of the minimum tax idea, inclusion of state and local bond interest has been controversial. Tax-exempt interest was among the items of tax preference in the proposals of both the Johnson and Nixon Administrations in 1969, was included as a preference in the House version of the 1969

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115. For more comprehensive discussion, see the sources cited *supra* note 9.

116. See generally Pechman & Scholz, *supra* note 16 (calculation of the revenue impact of various preferences).

117. I.R.C. §§ 103, 103(A) (1982).

Tax Reform Act, and was also included as a tax preference in the Senate version of the 1982 legislation.<sup>118</sup> Yet, tax-exempt interest has never emerged in a list of tax preferences approved by a House-Senate conference.<sup>119</sup> Such interest is unquestionably a source of income which should be included in a broad-based tax and should be added to the minimum tax base in the transition. It may prove necessary to compensate state and local governments for this addition by offering direct federal interest subsidies to maintain reduced interest costs at the state and local level,<sup>120</sup> but the failure to include such interest in a broad income tax base would be a bad omen indeed.

Present law also exempts from income interest earned on life insurance reserves whenever paid "by reason of the death of the insured."<sup>121</sup> Income earned on savings in the form of life insurance is thus accorded preferential treatment which should be eliminated under a broad-based income tax. There may well be good reasons for excluding pure insurance gains even from a broad-based income tax base, but the arguments against taxing mortality gains simply do not apply to life insurance proceeds attributable to the build-up of life insurance reserves.<sup>122</sup> Accordingly, interest earned on life insurance reserves should be included in any broad-based income tax and, along with state and local bond interest, should be added to the minimum tax base in the transition.

The reasons for treating the transfer of assets at death (and gift) as an occasion for the realization and taxation of accrued appreciation have been well discussed in the literature.<sup>123</sup> The provision of present

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118. For a more general discussion of limitation of preference items, see *supra* notes 72-78 and accompanying text; SENATE REPORT ON TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982, S. REP. NO. 494, 97th Cong., 2d Sess. 110, *reprinted in* 1982 U.S. CODE CONG. & AD. NEWS 101-02 [hereinafter cited as SENATE REPORT ON 1982 ACT].

119. *But cf.* I.R.C. § 291(a)(3) (1982) (inclusion of tax-exempt interest as preference for certain financial institutions).

120. *See, e.g.*, H.R. REP. NO. 413, 91st Cong., 1st Sess. 172-74 (1969) (proposing election to issue taxable bonds with an interest subsidy from the federal government); BLUEPRINTS, *supra* note 9, at 85 (proposal for a federal interest subsidy to state and local governments). To the extent that direct subsidies are required to replace tax preferences eliminated by base-broadening, additional revenues will not be available to facilitate rate reductions. As a result, rates somewhat higher than otherwise necessary may be required. None of the authorities discussing tax rates applicable to a broadened tax base cited in this Article makes any adjustment for potential direct subsidies.

121. I.R.C. § 101(a) (1982).

122. *See Consumption Tax Implementation, supra* note 34, at 1611-12.

123. *See, e.g.*, Graetz, *Taxation of Unrealized Gains at Death—An Evaluation of the Current Proposals*, 59 VA. L. REV. 830 (1973); Kurtz & Surrey, *Reform of Death and Gift Taxes: The 1968 Treasury Proposals, The Criticisms, and A Rebuttal*, 70 COLUM. L. REV. 1365 (1970).

law which exempts from income taxation unrealized appreciation in assets held until death has often been called the single most important loophole in the income tax, and Congress has on several occasions considered revising these rules. In 1976, a provision was enacted that would have required a carryover of the decedent's basis on transfers of appreciated property at death, but in 1980 the provision was repealed retroactively to its date of enactment.<sup>124</sup> In moving to a broad-based income tax, the issue cannot be ignored, notwithstanding its recent history. An appropriate transitional step would be to add to the minimum tax base both unrealized appreciation of assets held at death and unrealized appreciation of assets donated to charity.<sup>125</sup> Additionally, in light of the emasculation of the estate tax by recent legislation, consideration should also be given to including amounts received by bequest (or gift) in the minimum tax base (and consequently the broadened income tax base) of the recipient.<sup>126</sup>

As with income from capital, expansion of the minimum tax base with regard to labor income should first occur by including a variety of sources now excluded by specific statutory provisions. Other than deferred compensation, which will be discussed subsequently, and the exclusion for meals and lodging, which will be considered in connection with nonstatutory fringe benefits, the principal statutory exclusions from gross income under the current income tax are for life insurance,<sup>127</sup> health insurance,<sup>128</sup> sick pay,<sup>129</sup> certain legal services,<sup>130</sup> and scholarships, fellowships, prizes and awards.<sup>131</sup> In addition, the first \$75,000-\$95,000 of earned income from foreign sources is tax-exempt

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124. See Pub. L. No. 96-223, § 401(a), 94 Stat. 299 (1980) (repealing I.R.C. § 1023). See also I.R.C. § 1014 (1982) (basis of property acquired from decedent).

125. Unrealized appreciation of assets donated to charity was included as a preference under the minimum tax in the 1969 proposals. See *supra* note 74.

126. For an argument in favor of including amounts received by gift or bequest in income, see generally Dodge, *Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income*, 91 HARV. L. REV. 1177 (1978).

127. I.R.C. § 79 (1982). An employer's payments of premiums for up to \$50,000 of group term life insurance are excludable from an employee's income.

128. I.R.C. § 106 (1982). In certain cases employees may exclude amounts provided by employers in the form of health insurance premiums and reimbursements of an employee's uninsured medical expenses.

129. I.R.C. § 104(a) (1982). Subject to dollar limitations and other requirements, disability payments under an employer-financed accident or health plan may be excluded from an employee's income. I.R.C. § 104(a)(3) (1982).

130. I.R.C. § 120 (1982). Amounts contributed by an employer to a prepaid legal services plan for employees and the value of legal services received under such a plan are excluded from employees' income under certain conditions.

131. I.R.C. §§ 74, 117 (1982). Scholarships and fellowships are generally excluded from gross income, and prizes and awards are excluded in certain limited circumstances.

under certain conditions.<sup>132</sup> The Internal Revenue Code provides other, somewhat less important, exclusions from income for: (1) combat pay, mustering-out pay, and certain retirement pay for members of the armed services;<sup>133</sup> (2) veterans' disability, survivor, and pension benefits;<sup>134</sup> and (3) the rental value of parsonages and rental disallowances paid to ministers.<sup>135</sup>

Various arguments have been advanced for repealing each of these statutory exclusions from income, and, with the possible exception of exclusions relating to health benefits, none would be excluded from a "comprehensive" income tax base. Broadening the base by including these items would, of course, require reversal of explicit congressional decisions to favor labor income of particular kinds and would disappoint their proponents (for example, labor unions that pressed for the exclusion of certain legal services), but inclusion is essential if a broad tax base is to be achieved. Adding these items to the list of preferences under the minimum tax would be an important step in that direction.

## 2. *Deductions and Deferrals*

Implementation of an income-neutral tax structure also requires modification of current depreciation rules. The Economic Recovery Tax Act of 1981 explicitly divorced income tax depreciation rules from any concept of economic depreciation, and provided an arbitrary set of cost recovery allowances instead.<sup>136</sup> Although certain revisions were made in the 1981 rules by the Tax Equity and Fiscal Responsibility Act of 1982, the basic thrust of the 1981 legislation remains unchanged. Under a broad-based income tax stripped of economic incentive provisions, depreciation rules should measure the actual cost of capital during the taxable period, namely "the reduction in value of productive capital occasioned by use, deterioration or obsolescence."<sup>137</sup> In times

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132. I.R.C. § 911 (1982).

133. I.R.C. § 112 (1982) (combat pay); *id.* § 113 (mustering-out pay); *id.* § 122 (uniformed services retirement pay).

134. I.R.C. § 104(a)(4) (1982).

135. I.R.C. § 107 (1982).

136. I.R.C. § 168 (1982). See STAFF OF THE JOINT COMM. ON TAXATION, 97TH CONG., 1ST SESS. (1981), GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981, at 67-100 (Comm. Print 1981).

137. Warren & Auerbach, *Transferability of Tax Incentives and the Fiction of Safe Harbor Leasing*, 95 HARV. L. REV. 1752, 1753 (1982). See also Samuelson, *Tax Deductibility of Economic Depreciation to Ensure Invariant Valuations*, 72 J. POL. ECON. 604, 606 (1964) (deduction of economic depreciation conforms to income definition and leaves investment choices among assets unaffected).

of inflation, this allowance for economic depreciation should include adjustments for increases in the general price level.

The current minimum tax rules partially correct excessive depreciation allowances by including accelerated depreciation on real property and on leased personal property, as well as certain rapid amortization allowances, in the minimum tax base.<sup>138</sup> These rules, however, are inadequate for a broad-based income tax. The entire difference between the permitted cost recovery allowance and the best estimate of economic depreciation should be included in the minimum tax base. Recent empirical work by Hulten and Wyckoff<sup>139</sup> provides considerable refinement in the estimation of economic depreciation and should help facilitate this task, although difficulties will remain if significant inflation occurs because of the need to index depreciation to reflect price level changes. Consideration should also be given to revising the treatment of debt-financed investment either by reversing the *Crane* rule, which allows inclusion of debt-financed investment in depreciable basis,<sup>140</sup> or by further adjusting the allowance of interest deductions when depreciable property is financed with debt.<sup>141</sup> And to the extent that any other deferrals, accelerated deductions, or immediate deduction of capital expenses are not currently in the minimum tax, they also would be candidates for inclusion in the tax base.

### 3. *Limiting Tax Shelters to Related Income*

Finally, under a truly comprehensive income tax base, the provisions which now provide opportunities for tax shelters should be removed. Preferential treatment of certain kinds of receipts and payments, whether in the form of special exclusions, deductions, credits, reduced tax rates, or deferral of tax liability, should be eliminated. During the transition, however, we should anticipate some reluctance on the part of Congress to eliminate all tax subsidies and to forego completely this popular means of channeling investments to achieve various social policy goals. In the face of this reluctance, an immediate elimination of all tax shelters may not be feasible. Fair distribution of the tax burdens during the transition, however, seems at least to require a limitation on

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138. I.R.C. § 57(a)(2), (3), (4), (12) (1982).

139. Hulten & Wyckoff, *The Measurement of Economic Depreciation*, in DEPRECIATION, INFLATION AND THE TAXATION OF INCOME FROM CAPITAL 82 (C. Hulten ed. 1981).

140. *Crane v. Commissioner*, 331 U.S. 1 (1947).

141. See Bradford, *The Economics of Tax Policy Toward Savings*, in THE GOVERNMENT AND CAPITAL FORMATION II (G. Von Furstenberg ed. 1980); Warren & Auerbach, *supra* note 137, at 1757.

the use of losses to shelter other income.<sup>142</sup> This could be accomplished by adding a provision to the minimum tax that allows deductions from "tax shelter" investments to offset only income related to the investment.<sup>143</sup> Such an approach is now found in the minimum tax rules that limit the deduction of interest to net investment income,<sup>144</sup> and close analogies are contained in current limitations on deductions for so-called "hobby losses"<sup>145</sup> and vacation homes.<sup>146</sup> A general proposal of this sort was included in the 1973 tax reform proposals of the Nixon Administration,<sup>147</sup> and a limitation on the deduction of tax shelter losses was also contained in the House of Representatives' version of the 1976 Tax Reform Act, but the Senate rejected the idea and a limitation on losses was not included in the final version.<sup>148</sup>

## B. PROBLEMS THAT MUST BE SOLVED INDEPENDENTLY FROM THE MINIMUM TAX

### 1. *Nonstatutory Fringe Benefits*

Section 61 of the Internal Revenue Code defines income as including compensation for services whether in cash or in kind, but a wide variety of employee benefits usually referred to as "nonstatutory fringe benefits" have been excluded from income by Internal Revenue Service regulations, rulings, or administrative practice.<sup>149</sup> Examples are employees' discounts, vacation facilities, airline and railroad passes, personal use of automobiles, and meals in free or subsidized company cafeterias. In addition, meals and lodging are excluded by statute under certain conditions.<sup>150</sup> However, the ability of certain taxpayers

142. See Shultz Testimony, *supra* note 79, at 6879-80. The new treatment of net operating losses under the 1982 minimum tax amendments does not accomplish this result in all cases, but does reduce allowable losses by items of tax preference. SENATE REPORT ON 1982 ACT, *supra* note 118, at 111-12, 1982 U.S. CODE CONG. & AD. NEWS at, 101-02. This provision would increase in effectiveness as the list of tax preference items becomes more comprehensive.

143. See Graetz, *supra* note 72, at 48-50.

144. See I.R.C. §§ 55(e)(3)(B), (e)(5) (1982) (following an approach contained in § 163(d) (1982)).

145. I.R.C. § 183 (1982).

146. I.R.C. § 280(A) (1982).

147. See Shultz Testimony, *supra* note 79, at 6879-80.

148. See generally Graetz, *supra* note 72, at 48-50 (discussion of limitation of tax shelter deductions to related income).

149. The discussion of nonstatutory fringe benefits is based upon a similar discussion of this issue in Graetz, *Expenditure Tax Design, in WHAT SHOULD BE TAXED: INCOME OR EXPENDITURE?*, *supra* note 36, at 161, 210-13. See also Simplification Committee, *supra* note 9, at 578 (the value of fringe benefits must be allocated between personal and business benefit with the former includible as income).

150. I.R.C. § 119 (1982).

to obtain tax-free fringe benefits through these practices violates standards of tax equity and produces allocative inefficiencies.<sup>151</sup> The imposition of a broad-based income tax requires that a comprehensive set of principles for fringe benefit taxation be adopted either by legislation or regulation.

Given the variety of fringe benefits, developing practical rules that include most of the benefits in a broad income tax base will be extremely difficult.<sup>152</sup> The basic rules must distinguish working conditions from in-kind compensation. The former would be regarded as primarily for the benefit of the employer and therefore not includable as income to the employee. An important noncompensatory business purpose for providing the good or service in question to an employee should be a prerequisite for exclusion. In other words, benefits would not be excluded unless the good or service was related to the nature of the employee's work and was something ordinarily useful to someone in the employee's position.<sup>153</sup>

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151. The horizontal equity standard is violated whenever the availability of tax-free compensation varies significantly among jobs, for example, as between union and nonunion workers. Similarly, to the extent that the taxation of an item depends upon whether it is furnished by employers, whether employers reimburse employees' expenses in obtaining the item, or whether employees bear the costs of the item directly, horizontal equity will typically be violated. Close coordination is therefore required between rules that include employee benefits in the tax base and those that allow employees or self-employed persons to deduct items of compensation as business expenses. Particular care will have to be exercised under a broad-based income tax to prevent highly compensated persons from structuring their remuneration so as to receive a maximum amount of compensation in the form of fringe benefits.

Moreover, when significant amounts of compensation are excluded from the tax base, employers are given an incentive to provide such compensation. For example, if employees were subjected to a 25% marginal tax rate, they would prefer \$76 of tax-free compensation in kind to \$100 of taxable wages. Employers would likewise prefer paying \$76 to paying \$100, since there would be no difference in treatment at the employer level. The lower relative cost of in-kind benefits produces economic biases, which induce employees to take a significant proportion of their compensation in the form of excluded benefits. By the same token, such exclusions tend to induce labor to shift to situations amenable to the provision of excluded compensation.

152. Under the existing income tax, the Internal Revenue Code and current regulations are overly broad and largely uninformative. Little published guidance is available to either taxpayers or revenue agents. A discussion draft of proposed regulations relating to fringe benefits was published in 1975 by the Treasury but was subsequently withdrawn, and the Internal Revenue Service has recently been precluded by Congress from publishing either a comprehensive set of regulations or a complete set of examples through issuance of revenue rulings.

153. A benefit provided at the employer's place of business should be more likely to be characterized as a working condition, but this should not be determinative. Other relevant factors, none of which alone should be determinative, include the following: (1) Did the employee have an option to accept or reject the good or service? If so, this would argue for inclusion. (2) Was the good or service something that the employee would normally pay for out of after-tax dollars? If so, this would argue for including the amount as compensation. (3) Was the good or service provided to the employee's family? If so, it would most likely be regarded as compensation.

Unlike other issues considered in prior sections of this Article, the wide variety of nonstatutory fringe benefits makes their inclusion in the minimum tax base seem neither desirable nor practical. Rather, a more appropriate step toward broad-based taxation would require Congress or the Treasury to develop rules directly including such amounts in gross income under section 61, a task which will not be an easy matter, either politically or administratively. As a practical alternative, Congress should consider disallowing deductions to employers for fringe benefits that are difficult to value or allocate to particular employees. Total exclusion of such items from the tax base is not acceptable under a broad-based income tax.

## 2. *Deferred Compensation*

The treatment of deferred compensation likewise poses a difficult issue which does not seem readily susceptible to resolution by amendment of the minimum tax. The Tax Equity and Fiscal Responsibility Tax Act of 1982 substantially modified the rules relating to the exclusion of deferred compensation from income,<sup>154</sup> but the basic approach of the Code, which allows exclusions of employer contributions to pension plans from the current income of employees, and permits self-employed individuals somewhat similar benefits, has not been changed.<sup>155</sup> The exclusion from income of limited amounts put aside in "Individual Retirement Accounts" is also continued.<sup>156</sup> The question of the appropriate treatment of such amounts under a broad-based income tax has been subject to debate, and favorable treatment of limited amounts of deferred compensation seems justified even under a broad-based income tax to mitigate somewhat the necessary income tax bias in favor of present as opposed to future consumption. The Bradley-Gephardt bill deals with the deferred compensation issue by impos-

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(4) Was the good or service provided routinely or only sporadically? If the former, inquiries should be made to determine whether it was part of the negotiated wage structure and therefore something the employee expected as compensation.

To convert such general principles into a workable system, Congress or the Treasury must provide a reasonably comprehensive set of examples indicating whether particular goods or services are includable in an employee's receipts and, if so, at what value. *De minimis* rules and reasonable rules for the valuation and allocation of fringe benefits are also essential to effective fringe benefit taxation. If the principles described above were adopted, items such as supper money, employee discounts, free admission to athletic or entertainment events, employees' use of vacation facilities and country club memberships, meals and lodging provided to employees, and interest-free loans provided to employees would be includable in income tax receipts.

154. Pub. L. No. 97-248, §§ 235-254, 51 U.S.L.W. 10 (Sept. 14, 1982).

155. See I.R.C. §§ 401-415 (1982) (deferred compensation, pension, profit sharing, and other benefits partially excluded from tax liability).

156. I.R.C., § 219 (1982).

ing a tax of fourteen percent on currently exempt pension and other retirement funds, an approach also suggested by the Treasury in *Blueprints for Tax Reform*.<sup>157</sup> Retirement benefits from the government, such as social security benefits, railroad retirement benefits, and veterans' pensions should probably be included in income under a broad-based tax.<sup>158</sup>

For present purposes, it is sufficient to note only that the question of the appropriate treatment of deferred compensation, including the treatment of employer and government based plans, requires resolution as a broad-based tax is considered, and, if past congressional action is any guide, will undoubtedly result in particularized compromises. Like fringe benefits, deferred compensation does not seem to be an appropriate subject for potential addition to the list of tax preference items under the minimum tax, and this aspect of transition to the broad-based income tax should be dealt with outside the minimum tax context.

### 3. *Transfer Payments*

Consideration should also be given to expanding the broad tax to include government transfer payments in addition to fringe benefits and deferred compensation. Payments such as social security benefits and veterans' pensions, now excluded from gross income,<sup>159</sup> are indistinguishable from wages and other income and should therefore in theory be included in the income tax base.<sup>160</sup> For many in-kind transfers, valuation would be difficult. Moreover, since the level of government transfers is presumably determined on the assumption that they are tax free, taxation would simply necessitate an increase in their level and perhaps an adjustment in tax exemptions and rates. As a practical matter, then, the income tax base should include only transfers that are not based on need and are either cash or easily valued if in kind.

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157. BLUEPRINTS, *supra* note 9, at 56-58.

158. *See, e.g., id.* (employer contributions to pension fund excluded from employees' tax base). If receipts are included in full, deductions should be allowed for individuals' contributions to such plans; otherwise a portion of the receipts should be excluded. *See supra* note 69.

159. Despite the absence of specific statutory authority, the long-standing policy of the Internal Revenue Service has been to exclude payments received under welfare legislation from income. *See, e.g.,* Rev. Rul. 72-605, 1972-2 C.B. 35 (veterans benefits); Rev. Rul. 70-280, 1970-1 C.B. 13 (unemployment benefits); Rev. Rul. 70-217, 1970-1 C.B. 12 (social security payments).

160. If such payments were not included in the income tax base, advantages would result to recipients depending on their marginal tax brackets, with higher bracket taxpayers obtaining a relatively greater advantage from exclusion. Where individuals contribute to such plans, however, deductions should be allowed. *See* Sunley, *Employee Benefits and Transfer Payments*, in *COMPREHENSIVE INCOME TAXATION*, *supra* note 9, at 76-77.

#### 4. *The Taxation of Business Entities*

Although detailed consideration of the issues of corporate taxation is beyond the scope of this Article, there is considerable controversy over how corporate income should be taxed, and a few general observations are in order. First, the dominant analytical posture concerning a broad-based individual income tax is grounded, at least partially, in the notion that all income should be taxed equally regardless of its source. Under this view, taxation of income at the corporate level is merely a mechanism necessary to ensure that undistributed corporate income does not escape taxation.<sup>161</sup> This theoretical posture suggests both a criticism and appropriate revision of the current corporate income tax. The separate corporate income tax should be repealed and undistributed corporate income should be directly attributed to shareholders and taxed at their marginal rates.<sup>162</sup> If a corporate income tax were continued, it should apply only to earnings retained by the corporation on the grounds that attribution of undistributed corporate income to shareholders is impractical.<sup>163</sup> Any corporate tax would only serve as a withholding tax to be credited to shareholders as corporate income is distributed or attributed to them. If an expenditure tax or a consumption tax were implemented at the individual level, the corporate tax should be repealed.<sup>164</sup> Alternatively, a corporate tax might be retained for corporate distributions as a means of collecting tax on pre-enactment investments.<sup>165</sup>

Experience has shown that a corporate tax that varies substantially in its level of rates and tax base from the individual tax structure produces misallocations of resources and inequities because of the ease with which corporations can be formed.<sup>166</sup> The widespread incorporation of individuals engaged in personal services to take advantage of either lower corporate tax rates or advantages for corporate pension and retirement plans provides ample illustration of this point. Both the corporate tax base and the corporate rate structure must therefore be coordinated with the broad-based, low-rate income tax implemented at the individual level. The approach of the current Bradley-Gephardt

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161. R. MUSGRAVE & P. MUSGRAVE, *PUBLIC FINANCE IN THEORY AND PRACTICE* 270-71 (1973).

162. BLUEPRINTS, *supra* note 9, at 69; C. MCLURE, *supra* note 34, at 146-84; Warren, *supra* note 34, at 739-41.

163. C. MCLURE, *supra* note 34, at 215-19; Warren, *supra* note 34, at 740.

164. Chapoton Testimony, *supra* note 8, at J-16; *Consumption Tax Implementation*, *supra* note 34, at 1634-42.

165. MEADE REPORT, *supra* note 34, at 233-35.

166. C. MCLURE, *supra* note 34, at 6; Warren, *supra* note 34, at 736-38.

bill, which makes no changes in the corporate income tax, leaving both rates and special deductions and credits generally unaffected, therefore cannot be accepted.<sup>167</sup>

If the Congress were to agree to move to a broad-based, low-rate income tax at both the individual and corporate level, a phased-in approach to corporate tax revision could also be accomplished. Again, the 1982 amendments, which cut back on corporate tax preferences, point the way. The Tax Equity and Fiscal Responsibility Act of 1982 contains provisions which reduce certain specified corporate tax preferences by fifteen percent. Further reductions in such preferences could be accomplished in conjunction with a phased-in elimination of the tax on corporate earnings distributed to shareholders as dividends, or through general reductions in corporate tax rates. To minimize distortions in the allocation of resources and limit tax planning opportunities which will produce complexity in the operation of the tax law, as well as inefficiency and unfairness in terms of horizontal equity, the corporate tax rate (which would presumably apply only to retained earnings) should be lowered if the top rate for individuals is reduced from its current fifty percent level to the twenty-five to thirty percent range. The new rate should be set at a level equivalent to the flat-rate applicable to individuals or at a level which approximates the top rate which will be applicable to a low-rate broad-based individual income tax.

### 5. *Indexation*

Inflation produces two kinds of problems for an income tax. First, the substantive impact of tax brackets and specified dollar amounts changes if no adjustment is made for price level changes. The need for indexation of such amounts would remain under a broad-based low rate income tax if inflation is significant in the years ahead.<sup>168</sup> Second, an income tax base in a variety of circumstances requires dollars from different time periods to be taken into account in measuring gain or loss. The major instances where this problem arises involve depreciation deductions, inventory accounting, and gain or loss on the sale of assets and debt. Lowering tax rates and broadening the tax base may

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167. Bradley-Gephardt, *supra* note 3. *But see supra* note 30 (Senator Bradley and Representative Gephardt have indicated that a corporate taxation bill will be introduced in the Ninety Eighth Congress). The Chairman of the Tax Section of the American Bar Association has similarly concluded that "adoption of a flat-rate tax for individuals cannot be considered apart from the taxation of business entities." Aidinoff Testimony, *supra* note 8, at 9.

168. I.R.C. § 1(f), added by the Economic Recovery Tax Act of 1981, currently provides for such indexation effective beginning in 1985.

lessen somewhat the impact of inflation in distorting an income tax base, but the basic difficulty remains unchanged. As a theoretical matter, basis of assets should be indexed to reflect inflation, and principal and interest amounts of debt should also be adjusted as price levels change. In moving to a broad-based, low-rate income tax, Congress must necessarily weigh the need for such adjustments against the complexity they would necessarily produce.<sup>169</sup>

## VI. COMPLETING THE TRANSITION TO A LOW-RATE BROAD-BASED INCOME TAX

When the minimum tax base has been broadened as suggested in the prior sections of this Article, and other significant base-broadening issues, such as those previously discussed, have been resolved, only one step remains to complete the transition to a broad-based income tax: the establishment of the proper level of personal exemptions and rates of tax.

Once the corporate and individual tax bases have been established, rates can be set to produce the desired level of revenues and distribution of the tax burden.<sup>170</sup> Thus, after Congress has resolved tax base issues, the minimum and regular tax provisions should be integrated both with an exemption level designed to make the broad-based tax widely applicable to all but those at the poverty level, and with tax rates appropriate to achieve the desired distributional consequences. Proceeding to a broad-based, low-rate tax by first expanding the minimum tax base should provide important information concerning the tax base that will ultimately be made generally applicable and should eliminate a vast number of disputes over transitional issues. For high income taxpayers, the minimum tax will gradually become more generally applicable during the transition notwithstanding its high exemption of \$30,000. At this stage, taxpayers above that level of income will be paying tax on a broad base at a rate equal to twenty percent (at a minimum), and will pay higher taxes if the regular present income tax rules apply. When the broad-based tax becomes the generally applicable tax, some increase in the twenty percent rate should be possible without introducing new transitional issues or resurrecting issues which have been dealt with through the minimum tax. Certainly a top rate of

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169. For a more detailed discussion of the indexation issue, see INFLATION AND THE INCOME TAX (H. Aaron ed. 1976); MEADE REPORT, *supra* note 34, at 99-122; Simplification Committee, *supra* note 9, at 589.

170. See *supra* notes 16-24 and accompanying text. See also Chapoton Testimony, *supra* note 8, at J-10 to -11 (discussion of distributional effects of different rate structures).

twenty-five percent, which the Treasury Department and others have suggested could achieve a similar distribution of income tax burdens as present law,<sup>171</sup> or the twenty-eight percent rate which Senator Bradley and Representative Gephardt have used in an effort to achieve a distribution of the tax burden identical to present law,<sup>172</sup> should not raise new transitional issues. Changes in tax rates of this magnitude have occurred throughout the history of the income tax. Moving to a flat rate, however, would impose a substantial new burden on middle income taxpayers and would introduce additional transitional issues.

#### VII. ALTERNATIVE TRANSITIONAL STRATEGIES IF A FLAT-RATE CONSUMPTION (RATHER THAN INCOME) TAX IS DESIRED

If progressive tax rates were not desired and a genuine flat-rate tax on consumption were preferred to an income tax, such a tax should take the form either of a retail sales tax, similar to that used widely in the states, or a value-added tax, such as those used in other industrialized countries throughout the world.<sup>173</sup> While these taxes are generally imposed on less than a full consumption base, such a tax should be applied to a broad base at the federal level. The typical value-added or retail sales tax bases should be expanded to include services such as medical and hospital care services, financial services, foreign travel, and rental payments.<sup>174</sup> Relatively simple mechanisms could be adopted to avoid enacting a regressive tax and to insure that a value-added or retail sales tax would be roughly proportional to a person's income.

To move in this direction, a value-added or retail sales tax should be enacted concurrently with the phasing-out of the income tax. If a broad-based national value-added or sales tax were applied to the majority of taxpayers and a distribution of the tax burden approximating that of current law were desired, consideration should be given to retaining an income tax for upper-income individuals. The minimum tax of the 1982 Act, perhaps with the base-broadening amendments suggested in prior sections of this Article, might well serve the income tax function. Only if an individualized, progressive tax on consumption were desired should Congress consider a so-called expenditure tax,

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171. *E.g.*, Bradford Testimony, *supra* note 19, at 5-7; Pechman & Scholz, *supra* note 16, at 85.

172. Bradley-Gephardt, *supra* note 3.

173. *See generally* J. DUE, SALES TAXATION (1957); MEADE REPORT, *supra* note 34, at 228-45; *Consumption Tax Implementation*, *supra* note 34, at 1578-80.

174. *See* J. DUE, *supra* note 173, at 374-75.

under which consumption would be computed indirectly by deducting amounts saved from receipts available for consumption or savings.<sup>175</sup> Proponents of such a tax argue that any move to a broad tax base should take this course rather than taxing income.

William Andrews, the principal architect of current broad-based expenditure tax proposals, following a suggestion by the prior generation's leading expenditure tax proponent, Nicholas Kaldor,<sup>176</sup> has recommended that transition to an expenditure tax should be accomplished by first phasing-in a "supplemental personal expenditure tax" applicable to high-income individuals.<sup>177</sup> Andrews' proposed tax would basically be a graduated cash-flow expenditure tax designed to replace the portion of the income tax in which marginal rates equal or exceed forty percent. An exemption of about \$30,000 to \$35,000 (\$40,000 to \$45,000 for joint returns) would exempt those taxpayers below the forty percent marginal income bracket from tax as under the current minimum tax. Professor Andrews argues that such a tax would maintain the progressivity of current income tax law, while eliminating "the worst distortions and inequities in the existing [income] tax [that] result from the application of very high marginal rates to a base in which there are [wide] disparities in the treatment of investment returns."<sup>178</sup> Existing disparities in the treatment of such returns would be maintained in the basic income tax (at least during a transition to a universal expenditure tax), but the supplemental expenditure tax would be imposed on a comprehensive consumption tax base which would not provide tax incentives for particular kinds of investments.<sup>179</sup>

Professor Andrews' proposal is related to a suggestion advanced by the Meade Commission, which urged a consumption tax base for Britain.<sup>180</sup> The Meade Commission also considered a graduated expenditure tax, limited in application to higher bracket taxpayers, to ease the transitional problems of moving to a generally applicable expenditure tax.<sup>181</sup> It would, however, have combined a graduated ex-

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175. *Consumption Tax Implementation*, *supra* note 34, at 1577-78. See also sources cited *supra* note 36 (discussing the advantages and disadvantages of an income tax versus a personal tax on consumption).

176. N. KALDOR, *AN EXPENDITURE TAX* 224 (1955).

177. Andrews, *A Supplemental Personal Expenditure Tax*, in *WHAT SHOULD BE TAXED: INCOME OR EXPENDITURE?*, *supra* note 36, at 129.

178. *Id.* at 137-39.

179. *Id.* at 142-50.

180. MEADE REPORT, *supra* note 34, at 204-15, 442-46.

181. *Id.* at 213.

penditure tax with a single basic rate of tax on consumption (in the form of a value-added tax), rather than with an income tax.

The most troubling aspect of Andrews' proposal is its treatment of savings. Professor Andrews argues that adopting a supplemental personal expenditure tax in place of income tax rates over forty percent would provide "relief for savers" on a much more "coherent and uniform basis" than the many special provisions of the current income tax. He concludes that "[b]ecause of the structure of the change the greatest relief would be given those whose savings are now most severely taxed."<sup>182</sup> While this is certainly true, the fact that the proposal provides a tax advantage only for the savings of persons with taxable income of \$30,000 to \$35,000 or more raises serious questions about its fairness. The Meade Commission would avoid this difficulty by providing an advantage for the savings of all taxpayers. Its combination of a value-added tax and a supplemental graduated expenditure tax therefore seems far preferable to Andrews' income-expenditure tax combination.

Detailed proposals for a transition from income to expenditure taxation have also been offered by a Swedish study<sup>183</sup> and by the United States Treasury.<sup>184</sup> Both the Treasury and the Swedish studies recommend exclusion from the expenditure tax base of all assets held at the date of enactment (without regard to the owner's age) but to minimize "inequitable distributional effects" of such treatment, the Treasury recommends that taxpayers be required to compute both income and expenditure tax liability for a ten-year period and to pay the greater amount.<sup>185</sup> The Treasury suggests that this requirement might be limited to wealthier taxpayers, and thus in effect recommends a ten-year period during which a broad-based expenditure tax would serve as an alternative minimum tax, payable whenever it exceeds the regular income tax.<sup>186</sup>

Under the Treasury's plan, a broad-based consumption tax would

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182. Andrews, *supra* note 177, at 141.

183. S. LODIN, *supra* note 36, at 123.

184. BLUEPRINTS, *supra* note 9, at 209.

185. *Id.* at 205, 209-11, 214 n.12. The Meade Commission also suggests the possibility of phasing-in the expenditure tax by substituting an additional one-tenth of the expenditure tax base for the income base each year for ten years. MEADE REPORT, *supra* note 34, at 188.

186. I too have argued elsewhere that a graduated expenditure tax might be used as a minimum tax. Graetz, *supra* note 72, at 53. For this purpose an expenditure tax should be an alternative to the income tax—payable by taxpayers with substantial incomes (say over \$30,000) whenever it exceeds the regular income tax liability—not a tax generally applicable to all upper-income taxpayers in lieu of the income tax, as recommended by Professor Andrews.

therefore be approached, as has been suggested here for a broad-based income tax, by using a minimum tax as a transitional device. However, in the case of a broad-based consumption tax, the 1982 minimum tax amendments would be largely useless in providing a first step. If a consumption tax were desired, the minimum tax of current law should be replaced with a new consumption-based minimum tax, which over time would become the generally applicable broad-based tax.<sup>187</sup>

A more direct route to an expenditure tax is possible, but the transitional problems are substantial. I have argued elsewhere that if a broad-based progressive tax on consumption is desired, a relatively restrictive attitude should be adopted with respect to claims for transitional relief, with such relief generally limited to elderly taxpayers.<sup>188</sup> The current generation of elderly taxpayers has been subject to income tax during preretirement years, and it therefore seems inappropriate to subject the elderly to a consumption tax during retirement, since they will not have received any of the advantages to savings provided by expenditure taxation during their working years.

## CONCLUSION

By happy coincidence, Congress has strengthened and made coherent the provisions of the minimum tax just as it begins serious consideration of moving to a "flat-rate income tax"—a broad-based income tax with substantially lowered rates. In this Article, I have urged that the 1982 minimum tax amendments should be regarded as the first step in the move to a flat-tax. It is an important first step indeed, since the new minimum tax has satisfactorily resolved such major potential difficulties under a broad-based income tax as the treatment of capital gains, itemized deductions, and tax credits, and has partially resolved other

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187. If a progressive broad-based tax on consumption were desired by the Congress, it would be possible to approach such a change by replacing the alternative minimum tax adopted in the 1982 legislation with an alternative minimum tax based on consumption and then to extend the consumption tax to all taxpayers. Such a course of action would not be an extension of the present minimum tax, but would require the substitution of a different minimum tax base. Some aspects of the 1982 amendments to the minimum tax would be helpful, though, in moving to a consumption-based minimum tax. The similar treatment of ordinary income and capital gains, the limits on itemized deductions, and the denial of tax credits are a few examples. Other provisions, however, such as the inclusion of accelerated depreciation and deductions for intangible drilling and mining expenses, move in the wrong direction. A restructuring of the tax would be necessary in any event to ensure the taxation of consumption and not of savings. For example, a general deduction should be allowed for savings, and borrowed amounts should be included in receipts. See generally *Consumption Tax Implementation*, *supra* note 34 (discussing the practical difficulties of a tax on personal consumption).

188. *Id.* at 1656-58. See *supra* note 55 and accompanying text.

important issues, such as those concerning depletion and depreciation. Moreover, by using the minimum tax as the vehicle for transition, the difficult political issue of setting broad-based income tax rates and exemptions may be postponed until base-broadening issues have been resolved, since the minimum tax rate now applicable is generally within the range considered appropriate by flat-tax advocates.

Further base-broadening is the necessary next step in the transition and some important additions to both the minimum tax and regular income tax rules have been discussed here. If, for example, Congress were to add to the list of minimum tax preferences interest on state and local bonds and on life insurance reserves, unrealized gain on assets transferred by death and gift, the excess of allowable depreciation over economic depreciation, and the principal statutory exclusions from wages, a major second step would be accomplished. Other issues would still require resolution. The taxation of fringe benefits and deferred compensation are two important examples which have been discussed in this Article. Revision of the taxation of income from corporations and other entities will also have to be considered. In particular, the elimination of the corporate tax on amounts distributed to shareholders as dividends would seem an appropriate change.<sup>189</sup>

I do not mean to suggest here that the subsequent steps to a broad-based income tax will be easy or politically noncontroversial. I merely want to emphasize that if such a tax is indeed the goal of forthcoming tax reform efforts, many of the most difficult issues have already been hurdled by the 1982 revisions of the minimum tax. Further broadening of the minimum tax base can serve as a testing ground of Congressional will to enact a uniform comprehensive income tax while restricting any tendency to use flat-tax proposals as a device for a substantial shift in the tax burden from upper to low and middle income taxpayers. Selection of the minimum tax as the transitional vehicle should preclude the use of broad-based tax reform simply as a guise for the elimination of progressivity.

On the other hand, if the ultimate goal is a broad-based progressive tax on consumption, and if a minimum tax on consumption were to serve as the transitional mechanism to that tax, as the Treasury has suggested, a different sequence of events would be required. As a first step, the minimum tax of present law would have to be restructured to apply to a consumption, rather than to an income base.

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189. See the sources cited *supra* note 34.

