

1-1-2001

# The Widening Gap Under the Internal Revenue Code: The Need for Renewed Progressivity

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Publication Information

Vada Waters Lindsey, *The Widening Gap Under the Internal Revenue Code: The Need for Renewed Progressivity*, 5 Fla. Tax Rev. 1 (2001)

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## Repository Citation

Lindsey, Vada Waters, "The Widening Gap Under the Internal Revenue Code: The Need for Renewed Progressivity" (2001). *Faculty Publications*. Paper 224.

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# FLORIDA TAX REVIEW

VOLUME 5

2001

ISSUE 1

## The Widening Gap Under the Internal Revenue Code: The Need for Renewed Progressivity

Vada Waters Lindsey\*

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*"I have never viewed taxation as a means of rewarding one class of taxpayers or punishing another. If such a point of view ever controls our public policy, the traditions of freedom, justice and equality of opportunity, which are the distinguishing characteristics of our American civilization, will have disappeared and in their place we shall have class legislation with all its attendant evils."* Andrew Mellon (1924)<sup>1</sup>

## I. INTRODUCTION

The words written by Andrew Mellon more than 75 years ago represent an idealistic view of the tax system. Despite the ideas expressed by Mr. Mellon, it is difficult to devise a tax scheme that conforms to his standards. Our present scheme of taxation is intended to promote vertical equity, which means that the higher income taxpayer should pay a higher level of taxes based on an ability-to-pay concept. In theory, this objective is met by the progressive tax structure imposed under the Code.<sup>2</sup> Arguably, a progressive tax system is inconsistent with the principles expressed by Mellon because of the purported penalty levied against high-income taxpayers in the form of inflated tax rates and the reward bestowed on low-income taxpayers in the form of lower tax rates. In reality, a progressive tax system does not reward or punish one class of taxpayers over another, but it is necessary to ensure that taxpayers do not pay more tax dollars to finance the government than they can afford. A progressive tax scheme is also necessary to enable every taxpayer to retain sufficient income to live above the poverty threshold. To the extent that a taxpayer lives below the poverty threshold, that taxpayer should not be required to pay income taxes. The current tax scheme is only partially successful in preventing taxpayers' after-tax income from falling below the poverty threshold.

The graduated tax rates represent only a small component of the progressive tax system. Progressivity is also established by techniques such as the earned income tax credit, the income tax exemption, phase-out of deductions for high-income taxpayers, corporate taxation and estate and gift taxation. However, the effectiveness of these techniques has been limited in recent years by Congressional acts. Newly proposed Congressional bills and the several Presidential platforms result in further eradication of progressivity. Whether

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1. Andrew Mellon, quoted in Sheldon D. Pollack, *The Failure of U.S. Tax Policy: Revenue and Politics* 243 (1996).

2. Presently, there are five marginal tax rates under the Code: 15%, 28%, 31%, 36% and 39.6%. IRC § 1. Married individuals filing joint returns, heads of households and unmarried individuals are subject to the highest tax rate when their annual taxable incomes exceed \$250,000. Id. § 1(a)-(c). Married individuals filing separate returns are subject to the highest tax rate when their taxable incomes exceed \$125,000. Id. § 1(d).

these proposals represented election year political rhetoric or serious tax proposals, they generally provided substantial tax savings to the wealthy and little benefit to lower income taxpayers. For example, President George W. Bush's presidential platform included a substantial tax cut. Under this proposal, 52.6% of the tax cuts were geared toward taxpayers in the top 5% income level while only 11% would benefit taxpayers in the bottom 60% income level.<sup>3</sup> Prior to withdrawing from the election, presidential candidate Senator John McCain proposed tax cuts where 34.9% of the benefits would go to taxpayers whose income was in the top 5%.<sup>4</sup> Only 6.7% of the benefits would have gone to taxpayers in the bottom 60% income level.<sup>5</sup> Major tax bills that had received favorable votes from Congress resulted in the top 1% taxpayers receiving average tax benefits 84 times that of the bottom 80% of taxpayers.<sup>6</sup>

In light of these proposals and tax legislation that Congress has already enacted, the oft-debated issue of whether progressive tax system is optimal needs to be reconsidered. There has always been little agreement amongst scholars on whether the progressive tax system is fair or whether some other system, such as proportional taxation or a consumption-based system is superior.<sup>7</sup> In 1998, Professors Martin J. McMahon, Jr. and Alice G. Abreu wrote a law review article critically analyzing empirical data on changes in the distribution in income with total taxes paid between 1977 and 1990.<sup>8</sup> The empirical data supported a finding that although the income of taxpayers in the top income percentile has increased precipitously, their federal income tax burden has not increased proportionately.<sup>9</sup> The article points out that the after-tax income of taxpayers in the top 10% has increased between 1977 and 1990, while it has decreased for all other taxpayers.<sup>10</sup> This apparent trend that results in weakened progressivity has continued throughout the 1990s.<sup>11</sup> Professors McMahon and Abreu further point

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3. See Richard W. Stevenson, *McCain to Propose Middle-Class Tax Cut and Private Accounts Within Social Security*, N.Y. Times, Jan. 11, 2000, at A23 (noting arguments from independent analysts that McCain proposal would favor wealthy taxpayers).

4. See *id.*

5. See *id.*

6. John D. McKinnon, *White House Takes On GOP's Tax Cuts, Says They Favor Top 1%, Balloon Later*, Wall St. J., July 18, 2000, at A24 (reporting Treasury contention that Republican tax proposal overwhelmingly favored wealthy taxpayers).

7. See *infra* text accompanying notes 27-33.

8. Martin J. McMahon, Jr. & Alice G. Abreu, *Winner-Take-All Markets: Easing the Case for Progressive Taxation*, 4 Fla. Tax Rev. 1 (1998) [hereinafter McMahon & Abreu].

9. See *id.* at 7-8.

10. See *id.* at 19-20.

11. See Internal Revenue Service, 19 Stat. of Income Bull., *Selected Historical & Other Data*, at 197 (Summer 1999) (illustrating that for tax years 1995 to 1997, lower income taxpayers generally paid an increasing amount of their adjusted gross income in taxes, while higher income taxpayers paid a decreasing amount of their adjusted gross income in taxes).

out that the increase is greater for taxpayers in the top 1%.<sup>12</sup> Congress has made several amendments to the Code and created more progressivity between the middle to upper income bracket and the wealthiest taxpayers through the use of phase-outs. Specifically, Congress enacted the child tax credit, Roth IRAs, education IRAs, and Hope and Lifetime Learning Credits. All of these tax benefits are phased out based on a taxpayer's adjusted gross income. With the exception of the child tax credit, these tax benefits primarily benefit the middle to upper income taxpayer. Hence, Congress has made some inroad toward protecting progressivity between the middle class and the upper class.<sup>13</sup>

While it is apparent that most of the recently enacted tax benefits do not benefit the wealthiest taxpayers, because of the use of phase-outs, they also do not benefit the lower income taxpayers. One group of taxpayers that is particularly affected by this problem is the low to middle class taxpayer. Assume, for example, that a married couple has three children and adjusted gross income of \$35,000 during the year. The earned income credit is not available to them because it is completely phased out for earned income levels above \$31,152. Assume also that the couple does not own their own home. In all likelihood, they will not have sufficient deductions in order to itemize and hence must claim the standard deduction. They are financially unable to invest money in Roth or educational IRAs, even though those accounts are not subject to taxation upon distribution, because they need to use their disposable income to buy disposable diapers. Their "tax advisor" advised them to purchase stock because the gain from the disposition is subject to tax rates of 10% if they hold the stock for more than a year and 8% if they hold the stock for at least five years. They informed the tax advisor that they could not afford to buy stock because they needed to stock their cabinets with food and buy clothes instead. Hence, the financial status of the low to middle income taxpayers precludes them from capitalizing on the recently enacted tax incentives. While the primary reasons for the recent enactments were to encourage saving and education, Congress's decision to utilize phase-outs implies a secondary objective of increasing progressivity. Because low to middle income taxpayers cannot take advantage of these tax benefits, Congress's efforts, therefore, are unsuccessful.

Many of the lowest income taxpayers receive substantial benefit in the form of the earned income tax credit. The middle class taxpayers are able to

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12. McMahon & Abreu, *supra* note 8, at 19. The basic premise of the article was that there were fundamental differences between the top 10% and top 1% in the distribution of income and tax liability. Because of these differences, Professors McMahon and Abreu argued that these taxpayers should not be categorized similarly and that the taxpayers in the top 5% in general and the top 1% in particular should be subject to increased progressivity either in the form of an increased rate schedule or through the use of phase-outs and floors. *Id.* at 77.

13. Congress has not increased the progressivity between the wealthy and the super-wealthy as advocated by Professors McMahon and Abreu.

exploit many tax incentives, including mortgage deductions, Roth IRAs and educational IRAs. The wealthy benefit from the favorable capital gain tax rates. This country's tax system has always been based upon a progressive structure. Additional steps need to be taken to ensure progressivity between the lower to middle income taxpayer and higher income taxpayers and to counter other tax benefits provided to the higher income taxpayers that have resulted in a flatter tax structure. Additional progressivity would also benefit low income taxpayers that receive negligible earned income tax credits.

Part II of this article explores the methodology, constitutionality and equity of progressive taxation. Part II also explores the history of graduated tax rates and the constant fluctuations to establish the proper level of taxation. Part III of the article outlines the failure of the current tax scheme in promoting a progressive tax system. For example, if a wealthy taxpayer purchases a capital asset after December 31, 2000, and holds on to the asset for five years, the taxpayer is subject to a tax rate of 18% upon the disposition of the asset. Upon a comparison of that rate with the 15% ordinary income rate for low income and low to middle income taxpayers, the tax system fails to uphold the ability-to-pay principle. Either the low income taxpayer's rate is too high or the high income taxpayer's rate is too low. Part III also considers the impact of proposed legislation, and explores the increased gap between the wealthy and the lower income taxpayers created under the Code. Part IV of this article examines the reasons supporting the continued maintenance of progressive taxation in today's society. This part will also address whether globalization dictates a retrenchment from progressive taxation to protect this country from becoming less competitive with other countries. Part IV will also address how the tax scheme should be reformed to strengthen progressivity. This reformation is essential to reverse the negative impact of tax provisions on women and minorities. This part concludes with a proposal to reduce the lowest marginal brackets to ensure that most taxpayers will benefit from the tax cut while adhering to the traditional ability-to-pay and progressive tax principles.

## II. THE METHODOLOGY AND EQUITY OF PROGRESSIVE TAXATION

### A. *The Role of Fairness in Tax Policy and the Proper Measure of Taxation*

Our system of income taxation purports to promote both horizontal and vertical equity under the Code. Horizontal equity requires similarly situated taxpayers to be treated similarly.<sup>14</sup> Vertical equity requires that taxpayers with higher incomes pay income taxes at a higher level under an ability-to-pay

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14. This article only addresses the vertical equity objective.

concept. Under the ability-to-pay principle, those taxpayers with higher income are presumed to be able to bear a greater share of the tax burdens.<sup>15</sup> The ability-to-pay principle has its genesis going as far back as the Income Tax Act of 1913, where the legislative history states that “the tax upon incomes is levied according to ability-to-pay.”<sup>16</sup> The fundamental underpinning for the vertical equity concept is fairness. However, there is little agreement as to the true meaning of fairness in tax policy. Professors Robert E. Hall and Alvin Rabushka rely on definitions of fairness found in dictionaries to define the term.<sup>17</sup> They define a fair income tax as providing the equal treatment to taxpayers.<sup>18</sup> Professors Hall and Rabushka do not believe that vertical equality has fared well because of partisan politics. Specifically, they state:

Despite attempts to equalize after-tax income through steeply graduated tax rates, one Congress after another has riddled the tax code with hundreds of loopholes that permit some millionaires to pay no income tax whatsoever and some high earners to pay low taxes. . . . The reason is that every time tax rates are increased, Congress, in response to political pressures from organized interest groups, inserts new deductions and loopholes into the tax code to offset the effects of higher rates. The ideology of vertical equity, or ability-to-pay, runs smack into the economic and political realities of economic distortions and well-organized interests.<sup>19</sup>

Economists have traditionally looked to two principles, the “benefit principle” and the “ability-to-pay principle,” in defining the meaning of a fair tax system and allocating the country’s tax burden.<sup>20</sup> The benefit theory focused on allocating tax burdens based on the governmental services provided to the taxpayer.<sup>21</sup> Professor Graetz restated the oft-quoted definition of fairness under the federal income tax laws as taxing similarly situated taxpayers similarly based on an ability-to-pay concept.<sup>22</sup> Professor McMahon believes that the debates on fairness of taxation have neglected to incorporate the traditional vertical and horizontal equities and are instead being tied to “a disguised complaint” of the

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15. Joel Slemrod, *Tax Progressivity and Income Inequality* 2 (1994).

16. See Robert M. Willan, *Income Taxes: Concise History and Primer* 139 (1994) (reviewing legislative history surrounding 1913 Act).

17. Robert E. Hall & Alvin Rabushka, *The Flat Tax* 25 (2d ed. 1995).

18. See *id.* at 26.

19. See *id.* at 28.

20. See Slemrod, *supra* note 15, at 2.

21. See *id.*

22. Michael J. Graetz, *The Decline (and Fall?) of the Income Tax* 11 (1997).

level of taxation.<sup>23</sup> Professor Barbara Fried rejects the significance of all of these definitions. She believes that no "sensible theory of distributive justice" should focus on whether rate structures are fair or unfair because the effectiveness of rate structures stand or fall on how well they realize "moral commitments about the proper role of government."<sup>24</sup> Finally, some scholars consider a fair tax as one that equalizes sacrifices and has its basis in the decreased utility of money. Under this theory:

An equitable apportioning of sacrifice requires inflicting equal hurt on each taxpayer. It seems likely that a dollar has less "value" for a person with a million dollars of income than for a person with only a thousand dollars of income. To take the same number of dollars from each is not to require the same amount of sacrifice from them. Instead a fair tax would take more from the wealthier individual, and this is what a progressive tax does.<sup>25</sup>

Any definition of fairness must incorporate the ability-to-pay concept because the most viable and equitable tax system is one that allocates the tax burden based on the traditional ability-to-pay concept. The benefit principle is far too difficult to measure and results in a subjective evaluation of a multitude of benefits and the inherent difficulty of establishing the proper weight that should be afforded to each benefit. A strong argument exists for providing equal treatment to all taxpayers. However, there is not a viable way to provide equal tax treatment to all taxpayers while creating a structure that generates revenue and adhering to the ability-to-pay concept. Conversely, the progressive tax system is fair because it implements the traditional ability-to-pay principle; therefore, it represents an appropriate mechanism for allocating tax burdens.

Despite the progressive tax structure's adherence to the ability-to-pay concept, it remains controversial and lacks consensus support. As such, there is a divergence of scholarly opinions as to whether it is appropriate to subject taxpayers to different tax rates. Some scholars advocate the use of proportional taxation to allocate tax burdens.<sup>26</sup> Other scholars believe that the progressive tax

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23. Martin J. McMahon, Jr., *Individual Tax Reform for Fairness and Simplicity: Let Economic Growth Fend for Itself*, 50 Wash. & Lee L. Rev. 459, 461 (1993).

24. Barbara H. Fried, *The Puzzling Case for Proportionate Taxation*, 2 Chap. L. Rev. 157, 158 (1999).

25. Walter J. Blum & Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation* 39-40 (1953). Professors Blum and Kalven did not support progressive taxation but simply considered and rejected the arguments supporting progressive taxation.

26. See, e.g., Hall & Rabushka, *supra* note 17, at 26 (arguing that no definition of "fairness" establishes that a progressive tax system is fairer than a flat tax system); Jeffrey A. Schoenblum, *Tax Fairness or Unfairness? A Consideration of the Philosophical Bases for Unequal Taxation of Individuals*, 12 Am. J. Tax Pol'y 221, 225 (1995) (contending that "[t]o

is the most equitable way to allocate the country's tax burdens.<sup>27</sup> Other scholars reject both proportional and progressive taxation in favor of a consumption-based tax system.<sup>28</sup> A consumption tax imposes taxes based on a taxpayer's annual consumption. One argument supporting the consumption tax originates in the writings of Thomas Hobbes.<sup>29</sup> Hobbes believed that the consumption tax was the fairest tax. He believed it was unfair that a taxpayer that worked as diligently as another taxpayer, but chose to save his money rather than spend it should be subjected to greater taxes.<sup>30</sup> Scholars supporting the consumption tax share the Hobbesian vision that a fair tax should be not penalize savers.<sup>31</sup> They also believe that the consumption tax is superior to other forms of taxation because increased savings will stimulate national productivity<sup>32</sup> and simplify tax administration.<sup>33</sup> A broad-based consumption tax fits into two different categories: 1) direct or personalized; or 2) indirect or impersonal.<sup>34</sup> Indirect tax, such as a retail sales tax or value-added tax, allows for businesses to simply add the tax to goods and services sold. A direct tax would require an individual to

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the extent that our society continues to adhere to certain traditional liberal principles, in that it elevates the values of the autonomous individual and the equal status of each such individual before the state, any system of taxation that differentiates among taxpayers ought to require a compelling philosophic justification" and that no persuasive theory has been developed).

27. See, e.g., McMahon & Abreu, *supra* note 8, at 70 ("a progressive income tax can help to preserve equality of opportunity for successive generations of Americans. . . by reducing the disparities in after-tax income that dampen opportunity. . ."); Marjorie E. Kornhauser, *Equality, Liberty, and a Fair Income Tax*, 23 *Fordham Urb. L.J.* 607, 608 (1996) (noting that "an ideal flat income tax or an ideal consumption-based tax would be simpler and more coherent than the current progressive tax; however, an *ideal* progressive tax would be simpler as well.")

28. See, e.g., Richard L. Doernberg, *A Workable Flat Rate Consumption Tax*, 70 *Iowa L. Rev.* 425, 484 (1985) ("The flat rate consumption [tax] offers an impressively straightforward reform of the current system").

29. Barbara H. Fried, *Fairness and the Consumption Tax*, 44 *Stan. L. Rev.* 961, 962 (1992).

30. See *id.* at 962 n.6.

31. See, e.g., William O. Andrews, *Fairness and the Personal Income Tax: A Reply to Professor Warren*, 88 *Harv. L. Rev.* 947 (1975).

32. See Fried, *supra* note 29, at 962 (reviewing various proponents arguments in favor of consumption tax). But see Thomas Michael Federico, *Recent Congressional Consumption Tax proposals: A Theoretical Inquiry Into their Effects on the Declining U.S. Saving Rate*, 7 *Fla. J. Law & Pub. Pol'y* 337, 362 (1996) (opining that there is a lack of evidence supporting increased savings under a consumption tax).

33. See Fried, *supra* note 29. But see Deborah L. Paul, *The Sources of Tax Complexity: How Much Simplicity Can Fundamental Tax Reform Achieve?*, 76 *N.C. L. Rev.* 151, 181, 193-209 (1997)(arguing that consumption taxes would not lessen complexity and actually creates complexity in an attempt to achieve equity and raise revenue).

34. Charles E. McClure, Jr., *The U.S. Debate on Consumption Based Taxes: Implications for the Americas*, 29 *U. Miami Inter-Am. L. Rev.* 143, 148 (1998).

complete a tax return using methods such as gross receipts or cash flow.<sup>35</sup> Under the gross receipts method, taxpayers would total their spending amounts at year-end and the tax would be levied on the basis of that consumption. A significant drawback to implementing a consumption type tax is that it leads to regressive taxation. There is a substantial body of scholarship addressing the inequities of a consumption type tax.<sup>36</sup> Hence, despite the fact that the consumption tax has several advantages over the present income tax scheme, it is inconsistent with the traditional ability-to-pay principles.<sup>37</sup>

Professors Walter J. Blum and Harry Kalven, Jr. wrote an essay critically examining the principles and justifications of progressive taxation more than 40 years ago.<sup>38</sup> It continues to be one of the most comprehensive studies of the progressive tax system. In their essay, Professors Blum and Kalven correctly pointed out that progressivity could be established under a single rate of taxation by granting exemptions to all taxpayers.<sup>39</sup> According to Professors Blum and Kalven, progressivity was inherent where exemptions were used.<sup>40</sup> Hence, they considered whether additional progressivity could be justified. Professors Blum and Kalven noted that exemptions were necessary to satisfy a "minimum standard of living."<sup>41</sup> Professors Blum and Kalven presented their question for consideration as "[o]n what grounds is a progressive tax on all incomes over a minimum subsistence exemption to be preferred to a proportionate tax on all incomes over a minimum subsistence exemption?"<sup>42</sup> They also concluded without explanation that "[i]t is so clear that no one today favors" a regressive tax

35. Constitutional concerns and the lack of simplification make the direct tax a less popular alternative to the current income tax system. See Erik M. Jensen, *The Apportionment of "Direct Taxes": Are Consumption Taxes Constitutional?*, 97 *Colum. L. Rev.* 2334 (1997).

36. See, e.g., Graetz, *supra* note 22, at 204 (stating that a consumption tax would not promote the ability-to-pay concept because it would not tax income that was saved and a flat-rate consumption tax would be regressive). One commentator states as follows:

[C]onsumption taxes tend to be regressive, as compared to income taxes. Higher income individuals spend a smaller percentage of their income on consumption. Higher income individuals have a higher percentage of their income from savings. To achieve the same distribution of burden by income class, the rate structure of a consumption tax must be *more* progressive than that of an income tax.

John S. Nolan, *The Merit of an Income Tax Versus a Consumption Tax*, 12 *Am. J. Tax Pol'y* 207, 215 (1995).

37. See Paul, *supra* note 33, at 194.

38. See Blum & Kalven, *supra* note 25.

39. *Id.* at 4; see Charles R. O'Kelley, Jr., *Tax Policy for the Post-Liberal Society: A Flat Tax Inspired Redefinition of the Purpose and Ideal Structure of a Progressive Income Tax*, 58 *S. Cal. L. Rev.* 727 (advocating a personal exemption in conjunction with a flat tax to ensure progressivity).

40. See Blum & Kalven, *supra* note 25, at 4.

41. See *id.*

42. See *id.*

because "the term itself has become colored" and, therefore, it is not a serious alternative.<sup>43</sup> Other scholars share Professors Blum's and Kalven's position that the country should not adopt a regressive tax system<sup>44</sup> while other scholars are not quite as dismissive.<sup>45</sup>

### B. *The Constitutionality and Equity of Progressive Taxation*

The constitutionality of progressive tax rates is long settled.<sup>46</sup> The Supreme Court will invalidate a tax law as a violation of the Constitution where it is:

\* \* \* so arbitrary as to constrain to the conclusion that it was not the exertion of taxation but a confiscation of property, that is, a taking of the same in violation of the Fifth Amendment, or, what is equivalent thereto, was so wanting in basis for classification as to produce such a gross and patent inequality as to inevitably lead to the same conclusion.<sup>47</sup>

One of the earliest Supreme Court cases addressing the constitutionality of progressive rates was in the context of the estate tax. In a case decided during 1900, the Supreme Court considered the constitutionality of the War Revenue Act of 1898 that had imposed a tax on legacies exceeding \$10,000.<sup>48</sup> The basis of the constitutional attack was that the tax was void because it was not uniform throughout the country as required under Article 1, Section 8 of the Constitution.<sup>49</sup> The Court determined that the uniformity referred to geographical uniformity rather than a "thought of restricting Congress to intrinsic uniformity."<sup>50</sup> The Supreme Court recognized that some commentators and economists supported progressive taxation because it was more "just and equal"

43. See *id.* at 3.

44. See Joseph Bankman & Thomas Griffith, *Social Welfare and the Rate Structure: A New Look at Progressive Taxation*, 75 Cal. L. Rev. 1905, 1911 (1987) (noting wide support for analysis and viewpoint expressed in work of Blum and Kalven).

45. See Schoenblum, *supra* note 26, at 244 ("Regressivity and equal, per capita taxation necessarily have to be considered, because the same arguments that stymie progressivity undermine the case for the fairness of proportionality.")

46. See *Tyee Realty Co. v. Anderson*, 240 U.S. 115, 117-18 (1916); *Brushaber v. Union Pac. R.R. Co.*, 240 U.S. 1, 24-25 (1916); *Knowlton v. Moore*, 178 U.S. 41, 106-07 (1900); *Acker v. Commissioner*, 258 F.2d 568, 575 (6th Cir. 1958), *aff'd*, 361 U.S. 87 (1959).

47. *John Douglas Messina v. United States*, 202 Ct. Cl. 155, 160-61 (1973) (citing *Brushaber*, 240 U.S. at 24-25).

48. See *Knowlton*, 178 U.S. at 43.

49. *Id.* at 77. Article I, § 8 of the Constitution provides that, "duties, imposts and excises shall be uniform throughout the United States." U.S. Const. art. I, § 8, cl. 1.

50. See *Knowlton*, 178 U.S. at 102.

than proportional taxation, but did not find it necessary to rely on that support.<sup>51</sup> Rather, the Court stated that in the absence of a constitutional limitation, the issue of what was just and equal was a legislative question.<sup>52</sup> Hence, the Court applied a deferential approach to the legislature and stated it would only use its judicial power where the tax was arbitrary and confiscatory.<sup>53</sup>

In 1916, the Supreme Court addressed whether the progressive tax feature of the Income Tax Act of 1913 was arbitrary and unreasonable and therefore a violation of due process.<sup>54</sup> Specifically, the Supreme Court considered whether the progressive tax was unconstitutional because of the classification based on wealth.<sup>55</sup> The Court noted that there was no express provision prohibiting progressive taxation in the Constitution and held that the statutory provision was not an arbitrary abuse of power.<sup>56</sup> The subsequent courts that have addressed the issue summarily dismiss the constitutional attacks and simply rely on the early Supreme Court decisions upholding progressive taxation.<sup>57</sup>

### C. Methods of Establishing Progressive Taxation

The progressive tax system is achieved in six primary ways: 1) graduated tax rates;<sup>58</sup> 2) the earned income credit;<sup>59</sup> 3) income tax exemption for low incomes; 4) phase-out of personal deductions for higher income taxpayers;<sup>60</sup> 5) corporate taxation<sup>61</sup>; and 6) estate and gift taxes.<sup>62</sup> This section examines how these tax features create progressive taxation.

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51. See *id.* at 122.

52. See *id.* The Court also deferred to an earlier Supreme Court that addressed whether the progressive rates in the Illinois inheritance tax violated the due process and equal protection clauses of the Fourteenth Amendment. See *Maguon v. Illinois Trust & Sav. Bank*, 170 U.S. 283 (1898).

53. See *Knowlton*, 178 U.S. at 122-23.

54. See *Brushaber*, 240 U.S. at 9.

55. See *id.* at 21.

56. See *id.* at 24-25.

57. See, e.g., *Acker*, 258 F.2d at 575 (citing *Knowlton* and *Brushaber* for proposition that constitutionality of progressive tax rates is a settled issue); *Messina*, 202 Ct. Cl. at 160-61 (stating that poor taxpayers are intentionally taxed at lower rates and this alone is insufficient to result in a violation of the Constitution).

58. See IRC § 1.

59. See *id.* § 32.

60. See *id.* § 68.

61. See *id.* § 11.

62. See *id.* §§ 2001 & 2010.

1. *Graduated Tax Rates.*—This country's use of graduated tax rates was apparent upon Congress's enactment of the historic Income Tax Act of 1913.<sup>63</sup> Congress's purpose of enacting the Act included reducing tariff duties and generating revenue. In the congressional debates preceding the enactment of the 1913 Act, Representative Murray of Oklahoma prophesied about the turbulent future of the graduated income tax rates, stating that "in this bill we have a clause we call the income tax, based upon a graduated scale as to the different rates; and I may say that this proper graduation will depend largely upon experiment."<sup>64</sup> This so-called experiment has resulted in numerous and frequent congressional revisions in an effort to develop the proper level of graduation. Congress has made a multitude of changes to the graduated rates since the enactment of the 1913 Act. The 1913 Act imposed a normal tax of 1% and additional taxes ranging from 1% to 6% on net income starting at \$20,000.<sup>65</sup> The maximum rate was imposed on net income exceeding \$500,000.<sup>66</sup> Under the Act of 1916, entitled "An Act to increase the revenue and for other purposes", Congress imposed a 2% tax on net income up to \$2,000 and an additional tax ranging from 1% for income exceeding \$20,000 and 13% for income exceeding \$2,000,000.<sup>67</sup> Under the War Income Tax Act of 1917,<sup>68</sup> Congress increased the progressivity of the rate structure to defray war expenses and for other purposes. In addition to the 2% tax rate assessed on net income up to \$2,000, Congress imposed a 4% tax on net income exceeding \$2,000.<sup>69</sup> Congress further increased the progressivity of the additional tax by enacting ten marginal tax brackets ranging from 1% to 63%.<sup>70</sup> Under the Revenue Act of 1918, Congress imposed a normal tax of 6% on net income up to \$4,000 and a 12% tax on the balance.<sup>71</sup> In 1918, there was also an additional tax imposed ranging from 1% to 65% and 54 different rates.<sup>72</sup> Congress continued its pattern of adjusting the progressivity of the rates when it enacted the Revenue Act of 1921. The normal tax of 4% and 8% were imposed on income of \$4,000 and amounts exceeding \$4,000,

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63. Pub. L. No. 63-16, 38 Stat. 166.

64. See Willan, *supra* note 16, at 4.

65. See *id.* at 5; 1 Standard Fed. Tax Rep. (CCH) ¶ 140 (2000).

66. See Willan, *supra* note 16, at 5.

67. 1 Standard Fed. Tax Rep. (CCH) ¶ 140 (2000).

68. Pub. L. No. 65-50, 40 Stat. 300.

69. 1 Standard Fed. Tax Rep. (CCH) ¶ 140 (2000).

70. See *id.* The increase was rather drastic. In 1916, taxpayers with net income above \$2,000,000 were subject to an additional tax of 13%, but in 1917, taxpayers with income above \$1,000,000 were subject to the maximum rate of 50%. *Id.* In 1916, taxpayers with net income between \$1,000,000 and \$1,500,000 were subject to a marginal rate of 11% and those with net income between \$1,500,000 and \$2,000,000 were subject to a marginal rate of 12%. *Id.*

71. See *id.*

72. See *id.*

respectively.<sup>73</sup> For tax year 1921, the marginal rates did not change from the earlier years, but more substantial changes were made under that act for tax year 1922.<sup>74</sup> Under the Revenue Act of 1921, Congress eased the progressivity of the surtax by enacting 48 marginal brackets ranging from 1% to 50%.<sup>75</sup> The 1924 Revenue Act lowered the progressivity in both the normal tax and the surtax. Congress implemented three brackets for the surtax ranging from 2% to 6% and imposed a surtax ranging from 1% to 40% utilizing 40 different marginal rates.<sup>76</sup> The 1926 Act altered the normal tax brackets again by creating three marginal rates from 1-½% to 5%, but also reduced the maximum rate on the surtax to 20%.<sup>77</sup>

Minor changes to the normal tax were made between 1926 and 1931 but no changes were made to the surtax. However, more significant adjustments to the progressive tax structure were made under the 1932 Act corresponding to the financial strain caused by the Great Depression.<sup>78</sup> Congress reinstated the same 4% and 8% normal taxes that had been in existence from 1919 through 1923.<sup>79</sup> It also greatly enhanced progressivity in the surtax enacting 53 marginal rates ranging from 1% to 55%.<sup>80</sup> Under the 1934 and 1935 Acts, the normal tax was 4%, and there were 29 marginal tax brackets under the surtax ranging from 4% on net income between \$4,000 to \$6,000 to 59% on net income of \$5,000,000 and up.<sup>81</sup> From 1936 to 1939, the number of marginal brackets under the surtax increased to 32 and the maximum rate increased to a startling 75%.<sup>82</sup> Congress made minor adjustments to the rates during 1940; however, beginning in 1941 and continuing for several years, Congress greatly increased the progressivity for all income categories. These increases corresponded with the financial constraints caused by World War II.<sup>83</sup> Although Congress had declined to impose a surtax on income lower than \$4,000 to \$5,000 under previous Acts, Congress altered that trend in 1941. Under the 1941 Act, Congress imposed a surtax ranging from 6% to 77% on net income.<sup>84</sup> The normal tax increased to 6% under the 1942 Act, and Congress imposed a surtax ranging from 13% on net income between \$0 and

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73. See *id.*

74. See *id.*

75. See *id.*

76. See *id.*

77. See *id.*

78. See Barber B. Conable, Jr., *Congress and the Income Tax* 38 (1989).

79. 1 *Standard Fed. Tax Rep. (CCH)* ¶ 140 (2000).

80. See *id.*

81. See *id.* ¶ 141.

82. See *id.*

83. See Conable, *supra* note 78, at 38.

84. 1 *Standard Fed. Tax Rep. (CCH)* ¶ 141.

\$2,000 and 82% on net income of at least \$200,000.<sup>85</sup> The dramatic increase in the marginal surtax brackets reached its pinnacle in 1944 when Congress imposed a surtax ranging from 20% on net income between \$0 and \$2,000 and 91% on net income exceeding \$200,000.<sup>86</sup>

In 1945, Congress once again adjusted the marginal rates and imposed a 17% surtax on net income between \$0 and \$2,000 and 88% on net income exceeding \$200,000.<sup>87</sup> Surprisingly, the rates remained constant through 1950. From 1951 through 1963, Congress only made minor modifications to the marginal surtax brackets and the brackets remained relatively constant.<sup>88</sup> Taxable year 1964 was the last year that Congress imposed the normal tax and surtax.<sup>89</sup> It also represented a year in which Congress reduced the marginal surtax rates and imposed a new rate structure ranging from 13% for net income between \$0 and \$500 and 74% for net income above \$200,000.<sup>90</sup>

From 1965 through 1981, the lowest marginal rate was 14% and the highest marginal rate was 70%.<sup>91</sup> While the bottom and top rates remained constant, there were fluctuations of the intermediary rates as well as inflationary modifications.<sup>92</sup> In addition, from 1979 through 1986, no tax was imposed for income less than \$2,200 for 1977 and 1978 and \$2,300 for 1979 through 1981.<sup>93</sup> From 1982 through 1986, Congress exempted taxable income less than a nominal amount. More importantly, Congress reduced the highest marginal rate from 70% to 50% but made more modest reductions in the other marginal tax brackets during those same taxable years.<sup>94</sup>

In the past 15 years, Congress has continued its inconsistency in promoting progressive taxation. Under the rate structure immediately prior to 1986, the tax rates ranged from 11% to 50%, and there were 15 marginal income rates.<sup>95</sup> In its attempt to simplify the Code, Congress significantly reduced the total number of marginal rates upon the enactment of the Tax Reform Act of 1986.<sup>96</sup> The reduced rate structure was implemented in two phases. During

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85. See *id.*

86. See *id.* Under the Act, Congress also reduced the normal tax from 6% to 3%. *Id.* The 3% surtax remained at 3% through 1964. *Id.* ¶ 142.

87. See *id.* ¶ 142.

88. See *id.* Ed A142 & 143. After that time, the surtax was phased out completely.

89. Compare *id.* ¶ 142 with *id.* ¶ 144.

90. See *id.* ¶ 143. During 1952 and 1953, however, Congress imposed surtaxes ranging from 19.2% to 89%, but Congress reduced the rates in 1954 to their pre-1952 percentages. *Id.* ¶ 142.

91. See *id.* ¶ 144.

92. See *id.*

93. See *id.*

94. See *id.*

95. See *id.*

96. Pub. L. 99-514, 100 Stat. 2085.

taxable year 1987, there were five rates ranging from 11% to 38.5%.<sup>97</sup> Beginning in 1988, the greatly compressed marginal rates were 15% and 28%.<sup>98</sup> Congress also imposed a surtax of 5% on taxable income between \$43,150 and \$89,560 for single taxpayers and \$71,900 and \$149,250 for married couples filing joint returns.<sup>99</sup> Hence, the 1986 Act essentially created three tax brackets, 15%, 28% and 33%, with the latter phased out for income levels above the designated amounts.<sup>100</sup> The rate structure created under the 1986 Act lasted until Congress's enactment of the Omnibus Budget Reconciliation Act of 1990.<sup>101</sup> Under that Act, Congress repealed the 5% surtax and introduced the 31% bracket for unmarried individuals with income of over \$49,300.<sup>102</sup> The rate structure enacted in 1990 continued to define the graduated rate structure until Congress enacted the Omnibus Budget Reconciliation Act of 1993.<sup>103</sup> In the 1993 Act, Congress amended the income tax rates for taxable year 1994 and established five marginal income tax rates of 15%, 28%, 31%, 36% and 39.6%.<sup>104</sup> Surprisingly, given the tumultuous history of the rate structure, Congress has not altered the rate structure since it enacted the Omnibus Budget Reconciliation Act of 1993, and the rate structure enacted under that Act continues to represent the graduated rate structure in existence today.<sup>105</sup> Although Congress has not adjusted the graduated tax rates for ordinary income, it has altered the level of progressivity in other ways, including capital gains rates.

2. *The Earned Income Tax Credit.*—A refundable tax credit is afforded to taxpayers that satisfy certain income limitations.<sup>106</sup> The credit is afforded to taxpayers whose income exceeds the threshold floor levels but falls below a threshold ceiling. Congress enacted the earned income tax credit in 1975 to counter the regressive nature of the social security taxes and as an anti-inflationary measure.<sup>107</sup> In recent years, the earned income tax credit has become more important in light of the repeal of the Aid to Families with Dependent

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97. 1 Standard Fed. Tax Rep. (CCH) ¶ 144 (2000).

98. See *id.*

99. See Willan, *supra* note 16, at 64.

100. 1 Standard Fed. Tax Rep. (CCH) ¶ 144 (2000).

101. Pub. L. No. 101-508, 104 Stat. 1388.

102. See Willan, *supra* note 16, at 69.

103. Pub. L. No. 103-66, 107 Stat. 312.

104. See *id.*

105. IRC § 1(a).

106. See IRC § 32.

107. S. Rep. No. 94-36, at 22 (1975). According to Professor Jonathan Barry Forman, it would be simpler if low-income taxpayers were not subject to the social security tax by either adding standard deductions and personal exemptions to the social security tax or exempting the first \$5,000 or \$10,000 of income from the tax. Jonathan Barry Forman, *Simplification for Low-Income Taxpayers: Some Options*, 57 Ohio St. L.J. 145, 184-85 (1996).

Children program in 1996. Proponents hail the program as both pro-family and pro-work, two problems that existed under the now defunct welfare system.<sup>108</sup> The maximum earned income credit amount has increased drastically since Congress's enactment of the credit in 1975. At that time, the maximum credit amount was \$400.<sup>109</sup> For taxable year 1999, the maximum credit allowed was \$3,816.<sup>110</sup> In 1975, the total refundable portion provided to taxpayers was \$886.7 million, and in 1997 the projected figure was \$24.6 billion.<sup>111</sup> Based on these statistics, the earned income tax credit is increasingly satisfying the congressional objectives of progressivity.

3. *The Use of Phase-outs.*—The use of phase-outs can be an effective method to achieve a progressive tax structure. The Code utilizes two types of phase-outs to achieve progressivity. First, the Code employs ceilings to preclude upper income taxpayers from availing themselves of certain deductions and credits or to reduce the amount of the deductions and credits afforded to upper income taxpayers. Second, a taxpayer is required to reduce itemized deductions if their adjusted gross income exceeds a threshold amount adjusted annually for inflation.<sup>112</sup>

a. *The Increased Use of Ceilings.*—Several recent statutory enactments employ phase-outs that prevent the wealthy taxpayers from availing themselves of the benefits. Congress utilized ceilings when it enacted several recent statutory provisions in the Code to promote or encourage education. Empirical data establishes that college graduates earn higher incomes than

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108. Anne L. Alsott, *The Earned Income Tax Credit and the Limitations of Tax-Based Welfare Reform*, 108 Harv. L. Rev. 533, 534 (1995). Professor Alsott notes the risk of associating the earned income tax credit with welfare because critics may view it as a handout similar to welfare payments. *Id.* at 537.

109. See *id.* at 537.

110. Rev. Proc. 98-61, 1998-52 I.R.B. 18, at 5.

111. See Internal Revenue Service, 19 Stat. of Income Bull., *Selected Historical & Other Data*, at 195 (Summer 1999). The approximate earned income credit for the stated years was as follows:

Year	Amount Refunded	Amount used to offset taxes
1975	\$886.7 million	\$111.0 million
1980	\$ 1.4 billion	\$164.5 million
1985	\$ 1.5 billion	\$209.2 million
1990	\$ 5.3 billion	\$659.3 million
1995	\$ 20.8 billion	\$ 2.0 billion
1996	\$ 23.2 billion	\$ 2.1 billion
1997	\$ 24.6 billion	\$ 2.2 billion
<i>Id.</i>		

112. See IRC § 68.

individuals who have not attended college. Hence, one of the most efficient mechanisms that should be used to combat poverty is by government support of educational programs. United States Census Bureau statistics establish that there is a substantial difference between the income that a college graduate earns and the income earned by high school graduates. According to the Census Bureau, median income characteristics for 1998 were as follows:

Median Income of Full-Time, Year-Round Workers

Characteristic	Female	Male
High School Grad	\$21,963	\$30,868
Bachelor's Degree	\$35,408	49,982 <sup>113</sup>

Because of the correlation between one's level of education and income level, Congress has promoted education to better enable low income and middle income students to attend college. First, a taxpayer is able to contribute \$500 to an education individual retirement account each year for beneficiaries younger than age 18.<sup>114</sup> Upon distribution, any gain will be excluded from income provided that they do not exceed the qualified higher education expenses.<sup>115</sup> The contribution limit is phased out for single taxpayers with adjusted gross income more than \$95,000 but less than \$110,000.<sup>116</sup> Second, Congress enacted the Hope Scholarship Credit and the Lifetime Learning Credit.<sup>117</sup> The Hope Scholarship Credit provides a nonrefundable credit up to \$1,500 per student for the first two years of postsecondary education.<sup>118</sup> The Lifetime Learning Credit provides a nonrefundable credit up to \$1,000 per taxpayer for qualified tuition and related expenses.<sup>119</sup> During a tax year, a taxpayer may elect only one of the foregoing tax benefits per student.<sup>120</sup> The credits are phased out if the taxpayer's

113. U.S. Census Bureau, *Money Income in the United States: 1998*; Current Population Reports, at xi (Sept. 1999) [hereinafter *Money*].

114. IRC § 530(b)(1)(A)(ii) & (iii).

115. See id. § 530(a). "Qualified higher education expenses" generally mean tuition, fees, books, supplies and other required equipment to the extent the beneficiary did not claim the Hope Scholarship Credit or the Lifetime Learning Credit. Id. §§ 529(e)(3)(A) & 530(b)(2)(A).

116. Id. § 530(c)(1). For taxpayers filing joint returns, the contribution is phased out where adjusted gross income exceeds \$150,000 and less than \$160,000. Id.

117. See id. § 25A(a).

118. See id. § 25A(b)(1).

119. See id. § 25A(c)(1).

120. See id. § 25A(c)(2) & (e)(2).

modified adjusted gross income is between \$40,000 and \$50,000.<sup>121</sup> Congress also enacted a provision that allowed taxpayers to deduct interest on educational loans.<sup>122</sup> Under this provision, taxpayers are able to deduct up to \$2,000 for interest paid on any qualified education loan during the first 60 days that interest payments are required.<sup>123</sup> The deduction is phased out if the taxpayer's modified adjusted gross income is between \$40,000 and \$55,000.<sup>124</sup>

In addition, Congress has also enacted tax incentives to increase the savings rate of lower to middle income taxpayers.<sup>125</sup> Congress enacted Roth IRAs during 1997 to encourage savings. Like other IRAs, the maximum amount taxpayers can contribute to a Roth IRA is \$2,000 per year.<sup>126</sup> There are several differences between traditional IRAs and Roth IRAs. Higher income taxpayers are able to contribute to Roth IRAs but are precluded from making deductible contributions to traditional IRAs. The yearly contribution amount to Roth IRAs is phased out for individual taxpayers with adjusted gross incomes between \$95,000 and \$110,000,<sup>127</sup> while the maximum contribution amount for ordinary deductible IRAs is phased out where adjusted gross income is between \$32,000 and \$42,000.<sup>128</sup> A second significant difference between Roth IRAs and traditional IRAs is that no deduction is allowed for amounts contributed to Roth IRAs while deductions are provided for the traditional IRAs.<sup>129</sup> Finally, if a payment from a Roth IRA is made on or after the day the contributor turns 59½

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121. *Id.* § 25A(d). For taxpayers filing a joint return the credits are phased out where modified adjusted gross income is between \$80,000 and \$100,000. *Id.*

122. See *id.* § 221.

123. *Id.* § 221(b)(1) & (d).

124. *Id.* § 221(b)(2). For taxpayers filing a joint return, the deduction is phased out where modified adjusted gross income is between \$60,000 and \$75,000. *Id.*

125. The current income tax structure encourages savings and investments similar to a consumption tax. Under a cash flow method, like the Unlimited Savings Account Tax, taxpayers would deduct the amount put into savings or investment vehicles from their gross income, thus avoiding taxation on that income until consumed. J. Clifton Fleming, Jr., *The Deceptively Disparate Treatment of Business and Investment Interest Expense Under a Cash-Flow Consumption Tax and a Schanz-Haig-Simons Income Tax*, 3 *Fla. Tax Rev.* 544 (1997); see Lester B. Snyder & Roger J. Higgins, *Evaluating the Consumption Tax Proposals: Changes in the Taxation of Interspousal Transactions, Use of Trusts, and Revising the Meaning of "Tax Planning"*, 33 *San Diego L. Rev.* 1485, 1487 (1996) (discussing tax proposals that would either exclude investment income from gross income or allow full deduction for investment income).

126. Regs. § 1.408A-3, q&a 3(b).

127. IRC § 408A(c)(3)(A) & (C). For married couples filing joint returns, the contribution amount is phased out for adjusted gross income between \$150,000 and \$160,000. *Id.*

128. *Id.* § 219(g)(2)(A) & (B). For married taxpayers filing a joint return, the maximum contribution amount phases out between \$52,000 and \$62,000. *Id.*

129. See *id.* § 408A(c)(1).

or is made to a beneficiary after the contributor's death or the individual becomes disabled, the payment is not included in the contributor's gross income.<sup>130</sup>

b. *Phase-out of Itemized Deductions and Personal Exemptions.*—Under the Code, taxpayers whose adjusted gross income exceeds the applicable amount must reduce their itemized deductions by a percentage.<sup>131</sup> During taxable year 1998, 4.8 million taxpayers were subject to the phase-out resulting in \$25.9 billion disallowed itemized deductions.<sup>132</sup> For taxable year 2000, the applicable amount was \$128,950 for married couples filing joint returns and \$64,475 for married filing separately.<sup>133</sup> In addition, the Code requires taxpayers with adjusted gross incomes above a threshold amount to reduce the personal exemption amount, and the exemption is completely phased out for some wealthy taxpayers.<sup>134</sup>

4. *Income Tax Exemption for Low Incomes.*—A taxpayer is not required to file a tax return to the extent that gross income does not exceed the allowance for a personal exemption<sup>135</sup> and standard deduction.<sup>136</sup> Both of these allowances are adjusted annually for inflation.<sup>137</sup> For taxable year 2000, the personal exemption allowance is \$2,800 for each taxpayer and spouse and an additional \$2,800 for each dependent.<sup>138</sup> The standard deduction for married taxpayers filing a joint return is \$7,350 and for single taxpayers it is \$4,400.<sup>139</sup> Based on the standard deduction and allowance for personal exemptions, single taxpayers

130. See id. § 408A(d)(1) & (2).

131. See id. § 68(a). The applicable amount is adjusted annually for inflation. See id. § 68(b)(1) & (2).

132. Tom Herman, *Backdoor Tax Increases Hit Growing Numbers of People*, Wall St. J., July 5, 2000, at A1.

133. Rev. Proc. 99-42, 1999-46 I.R.B. 568, at 7.

134. See id. at 8. For taxable year 2000, the personal exemption begins to phase out and is completely phased out based on the following adjusted gross income levels:

<u>Filing Status</u>	<u>Threshold Phase-out</u>	<u>Completed Phase-out</u>
	<u>Amount</u>	<u>Amount</u>
Married filing joint return	\$193,400	\$315,900
Heads of household	161,150	283,650
Single	128,950	251,450
Married filing separately	96,700	157,950

Id.

135. See IRC § 151.

136. See id. § 63.

137. See id. § 63(c)(4) and IRC § 151(d)(4).

138. Rev. Proc. 99-42, 1999-46 I.R.B. 568, at 8; see IRC § 151(b) (allowing personal exemption for taxpayer and spouse); id. § 151(c) (allowing additional personal exemptions for dependents).

139. See Rev. Proc. 99-42, 1999-46 I.R.B. 568, at 6.

are exempted from filing a tax return where the gross income does not exceed \$7,200 and married couples are not required to file a tax return where gross income does not exceed \$12,950.

5. *Corporate Taxation.*—The government collects billions of corporate tax dollars annually. Under the Tariff Act of October 3, 1913, corporations were subject to a flat tax of 1% on corporate income.<sup>140</sup> Today, the corporate tax consists of four marginal brackets ranging from 15% to 35%.<sup>141</sup> Generally, wealthy taxpayers, rather than lower income taxpayers, own stock in corporations; therefore, any corporate taxes collected by the government will result in increased progressivity. Investments held in the corporate form are subject to the so-called double tax because income is taxed at the corporate level<sup>142</sup> and then at the individual shareholder level upon distribution of the profits as dividends.<sup>143</sup> Dividend income represents the only stream of income that is subject to two levels of taxation.<sup>144</sup> As with other types of taxes, the corporate tax is controversial.<sup>145</sup> While opponents of the double tax argue that the Congress should repeal the corporate tax,<sup>146</sup> supporters believe it is an equitable manner of promoting progressivity.<sup>147</sup>

6. *Estate and Gift Taxation.*—The estate tax was first enacted during 1898 to help finance the war and “for other purposes.”<sup>148</sup> The progressive tax system is firmly established in the estate and gift tax scheme. Taxpayers are entitled to make sizeable gifts without being subject to the estate and gift taxes.

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140. See Willan, *supra* note 16, at 5.

141. IRC § 11(b)(1). Traditionally, the corporate tax rates were higher than the individual rates. However, 1993 legislation reversed this trend.

142. IRC § 11(a).

143. *Id.* § 61(a)(7).

144. For a discussion on how the corporate tax is inconsistent with “horizontal equity,” see Jeffrey L. Kwall, *The Uncertain Case Against the Double Taxation of Corporate Income*, 68 N.C. L. Rev. 613 (1990).

145. See Patrick E. Hobbs, *Entity Classification: The One Hundred-Year Debate*, 44 Cath. U. L. Rev. 437, 445-46 (1995) (stating that opponents of corporate double taxation do not believe there is substantial difference between corporations and partnerships while proponents believe that the independent legal entities result in special privileges requiring different treatment).

146. In one study, Professor Alvin C. Warren, Jr. considered several alternatives to the current system to resolve the double corporate tax. See Alvin C. Warren, Jr., *American Law Inst., Federal Income Tax Project: Integration of the Individual and Corporate Income Taxes* (1993).

147. See Kwall, *supra* note 144, at 633-35 (“[I]f the corporate tax acts as an indirect tax on shareholders, it can be defended on equitable grounds as having a progressive effect.”)

148. War Revenue Act of 1898, ch. 448, 40 Stat. 448.

For the following taxable years the exclusions per taxpayer are as follows:

Tax Year	Applicable Exclusion
2000 and 2001	\$ 675,000
2002 and 2003	700,000
2004	850,000
2005	950,000
2006 and thereafter	1,000,000 <sup>149</sup>

The progressive nature of the estate and gift tax is also apparent in the rate structure. Upon enactment, the tax imposed increased on the basis of the value of the property.<sup>150</sup> An additional tax was imposed on estates exceeding \$25,000.<sup>151</sup> The maximum additional tax was 3% on estates exceeding \$1,000,000.<sup>152</sup> Today, the tax rates range from 18% to 55% for estates exceeding the applicable exclusion.<sup>153</sup> The 55% rate applies to transfers over \$3,000,000 and was reinstated under the Omnibus Budget Reconciliation Act of 1993.<sup>154</sup> The legislative history contains the following reasons for its enactment: "to raise revenue, to address the Federal deficit, to improve tax equity, and to make the tax system more progressive, the committee believes that the top two estate and gift tax rates which expired at the end of 1992 should be reinstated."<sup>155</sup> An additional 5% tax is imposed on certain high taxable estates.<sup>156</sup> During 1995, only 3.4% of estates were subject to the estate tax<sup>157</sup> and presently only 2% of estates are subject to the estate tax.<sup>158</sup> The reported estate tax liability was \$11.8

149. See IRC § 2011.

150. See *id.*

151. See *id.*

152. See *id.*

153. See *id.* § 2001(c)(1).

154. See Pub. L. No. 103-66, § 13208, 107 Stat. 312, 469 (1993).

155. H.R. Rep. No. 103-111, at 644 (1993), reprinted in 1993 U.S.C.C.A.N. 378, 875.

The Act increased rates retroactively. As a result, the taxpayers in *Quarty v. United States*, asserted that the retroactivity was unconstitutional because it violated the Fifth Amendment's Due Process Clause and the Takings Clauses. *Quarty v. United States*, 170 F.3d 961, 964 (4th Cir. 1999). The court rejected the taxpayer's due process argument and concluded that the retroactive aspect of the legislation was rationally related to a legitimate legislative purpose. *Id.* at 967. It also rejected the taxpayer's argument that a taking had occurred because it was not arbitrary. *Id.* at 969-70.

156. See IRC § 2001(c)(2).

157. Barry W. Johnson & Jacob M. Mikow, *Federal Estate Tax Returns, 1995-1997*, Internal Revenue Service, 19 Stat. of Income Bull., at 69, 71 (Summer 1999) [hereinafter *Johnson & Mikow*].

158. Jackie Calmes and Jim VandeHei, *House Votes to Repeal the 'Death Tax': Clinton Veto Is Expected On Measure Affecting 2% of All Estates*, *Wall St. J.*, June 12, 2000, at A2.

billion, \$14.5 billion and \$16.6 billion for tax years 1995, 1996 and 1997, respectively.<sup>159</sup> The estate tax accounted for approximately 1% of all tax revenues collected during those years.<sup>160</sup> Hence, the estate tax accounted for a very small portion of the total tax revenue collected during those years.

### III. WEAKNESSES INHERENT IN THE CURRENT PROGRESSIVE TAXATION METHODOLOGY AND THE GROWING THREAT

#### *A. In General*

The after-tax income of taxpayers in the top 10% of income earners, particularly the top 1%, has increased between 1977 and 1990.<sup>161</sup> In Professors McMahon's and Abreu's comprehensive law review article, they critically analyzed empirical data on changes in the distribution of income compared with the total taxes paid between 1977 and 1990.<sup>162</sup> They noted that during 1990 families in the top one percentile had the same share of income as those in the bottom 40<sup>th</sup> percentile.<sup>163</sup> According to Professors McMahon and Abreu, the increase in the income of the top 1% has exceeded the increase in their tax liability.<sup>164</sup> Other tax experts have found similar patterns extending to tax year 1993. Between 1980 and 1993, while the total effective rate for all families hovered around 23%, it declined by approximately 10% for families in the top 1% income bracket.<sup>165</sup> The increase in the disparity between the income levels of the top 1% taxpayers and lower income taxpayers has not resulted in a proportional increase in the tax burden to the wealthy.<sup>166</sup>

Between 1991 and 1997, the tax as a percentage of adjusted gross income has fluctuated in part as a result of changes in the marginal rates. However, since 1995 the rates have remained unchanged, but the tax as a percentage of adjusted gross income continues to fluctuate. In particular, as the

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159. See Johnson & Mikow, *supra* note 157, at 82.

160. See *id.*

161. See McMahon & Abreu, *supra* note 8, at 1. Professors McMahon and Abreu derived this data from the *Distribution of Income and Tax Burdens by Household*, Appendix K in the Committee on Ways and Means, *Overview of Entitlement Programs*, 103d Cong., 1st Sess. (Comm. Print 1993). *Id.* at 5, n.7.

162. See *id.*

163. See *id.* at 5.

164. See *id.* at 8.

165. See Richard Kастey, et al., *Trends in Federal Tax Progressivity, 1980-93*, in *Tax Progressivity and Income Inequality 10* (Joel Slemrod, ed., 1994).

166. See McMahon & Abreu, *supra* note 8, at 8-9. One of the basic premises under the McMahon and Abreu article was that when you isolate the top 1% from other wealthy individuals, you uncover the disproportionate reduction in tax rates afforded to taxpayers in the top 1%.

income of the taxpayers comprising the highest tax brackets increased, their tax as a percentage of adjusted gross income decreased each year. This phenomenon was evident where the adjusted gross income of the taxpayers was \$1,000,000 or more.<sup>167</sup>

The tax as a percentage of adjusted gross income for high income taxpayers decreased by more than two percentage points between 1995 and 1997.<sup>168</sup> With the exception of adjusted gross incomes between \$200,000 and \$1,000,000, every other income level saw negligible changes in the percentages.<sup>169</sup> More significantly, there was even a slight increase in the tax as a percentage of adjusted gross income between 1995 and 1997 for taxpayers at the lower adjusted gross income levels.<sup>170</sup>

The decreased progressivity is the result of a combination of factors. Professor Sharon Nantell provided a possible justification for the disproportionate increase in the tax burden. Professor Nantell noted the following:

The most glaring consequence of a system of tax laws created by and for wealthy, white males is the exacerbation of 'a growing gap in the relative economic positions between rich and poor, the latter disproportionately represented by women, children and people of color.' Tax provisions such as the mortgage interest deduction and the preferential tax treatment for capital gains primarily benefit taxpayers in the upper-income brackets.<sup>171</sup>

Consequently, in determining whether the Code is effective in promoting a progressive tax system, consideration must be given to the tax benefits associated with personal residences, capital assets and other tax incentives.

The tax-favored treatment of capital gains accounts for a substantial portion of the tax savings afforded to the wealthy, and has been the subject of substantial debate and statutory modification.<sup>172</sup> Under the Code, the maximum

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167. See Internal Revenue Service, 15 Stat. of Income Bull., Selected Historical & Other Data, at 141, 197 (Fall 1995).

168. See *id.*

169. For taxpayers with adjusted gross income between \$200,000 and \$1,000,000, the tax as a percentage of adjusted gross income decreased by an average of 1%. See *id.*

170. For taxpayers with adjusted gross income between \$1 and \$1,000 the tax as a percentage increased from 2.9% to 7%, and taxpayers with adjusted gross income between \$1,000 and \$7,000 had their tax as a percentage of adjusted gross income increase by 0.6%. See *id.*

171. Sharon C. Nantell, *A Cultural Perspective on American Tax Policy*, 2 Chap. L. Rev. 33, 67 (1999) (citing Nancy E. Shurtz, *Gender Equity and Tax Policy: The Theory of "Taxing Men,"* 6 S. Cal. Rev. L. & Women's Stud. 485, 528 (1997)).

172. For example, Professor Martin J. McMahon, Jr. disfavors the preferential capital gain rates because of the discriminatory effect, negative impact on the progressive rate structure and increased complexity. Martin J. McMahon, *Individual Tax Reform for Fairness*

tax rate for net capital gains is 20%.<sup>173</sup> Where a taxpayer purchases an asset after December 31, 2000, and holds on to the capital asset for at least five years, the maximum tax rate is reduced to 18%.<sup>174</sup> During taxable year 1997, net capital gain represented a substantial portion of adjusted gross income and was second only to salaries and wages.<sup>175</sup> According to statistics published by the Internal Revenue Service, net capital gain totaled \$347.9 billion, an increase of 38.1% from the previous tax year.<sup>176</sup> Of the total \$347.9 billion figure, \$232.5 billion was reported on tax returns with adjusted gross income of \$200,000 or more and \$44.9 billion was reported on tax returns with adjusted gross income between \$100,000 and \$200,000.<sup>177</sup> Consequently, taxpayers earning \$100,000 or more reported approximately 80% of all net capital gain during taxable year 1997.<sup>178</sup> The obvious effect of this empirical data is that the primary beneficiaries of the favored rates are wealthy taxpayers, and a substantial portion of taxable income earned by upper income taxpayers was taxed at rates below or only slightly above income earned by lower income taxpayers. Specifically, Table I based on IRS Statistics, depicts the form of assets held by the wealthiest males and females.<sup>179</sup>

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and Simplicity: Let Economic Growth Fend for Itself, 50 Wash. & Lee L. Rev. 459, 470-73 (1993); see also 143 Cong. Rec. H6623-04, H6628 (daily ed. July 31, 1997) ("[t]he lowering of the capital gains rate benefits the wealthy in this country, and it is clear that will happen when we get the rate down to 18% which is almost the lowest tax rate on regular income, that this will have thrown gasoline on the whole class warfare issue").

173. See IRC § 1(h).

174. See *id.* §1(h)(2)(B). Where a taxpayer is taxed at the 15% rate on ordinary income, the maximum rate for assets held for 5 years is 8% irrespective of the holding period. *Id.* § 1(h)(2)(A).

175. See Internal Revenue Service, 18 Stat. of Income Bull., Bulletin Board, at 2-3 (Spring 1999).

176. See *id.*

177. See Internal Revenue Service, 18 Stat. of Income Bull., Revision to Winter 1998-1999 Issue, at 6, 143 (Spring 1999).

178. Interestingly, taxpayers reporting adjusted gross income of \$100,000 or more, reported only 21% of the net capital losses. *Id.* Because no more than \$3,000 of capital losses can be deducted against ordinary income, they are generally considered less favorable than ordinary losses. See IRC § 1211(b).

179. See Internal Revenue Service, 17 Stat. of Income Bull., at 71-73 (Winter 1997-98).

Table I

MALESFEMALES

\$600,000 - \$1,000,000		\$600,000 - \$1,000,000	
Financial Assets	21 Percent	Financial Assets	27 Percent
Other Real Estate	20 Percent	Other Real Estate	20 Percent
Personal Residence	17 Percent	Personal Residence	17.5 Percent
Retirement Accounts	13 Percent	Cash	14.5 Percent
Cash	10 Percent	Retirement Accounts	7.5 Percent
\$1,000,000 or \$10,000,000		\$1,000,000 or \$10,000,000	
Financial Assets	26 Percent	Financial Assets	39 Percent
Other Real Estate	18 Percent	Other Real Estate	18 Percent
Closely-held Stock	12.5 Percent	Cash	12 Percent
Cash	11 Percent	Personal Residence	10 Percent
Personal Residence	7.5 Percent	Closely-held Stock	7 Percent
Retirement Accounts	5 Percent	Retirement Accounts	6 Percent
\$10,000,000 or more		\$10,000,000 or more	
Financial Assets	33 Percent	Financial Assets	53.4 Percent
Closely-held Stock	28 Percent	Closely-held Stock	11.6 Percent
Other Real Estate	9.5 Percent	Other Real Estate	9 Percent
Cash	5 Percent	Cash	6 Percent
Personal Residence	2 Percent	Personal Residence	2 Percent

The IRS statistics show that a substantial portion of the top wealthholders' net wealth was attributable to investments in financial assets such as stocks and mutual funds. The statistics also show that there is a sizeable increase in the percentage of assets held in the form of financial assets as the wealth increases. With respect to males, the percentage of assets held in the form of financial assets increased from 21% to 33% as the wealth grew. Similarly, with respect to females, the percentage of assets held in the form of financial assets increased with the level of wealth from 27% to 53%. Given the status of stocks, mutual funds and other financial assets as capital assets, the disposition of these assets has the obvious benefit of taxing the gain at very favorable rates.

Another category of assets where the percentage of assets increases as wealth increases is closely held stock. Consistent with the treatment of financial assets, the disposition of closely held stock may receive favorable tax treatment. Under the Code, taxpayers that satisfy the statutory requirements are able to exclude 50% of the gain from the disposition of "qualified small business stock"

held for more than five years.<sup>180</sup> The maximum amount of the exclusion is the greater of \$10,000,000 or ten times the taxpayer's adjusted basis in the stock.<sup>181</sup> The empirical data establishes that for both males and females as the net worth increases so does the possibility that the sale or other disposition will result in tax-favored treatment in the form of an exclusion or lowered capital gain rates. Assuming that the taxpayers could satisfy all statutory requirements, the percentage of assets disposed of that would be afforded favorable treatment was:

<u>Net Worth</u>	<u>Males</u>	<u>Females</u>
\$ 600,000 – \$ 1,000,000	38% <sup>182</sup>	44.5%
\$ 1,000,000 – \$10,000,000	46%	57%
\$10,000,000 or more	63%	67%

### B. Homeownership Tax Incentives

Another tax incentive that limits the effectiveness of the progressive structure pertains to homeownership. The mortgage interest deduction results in the Code discriminating in favor of homeowners.<sup>183</sup> The Code allows for gain not exceeding \$250,000 (\$500,000 for married coupled filing a joint return) to be excluded from gross income where the taxpayer resided in the home for at least two years during a five year period.<sup>184</sup> The Code also allows a deduction for interest paid on indebtedness incurred on the acquisition or improvement of a personal residence<sup>185</sup> and interest paid on home equity up to \$100,000 of indebtedness.<sup>186</sup> For taxable year 1993, the home mortgage deduction resulted in total tax savings of \$45.1 billion.<sup>187</sup> Although some scholars advocate the total

180. IRC § 1202(a)(1). In order to qualify as a qualified small business, the aggregate gross assets must not exceed \$50,000,000. Id. § 1202(d).

181. See id. §§ 1(h)(4), (5) & 1202(b).

182. The percentages are based on the application of the exclusion on gain from the sale of a personal residence provided under IRC § 121, the tax-favored capital gain rates of IRC § 1, and the exclusion for gain from the disposition of qualified small business stock under IRC § 1202.

183. There is a disparity between Whites and other ethnic groups in home ownership. Only 46.3% of African Americans and 45.5% of Hispanics own their homes while 73.2% of Whites own theirs. Homeownership Annual Statistics: 1999, Table 20, U.S. Census Bureau, at <http://www.census.gov/hhes/www/housing/hvs/annual99/ann99t20.html> (last visited Feb. 14, 2001).

184. IRC § 121(a) & (b)(1). Where a husband and wife file a joint return, the amount of the exclusion is \$500,000. Id. § 121(b)(2).

185. Id. § 163(h)(3)(A)(i) & (B).

186. Id. § 163(h)(3)(A)(ii) & (C).

187. Senator Pete V. Domenici, *The Unamerican Spirit of the Federal Income Tax*, 31 Harv. J. on Legis. 273, 293 (1994).

repeal of the home mortgage deduction,<sup>188</sup> the deduction attributable to home equity indebtedness creates the greater problem. The proceeds from home equity indebtedness may be used for any purpose. Homeowners are able to deduct mortgage interest payments indirectly made for the purchase of automobiles, boats, tuition and vacations even though the Tax Reform Act of 1986 repealed a deduction for personal interest.<sup>189</sup>

### C. Corporate Taxation

There is evidence suggesting that the corporate tax is ineffective in taxing corporate income because of numerous corporate tax breaks.<sup>190</sup> According to the Congressional Budget Office, in 1952 corporate income taxes accounted for 32% of total federal revenues but only 9% in 1995.<sup>191</sup> The actual amount of total income tax after deductions and credits consistently increased from 1991 through 1996. However, the deductions and credits considerably exceeded the total income tax after deductions and credits, and the percentage increase in deductions and credits was disproportionately greater than the increase in the total income tax during most of those taxable years. The disparity was greatest in 1995 and 1996. The results are provided in Table II.

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188. See McMahon, *supra* note 23, at 487.

189. Several legal scholars have criticized the mortgage interest deduction as being discriminatory. According to Professor Joseph A. Snoe, Congress enacted the mortgage interest deduction provisions to lighten the burden associated with borrowing for education, health care and unforeseen emergencies. See Joseph A. Snoe, *My Home, My Debt: Remodeling the Home Mortgage Interest Deduction*, 80 Ky. L.J. 431, 437-40, 491 (1992). According to Professor Snoe, these policy concerns justify a deduction for all taxpayers that borrow funds to satisfy these expenses. *Id.* at 491; see also William T. Mathias, *Curtailing the Economic Distortions of the Mortgage Interest Deduction*, 30 U. Mich. J.L. Reform 43 (1996) (stating that "because of inequalities favoring the upper-income taxpayers, interest deduction should either be curtailed or eliminated").

190. In 1984, a publication was issued establishing that 128 out of 250 of the largest corporations did not pay any federal income taxes at least once between 1981 and 1983. See Steven M. Sheffrin, *Perceptions of Fairness in the Crucible of Tax Policy in Tax Progressivity and Income Inequality* 309, 322 (Joel Slemrod ed., 1994).

191. Christopher St. John, *Tax Breaks and Corporate Responsibility*, Me. L. Rev. (Feb. 4, 1998), <http://www.mecep.org/news2/980304.shtml> (last modified Mar. 2, 2000).

**Table II**

Year	Total Income Tax	% Change	Deduction	% Change	Credit	% Change
1991	\$ 92.6 billion	-	\$122.6 billion	-	\$28.5	.192
1992	\$101.5 billion	9.69	\$117.6 billion	-4.09	\$29.7	4.29 <sup>193</sup>
1993	\$119.9 billion	18.1	\$136.5 billion	16.1	\$34.5	16.0 <sup>194</sup>
1994	\$135.5 billion	13.0	\$142.3 billion	4.2	\$37.3	8.0 <sup>195</sup>
1995	\$156.4 billion	15.0	\$205.2 billion	44.2	\$42.4	13.8 <sup>196</sup>
1996	\$170.6 billion	9.1	\$216.7 billion	5.6	\$53.1	25.2 <sup>197</sup>

Another problem with the corporate tax is that it is unclear who actually bears the tax burden. The four possible contenders for bearing the burden are: 1) owners or shareholders of the corporation; 2) owners of capital in general; 3) consumers through inflated prices; or 4) workers through reduced wages.<sup>198</sup> Some businesses might shift such an expense to consumers by increasing costs, but too much shifting would be inflationary. Based on this practice, one could easily conclude that consumers actually bear the cost of the corporate tax expense because it is similar to any other business expense. It is also conceivable that corporate directors protect earnings and profits by reducing expenses, including workforce downsizing, reduced wages and increased operations in third world countries, which would place the onus of the corporate tax on the employees.<sup>199</sup> In theory, the corporate tax is borne entirely by the shareholders.

192. See Jonathan E. Shook and Janice Washington, *Corporation Income Tax Returns, 1992*, Internal Revenue Service, 15 Stat. of Income Bull., at 14-15 (Summer 1995).

193. See *id.*

194. See Michael G. Seiders, *Corporation Income Tax Returns, 1993*, Internal Revenue Service, 16 Stat. of Income Bull., Summer 1996, at 36, 43-44.

195. See Madeline Deming Boerner, *Corporation Income Tax Returns, 1994*, Internal Revenue Service, 17 Stat. of Income Bull., Summer 1997, at 50, 58-59.

196. See Matthew Scoffic & Patrice Treubert, *Corporation Income Tax Returns, 1996*, 19 Stat. of Income Bull., Summer 1999, at 50, 57-58.

197. See *id.*

198. See Joseph A. Pechman, *Federal Tax Policy*, 142, 144 (5th ed. 1987). One professor at the University of California at Davis posed the question to his introductory microeconomics class of 150 and received the following responses: 1) 6% believed workers bear the corporate tax; 2) 9% believed that shareholders bear the tax burden; 3) 30% believed that all investors in the economy bear the tax; and 4) 55% believed that consumers bear the tax. See Sheffrin, *supra* note 190, at 323.

199. If the corporate tax is borne by employees in the form of lower compensation, the CEOs and other high-ranking corporate executives seem to escape this financial burden. During 1999, the median salary including bonuses for top executives of 350 consulting firms

In practice, the corporate tax is actually borne by all four contenders with the more difficult question being the proper allotment. To the extent that the corporate tax is borne by consumers, it is a regressive tax because lower-income taxpayers spend a larger portion of their incomes on consumable products.

#### D. *The Earned Income Tax Credit*

Superficially, the increase in the refundable portion of the earned income credit since its enactment establishes its success in meeting Congress's objective of countering the regressive nature of the social security tax and serving as an anti-inflationary measure. At first glance, the earned income tax credit is an effective means of alleviating poverty. The earned income tax credit lifts some low-income taxpayers above the poverty level but does not lift all taxpayers above the poverty level. For example, during taxable year 1988, two-thirds of all poor taxpayers did not receive earned income credit benefits.<sup>200</sup> For 1999 the maximum earned income tax credit that could be received by a single taxpayer with two or more children or a married couple filing a joint return with two or more children was \$3,816.<sup>201</sup> In order to receive the maximum credit, the taxpayer's earned income could not exceed \$12,460.<sup>202</sup> Hence, when you combine the earned income with the earned income credit, the effective income for the year is \$16,276. For 1999, the poverty threshold for a family of four with two children in the household was \$16,895.<sup>203</sup> The family remains below the poverty threshold by \$619. The analysis is incomplete because the taxpayer is also liable for social security tax and a tax for Medicare. Wages are subject to

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was about \$1.7 million and \$120,000 higher than during 1998. David S. Brader, *Of Janitors and Billionaires*, Wash. Post, Apr. 16, 2000, at B7. The highest paid executive made \$170 million in salary, bonuses and stock options. *Id.* The article pointed out that the janitors cleaning the offices where the executives worked requested \$1 an hour raises for each of the next three years and that the \$1.7 million would have funded the combined requested salaries of 80 striking janitors during the third year. *Id.* There is also evidence that even corporations with low earnings and weak stock performance are rewarding their CEOs generous compensation packages. While Coca-Cola shares dropped by 13%, the exiting CEO received a total compensation package of \$70 million, and while Bank of America's shares dropped by 17%, the CEO received a compensation package totaling \$49 million. Gary Strauss, *The Billionaires Club New Economy Rockets CEO Pay into the Stratosphere*, USA Today, Apr. 15, 2000, at 1B.

200. Saul D. Hoffman & Laurence S. Seidman, *The Earned Income Tax Credit: Antipoverty Effectiveness and Labor Market Effects* 28 (1990).

201. See Rev. Proc. 98-61, 1998-2 C.B. 811.

202. See *id.*

203. Poverty 1999, U.S. Census Bureau at <http://www.census.gov/hhes/poverty/threshold/thresh99.html> (last visited Apr. 17, 2000).

social security tax of 6.2% and Medicare tax of 1.45%.<sup>204</sup> The entire tax liability for payroll taxes would total \$953. Consequently, after factoring in the payroll taxes, the taxpayer's after-tax income remains \$1,572 below the poverty threshold.<sup>205</sup> A different result would obtain where the household consisted of two children and was headed by a single parent. The poverty threshold for a single parent with two children was \$13,423 during 1999.<sup>206</sup> When you combine the earned income with the earned income credit, the effective income for the year is \$16,276. As a result of the earned income tax credit, the low-income taxpayer's effective income is \$2,853 above the poverty threshold. The maximum earned income tax credit that could be received by a single parent with one child was \$2,312 for 1999, and the maximum income to receive that amount was \$12,460.<sup>207</sup> The poverty threshold for this family was \$11,483 in 1999.<sup>208</sup> Hence, the effective income for the taxpayer is \$14,772 and \$3,289 over the poverty level.

The earned income credit, however, does not enable a taxpayer to move above the poverty level where the taxpayer does not have any children. The maximum earned income tax credit that could be received by a taxpayer with no children was \$347 for 1999, and the maximum income to receive that amount was \$5,670.<sup>209</sup> The poverty threshold for a single individual was \$8,480 in

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204. IRC § 3101(a), (b). The earned income tax credit was enacted to offset the regressive nature of the social security and Medicare taxes. See S. Rep. No. 94-36, at 22 (1975). Many low-income taxpayers must pay state income taxes as well. Some states waive the state income taxes for low-income taxpayers, but approximately one-half of the states require payment of income taxes irrespective of poverty level. Tax Report, Wall St. J., Mar. 29, 2000, at A1.

205. These results are based in part of the marriage penalty that affects some households. The House of Representatives and Senate had passed the "Marriage Tax Penalty Relief Act of 2000," which would have reduced the so-called marriage penalty for most taxpayers and reduced the marriage penalty inherent in the earned income tax credit. See H.R. 6m, 106th Cong. (2000). President Clinton vetoed the bill because of its expected benefit primarily to upper income taxpayers. See Jim VandeHei, Senate Passes Bill to Dump Marriage Tax: With Clinton Vowing to Veto, Hastert Seeks a Deal to Show Off for Voters, Wall St. J., July 19, 2000, at 24. Republicans attempted to override the presidential veto but failed by 16 votes. Jim VandeHei, G.O.P. Reloads with Marriage Tax, Debt Payment, Wall St. J., Sept. 14, 2000, at A1; see also Vada Waters Lindsey, The Burden of Being Poor: Increased Tax Liability? The Taxation of Self-Help Programs, 9 Kan. J.L. & Pub. Pol'y 225, 259-60, n.161 (1999) (opining that if the marriage penalty is eliminated, the marriage bonus must be eliminated as well).

206. U.S. Census Bureau, Poverty in the United States: 1998, Current Population Reports, at 1 (Sept. 1999) [hereinafter Poverty].

207. See Rev. Proc. 98-61, 1998-2 C.B. 811.

208. See Poverty, *supra* note 206, at 1.

209. See Rev. Proc. 98-61, 1998-2 C.B. 811.

1998.<sup>210</sup> The total income for a taxpayer earning the maximum income and therefore receiving the maximum earned income credit would be \$6,017. As a result, the taxpayer's income would be \$2,463 lower than the poverty threshold established for 1998.

#### E. Estate Taxation

The Internal Revenue Service projects that the estate tax liability will be reduced by \$1.8 billion and \$8.6 billion between years 2001 and 2007 because of the increase in the unified credit and other changes enacted under the Taxpayer Relief Act of 1997.<sup>211</sup> The effect of these changes is to reduce the progressivity in our overall tax structure. Significantly, the House of Representatives in a 279-136 vote passed the "Death Tax Elimination Act of 2000" to phase out the tax<sup>212</sup> altogether over a ten year period of time.<sup>213</sup> The Senate in a 59-39 vote also passed the measure.<sup>214</sup> As expected, former President Clinton vetoed the bill, but it is likely that efforts to repeal the tax will continue.<sup>215</sup> President Bush's tax plan includes the complete repeal of the Federal estate tax.<sup>216</sup> Therefore, if a new tax bill includes the elimination of the Federal estate tax, it is unlikely President Bush will veto the bill as did his predecessor. If the Federal estate tax is eliminated, there will be additional strain on the integrity of our progressive tax system.

#### F. The Use of Ceilings and Phase-outs

There are several weaknesses inherent where ceilings are employed to promote progressivity. First, it is unlikely that progressivity is achieved between low-income taxpayers and those taxpayers who are unable to avail themselves of tax incentives because their income levels run afoul of a ceiling. If you consider Roth IRAs, high-income taxpayers can easily afford to set aside \$2,000 per year and are able to exclude from income future accessions to wealth. Conversely, low-income taxpayers can theoretically invest in Roth IRAs as well, but they are essentially foreclosed from the investment option because all their disposable income is consumed by basic necessities. While low-income taxpayers are essentially foreclosed from contributing to the Roth IRAs, many high-income

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210. See Poverty, *supra* note 206, at 1.

211. See Johnson & Mikow, *supra* note 157, at 87.

212. See Calmes & VandeHei, *supra* note 158, at A2.

213. See H.R. 8, 106th Cong. (2000).

214. See Jim VandeHei, *Despite Veto Threat, Senate is Expected to Clear Marriage-Penalty Relief Plan*, Wall St. J., July 17, 2000, at A36.

215. See Tax Report, Wall St. J., Sept. 6, 2000, at A1.

216. See Glenn Kessler & Mike Allen, *Bush to Contend Both Taxes, Debt Can Be Reduced*, Wash. Post, Feb. 25, 2001, at A1.

taxpayers are eligible to make the contributions. For 1998, households in the upper 95<sup>th</sup> percentile earned income of \$132,199 and households in the upper 80<sup>th</sup> percentile earned income of \$75,000.<sup>217</sup> The median income for that same year was \$38,885.<sup>218</sup> The Roth IRAs are phased out for single individuals between \$95,000 and \$110,000 and for married couples between \$150,000 and \$160,000. The significance of these statistics is that the phase-outs do preclude the wealthiest taxpayers from availing themselves of tax-free accession to wealth, as advocated by Professors McMahon and Abreu,<sup>219</sup> but a sizeable portion of wealthy taxpayers can, in fact, take advantage of the Roth IRA tax benefits. Hence, as noted by Professors McMahon and Abreu, there is some widening to the level of progressivity between the very wealthy and the moderately wealthy but not to the level of progressivity between the lower to middle income taxpayer and the wealthiest taxpayers.<sup>220</sup>

A similar conclusion is reached when you consider educational IRAs, Hope Scholarship Credit and Lifetime Learning Credit. While the U.S. Census Bureau empirical data complements the government's promotion of higher education, there is an issue as to whether the education should be promoted as a direct expenditure or tax incentive. The recent legislation and budget establish that Congress supports education by combining the two approaches. However, the trends in federal student financial assistance indicate that the U.S. Department of Education is providing students with declining amounts of awards. During fiscal year 1999, federal student aid awards totaled \$53.2 billion.<sup>221</sup> During fiscal year 2000, federal student aid awards totaled \$50.6 billion.<sup>222</sup> Conversely, Congress has increased the use of tax incentives as a means of supporting education by enacting legislation that allows for an exclusion from income of gains from distributions from educational IRAs, a nonrefundable credit for certain educational expenses, and a deduction for interest paid on educational loans.<sup>223</sup> The problem with the legislation that promotes education is that the taxpayers with the most to gain from obtaining a college degree are not able to either establish an educational IRA or pay for qualified tuition and related expenses.<sup>224</sup> It is highly unlikely that a low-income

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217. See Money, *supra* note 113, at xv.

218. See *id.*

219. See McMahon & Abreu, *supra* note 8, at 77.

220. See *id.* at 76-77.

221. Interim Performance Objectives, Final Report Fiscal Year 1999, Student Financial Assistance, at <http://www.ed.gov/PDFDocs/finalquarterly.pdf> (last visited July 20, 2000).

222. See *id.*

223. See *supra* text accompanying notes 113-30.

224. Another unexpected problem with the Hope Credit and the Lifetime Learning Credit is that they are underutilized. During taxable year 1998, taxpayers claimed a total of \$3.5 billion in the educational credits rather than the predicted \$6.7 billion in savings. Thomas

taxpayer would be able to benefit from these tax incentives. Deductions and credits are useless without sufficient income to offset. It is not realistic to expect a lower to middle class family with three children and household income of \$25,000 to also be able to set aside \$500 per child for an educational IRA. Hence, the only families who are able to benefit from these tax incentives are middle to upper income families. In addressing the effectiveness of these tax incentives, it is important to recognize these severe limitations. The most effective way for the government to subsidize education is a combination of the tax incentives and direct expenditures. The Department of Education must continue to subsidize college for low-income to middle-income individuals by providing grants primarily and low-interest loans secondarily.

The phase-out of itemized deductions is also an ineffective method of ensuring progressivity. Although a substantial amount of itemized deductions were excluded, the phase-out is ineffective in protecting the integrity of the progressive tax structure for two reasons. First, most taxpayers in the lowest tax bracket claim the standard deduction,<sup>225</sup> and it is probable that even the phased out itemized deduction is substantially greater than the standard deduction. Second, wealthy taxpayers are fully able to claim above the line deductions such as business deductions. Conversely, the phase-out of the personal exemption is more successful in maintaining a progressive tax structure.

#### *G. Proposed Tax Legislation's Increased Threat*

The very partisan tax legislation enacted in recent years has resulted in generous tax savings to the wealthy. Congress has also proposed legislation that headed toward a weakening in the progressive tax structure. For example, during the summer of 1999, Congress passed a ten year \$792 billion tax cut. Included in the package were reductions in the capital gain rates and increases of contribution and annual limits on IRAs. Although Congress proposed a reduction in all of the marginal rates, the package as a whole discriminated in favor of the wealthy. The package was not discriminatory on its face, but its impact was discriminatory because low-income taxpayers do not have sufficient disposable income to make capital investments. As expected, President Clinton vetoed the tax-cut package.<sup>226</sup> While Congress proposed additional tax breaks for the wealthy, it also considered limiting the nonrefundable earned income tax credits

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A. Fogarty, Juicy educational tax credits go unused: Some say code's too complex for students to cash in, *USA Today*, Mar. 31, 2000, at 1B.

225. Most taxpayers in all tax brackets claim the standard deduction. For example, for taxable year 1998 the IRS reported that only 30.5% of tax returns claimed itemized deductions. See *Tax Report*, *Wall St. J.*, July 5, 2000, at A1.

226. See Bob Davis & Jacob M. Schlesinger, Clinton Vetoes \$792 Billion Tax Cut, Seeks to Lure GOP Toward Compromise, *Wall St. J.*, Sept. 24, 1999, at A16.

received by many low-income taxpayers. In the Congress's fiscal 2000 budget, House Republican leaders proposed converting the earned income credit payments from lump sum to 12 installment payments as a way to raise \$8.7 billion for labor, health and education programs.<sup>227</sup> The measure did not pass;<sup>228</sup> however, it exemplified the direction of the tax policy of the current Congress, because it contemplated severely limiting benefits to the poor as a way to fund appropriations.

Several Republican and Democratic Representatives also introduced the "National Retail Sales Tax Act of 1999"<sup>229</sup> and the "Fair Tax Act of 1999".<sup>230</sup> Both bills propose the elimination of the Federal income tax and the imposition of a consumption-type sales tax. On April 15, 1999, several representatives introduced the "National Retail Sales Tax Act of 1999" that would eliminate the income tax and impose a 15% on consumption.<sup>231</sup> On July 14, 1999, Representative John Linder (R-GA) and Representative Collin Peterson (D-MN) introduced the "Fair Tax Act of 1999" that also eliminates the current income tax and replaces it with a 23% tax on consumption.<sup>232</sup> The stated purpose of both bills was "[t]o promote freedom, fairness, and economic opportunity for families by repealing the income tax, abolishing the Internal Revenue Service, and enacting a national retail sales tax to be administered primarily by the States."<sup>233</sup>

Consistent with other election years, each candidate's platform usually includes modifying the Code. Whether the tax platforms represent political rhetoric or valid proposals, they play a significant role in enticing voters to vote for a particular candidate. According to a poll conducted by the National Republican Congressional Committee, 69% of 1000 voters in 41 contested congressional districts indicated that they would vote for candidates who supported the marriage penalty relief plan recently passed by the House.<sup>234</sup> Representative Charlie Stenholm, a conservative Democrat from Texas, stated "[t]his is nothing more than a political document that is clearly an effort to push a touchy-feely tax cut."<sup>235</sup> Presidential candidates had proposed more aggressive tax cuts than the tax package that was vetoed by former President Clinton.

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227. See David Rogers, *Divided GOP Leans Toward Making Broad Spending Cuts at Year's End*, Wall St. J., Oct. 4, 1999, at A32.

228. See *id.*

229. H.R. 1467, 106th Cong. (1999).

230. H.R. 2525, 106th Cong. (1999).

231. H.R. 1467, 106th Cong. (1999).

232. H.R. 2525, 106th Cong. (1999). Under the bill, the 23% figure is only in place during the year 2001. After that year, the bill sets out a formula to determine the tax rate. See *id.* § 101(b)(2) & (3).

233. See H.R. 2467, 106th Cong. (1999) & H.R. 2525, 106th Cong. (1999).

234. See Jim VandeHei, *House Passes GOP Marriage Tax-Cut Bill*, Wall St. J., Feb. 11, 2000, at A16.

235. See *id.*

Republican presidential candidate Gary Bauer proposed a 16% flat-tax on individuals and corporations.<sup>236</sup> President George W. Bush proposed a \$483 billion tax cut over a five-year period<sup>237</sup> and now proposes a \$1.6 trillion tax cut over a ten year period. A significant component of President Bush's proposal was the implementation of four flatter marginal rates ranging from 10% to 33% replacing the current five marginal rates ranging from 15% to 39.6%.<sup>238</sup> For single taxpayers, the 10% rate would apply to taxable income up to \$6,000 and for married taxpayers, the 10% rate would apply to the first \$12,000. Under President Bush's proposal, taxpayers currently taxed at the 36% and 39.6% rates would be taxed at a 33% marginal rate.<sup>239</sup> Former presidential candidate Senator John McCain of Arizona had proposed a \$240 billion tax cut over a five-year period that expands the 15% tax bracket to cover higher incomes.<sup>240</sup> Critics of the proposal indicate that preliminary analysis of the proposal showed that 34.9% of the tax cuts would benefit taxpayers whose income was in the top 5% and that only 6.7% of the benefits would go to taxpayers in the bottom 60% income level.<sup>241</sup> The same critics also pointed out that President Bush's proposal would give 52.6% of the tax cuts to taxpayers in the top 5% level while 11% would benefit taxpayers in the bottom 60% income level.<sup>242</sup> Former Democratic candidate Al Gore proposed a \$500 billion tax cut over the next ten years.<sup>243</sup> Mr. Al Gore's plan was targeted toward the low-income and middle-income taxpayers, and taxpayers earning more than \$100,000 would see marginal tax relief.<sup>244</sup> With the election finally decided, the debate shifts from election year rhetoric to serious consideration of President Bush's tax plan. While it is unlikely that the entire \$1.6 trillion tax proposal will become law, it is probable Congress will pass a substantial tax-cut during this year and enact some of the president's \$1.6 trillion tax cut plan. The endorsement of Alan Greenspan, the Federal

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236. See Rogers, *supra* note 227, at A32. Under the proposal, all corporate deductions would be disallowed. See *id.*

237. See Jackie Calmes, *Bush's Tax-Cut Plan Focuses on People at Bottom as Well as Top, and Comes With High Price Tag*, *Wall St. J.*, Dec. 1, 1999, at A28.

238. See *id.*

239. See *id.*

240. Richard W. Stevenson, *McCain to Propose Middle-Class Tax Cut and Private Accounts Within Social Security*, *N.Y. Times*, Jan. 11, 2000, at A21. Under Senator McCain's proposal, up to \$70,000 of taxable income for married couples filing joint returns and \$35,000 for single taxpayers would be subject to the lowest tax bracket of 15%. Currently, the ceiling for the 15% tax bracket is \$36,900 for married couples filing joint returns and \$22,100 for single taxpayers. See IRC § 1(a) & (c).

241. See Stevenson, *supra* note 240, at A21.

242. See *id.*

243. See Richard W. Stevenson, *Democrats Drawn to Tax Cuts, But Parties Still Split Over Size*, *N.Y. Times*, July 10, 2000, at A1.

244. See John D. McKinnon, *Pocketbook Politics: How Plans would Affect You*, *Wall St. J.*, Oct. 4, 2000, at C1.

Reserve Board's chairperson, to a tax cut increases the likelihood of tax relief.<sup>245</sup> The only significant issue remaining is whether the tax cut will safeguard the progressive tax structure or whether it will continue the trend of eroding the progressive tax structure.

#### IV. PROGRESSIVE TAXATION IN TODAY'S SOCIETY

##### A. *The Renewed Need for Progressive Taxation*

In a recent article, Professor Michael A. Livingston stated that any progressivity research should address topics such as impact of tax legislation and tax rates on women and minority taxpayers.<sup>246</sup> Empirical data establishes that many women and minorities are living below the poverty threshold. The poverty threshold for a family of four was \$16,660 in 1998.<sup>247</sup> At that time, the poverty rate was 12.7%, and the total number of families living below the poverty level was 34.5 million.<sup>248</sup> Although the percentage of people living below the poverty line is generally shrinking,<sup>249</sup> the disparity between the wealthy and the poor has steadily increased since 1967.

In 1998, households in the upper 95<sup>th</sup> percentile earned income 8.2 times greater than those in the lowest 20<sup>th</sup> percentile compared to 6.3 in 1967.<sup>250</sup> The

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245. David E. Sanger, *The President's Budget: The Context; Surplus Feast: Will Tax-Cut Appetizer Leave Room for Debt-Slice Dessert?*, N.Y. Times, Mar. 21, 2001, at A23. Mr. Greenspan approves of a tax cut in principle, but he has not expressly endorsed President Bush's \$1.6 trillion tax cut. *Id.*

246. See Michael A. Livingston, Blum and Kaven at 50: *Progressive Taxation, "Globalization," and the New Millennium*, 4 Fla. Tax Rev. 731, 737 (2000) [hereinafter Livingston].

247. See *Poverty*, supra note 206, at 1.

248. See *id.*

249. The poverty rate increased in 1998 for residents in the Northeast and West. See *id.* at viii.

250. See *Money*, supra note 113, at vi, viii. Between 1967 and 1998, the disparity in the household income between the highest and lowest income levels is as follows:

	Upper 95%	Lowest 20%	
	<u>Earned Income</u>	<u>Earned Income</u>	<u>Disparity</u>
1998	\$132,199	\$16,116	8.20
1997	128,521	15,640	8.22
1996	124,187	15,342	8.09
1995	120,860	15,402	7.85
1990	118,163	15,589	7.58
1985	110,984	15,149	7.33
1980	101,999	14,965	6.82
1975	94,787	14,574	6.50
1970	91,477	14,552	6.29
1968	85,824	14,367	5.97
1967	85,317	13,471	6.33

poverty level was substantially higher for several metropolitan areas<sup>251</sup> and for families headed by females. Females headed 53% of families living below the poverty threshold, and the poverty rate for families headed by females was 29.9%.<sup>252</sup> The percentage of children under the age of six living below the poverty level was 20.6%.<sup>253</sup> In the case of children under the age of six residing in households headed by females with no husband present, the poverty rate was a staggering 54.8%.<sup>254</sup> The poverty level was also high for Blacks (26.1%) and for Hispanics (25.6%).<sup>255</sup> The median income was \$25,351 for Blacks and \$28,330 for Hispanics.<sup>256</sup> This empirical data supports the longstanding trend that females continue to earn substantially less than males.<sup>257</sup> The ratio of female-to-male earnings for both high school graduates and college graduates is approximately 71%. Significantly, 12.7 million households, 12% of all households, were headed by females.<sup>258</sup> The median income of these households was \$24,393 compared to \$38,885 for all households.<sup>259</sup>

Many minorities and females represent the classic scenario set forth in the introduction. When you consider the empirical data, the level of progressivity necessary to promote a reasonable standard of living has far reaching implications. While it is alarming that so many minorities, women and children live far below the poverty threshold, our capitalistic society permits varied levels of wealth resulting from competition in the free market. Whether the economic advantages are earned by effective competition or inherited from a relative, our

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251. For example, the poverty level in some major metropolitan areas was as follows: Houston (28.1%); New York City (24.3%), Washington, DC (23.8%); Los Angeles (22.5%); Detroit (22.4%); Boston (22.1%); Chicago (17.3%) and Dallas (17.1%). See Nina Bernstein, *Poverty Rate Persists in City Despite Boom*, N.Y. Times, Oct. 7, 1999, at B1.

252. See *Poverty*, supra note 206, at vi.

253. See *id.*

254. See *id.*

255. See *id.* at viii.

256. See *Money*, supra note 113, at vi.

257. It is beyond the scope of this article to address the issues surrounding the gap in earnings between males and females. See generally Michael Selmi, *Family Leave and the Gender Wage Gap*, 78 N.C. L. Rev. 707 (2000) (creation of wage equality is tied to encouraging more men to take leave upon the birth of their children); Daniel R. Fischel & Edward P. Lazear, *Comparable Worth and Discrimination in Labor Markets*, 53 U. Chi. L. Rev. 891 (1986) (arguing that comparable worth remedy is insufficient because it does not remove barriers to entry in male-dominated jobs); see also Wynn R. Huang, *Article: Gender Differences in the Earnings of Lawyers*, 30 Colum. J.L. & Soc. Probs. 267 (1997) (female attorneys work in lower paying specialties and do not receive the same income premiums as men); Lucy B. Bednarek, *Note: The Gender Wage Gap: Searching for Equality in a Global Economy*, 6 Ind. J. Global Leg. Stud. 213 (1998) (inequality in gender wages must be addressed by considering effects of globalization);

258. See *Money*, supra note 113, at vi.

259. See *id.*

system permits the unequal distribution of wealth. As a result, it would be inconsistent with our capitalistic society to mandate a massive redistribution of wealth under the Code. However, the country as a whole should share a role in alleviating poverty, particularly with respect to children to at least prevent a cycle of poverty from generation to generation. The progressive tax structure allows the low-income families to retain most of their income and prevents many families' after-tax income from falling below the poverty level. There have not been any radical changes in society altering this conclusion. The progressive tax system remains viable even in today's society. Hence, the tax system should not be structured to allow for the wealthy taxpayers' after-tax income to increase while taxpayers in every other income level experience a decrease in their after-tax income. Moreover, the tax system cannot be structured to allow the tax as a percentage of adjusted gross income to decrease for the wealthiest taxpayers while remaining proportionate for most taxpayers in other income brackets and even increasing for some low-income taxpayers.

Part II of this article establishes that the progressive income tax structure has permeated our tax system since the enactment of the Income Tax Act of 1913. Professor Livingston opined that changes in the modern world "impose significant practical obstacles to the maintenance of a progressive tax system".<sup>260</sup> Societal changes do not require a complete overhaul of our tax structure. Rather, societal changes should only impact the level of progressivity. For example, to combat the economic adversity surrounding the Great Depression, Congress increased the surtax on the maximum marginal brackets from 20% to 55%. Congress imposed the highest marginal rate of 91% during the World War II. Congress slowly reduced the astounding 91% rate, and the maximum marginal rate is substantially lower today than it was when Professors Blum and Kalven wrote their notable critique of the progressive tax system. It is inconceivable that the rates would ever rise to the astronomical levels of yesteryear. Professor Livingston correctly points out that there is an "increasing conservatism of American politics."<sup>261</sup> A more accurate question is whether progressive taxation can be sustained at all in light of the increasing conservatism. Stated another way, is the progressive tax structure inherent throughout history appropriate in light of today's society? That question must be answered affirmatively. Irrespective of the method of taxation adopted by this country, it cannot conflict with the traditional ability-to-pay principles expressed in the legislative history of the historic Income Tax Act of 1913. It is unlikely that Congress would enact marginal rates approaching the rates in the past because of increased conservatism. However, the progressive tax structure is the most effective manner of satisfying revenue concerns while adhering to the ability-to-pay

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260. See Livingston, *supra* note 246, at 737.

261. See *id.*

concept. The consumption tax favors the wealthy taxpayers that obviously are in a better position to save large amounts of money over long periods of time. Proportional taxation has several advantages, but is inappropriate to convert to such a system of taxation because revenue shortfall considerations. Any viable proposal for a proportional tax system would result in a tax increase for many middle-income taxpayers to sustain the revenue demands. Of course, progressivity would still be a part of proportional taxation in the form of exemptions to prevent low-income taxpayers from being subjected to a hefty tax burden.

### *B. Globalization and Progressive Taxation*

Professor Livingston argues that globalization precludes a country from maintaining inflated tax rates because of a probable loss in business to competing nations.<sup>262</sup> Arguably, developed countries might lose business to developing countries due to lower wages in those developing countries, more costly environmental controls and labor protection laws. If those developing countries also maintain lower tax rates, that only represents one additional factor in contributing to a loss in business to those countries. However, these countries lack sufficient resources to pose bona fide threats to developed countries. Moreover, many developing countries actually maintain progressive rate structures. Taiwan's marginal rates for personal income ranges from 6% to 40%.<sup>263</sup> Capital gains are taxed in the same manner.<sup>264</sup> In Mexico, the marginal rates range from 3% to 40%.<sup>265</sup> Capital gains are also subject to the Mexican income tax.<sup>266</sup>

A more significant question raised by Professor Livingston concerns whether this country could lose business to developed countries. While Professor Livingston was concerned with the competitive disadvantages a country might encounter by maintaining high tax rates, he was particularly apprehensive about the impact on a country that taxed capital because of the ease of shifting capital to countries with lower taxes.<sup>267</sup> Professor Livingston raises valid issues. Nevertheless, many developed countries that possess sufficient resources to put forth a serious competitive threat also maintain progressive rate structures, and they also tax capital. Japan has been a leader in the manufacture of electronic

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262. See *id.* at 742.

263. See 1998 International Tax Summaries: A Guide for Planning and Decisions (Annual), at T-2 (Coopers & Lybrand ed.).

264. *Id.* at T-3.

265. See Nicasio del Castillo, Manuel F. Solano & Joseph M. Wolf, Business Operations in Mexico, 972-2nd Tax Mgmt. (BNA), at A-65.

266. See *id.*

267. See Livingston, *supra* note 244, at 742.

equipment and automobiles. In Japan, individuals are assessed a national income tax.<sup>268</sup> The marginal tax rates are 10%, 20%, 30% and 37%.<sup>269</sup> The tax is imposed on various forms of income, including business income.<sup>270</sup> Generally, Japan also imposes a local enterprise tax on business and rental income at a flat rate of 5%.<sup>271</sup> In addition, Japan imposes a corporate income tax at a 34.5% tax rate for large corporations and 25% tax rate for small corporations.<sup>272</sup> Gains from the disposition of corporate stock and other corporate securities are not subject to the progressive ordinary income tax rates but are subject to a flat tax rate of 26%.<sup>273</sup> In Germany, the graduated income tax rates range from 22.9% to 51%.<sup>274</sup> Income derived from the investment of capital is also subject to taxation but are no longer entitled to lower capital gain rates as had existed in the past.<sup>275</sup> Canada also has a system of progressive taxation. The three marginal rates vary from 17% to 29%.<sup>276</sup> While the top marginal rate is substantially lower than the maximum rate imposed under the Code, taxpayers are subject to a surtax of 3%, and income exceeding \$12,500 is subject to a surtax of 5%.<sup>277</sup> Income realized from capital ventures is also subject to capital gain taxation.<sup>278</sup> In Australia, the progressive rate schedule for the tax years 2000 through 2001 ranged from 0% for taxable income up to \$6,000 to 47% for taxable income above \$60,000.<sup>279</sup> Capital assets purchased after 1985 and held for over 12 months are subject to a capital gain tax rate that is 50% of the taxpayer's income tax rate.<sup>280</sup> Hence, it is premature to emphasize globalization as a reason to lower taxes because many countries' tax structures continue to tax capital and maintain progressive income tax rates.

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268. See Griffith Way, Rosser H. Brockman, Masatami Otsuka & Shimon Takagi, *Business Operations in Japan*, 969 *Tax Mgmt.* (BNA), at A-136-37.

269. See *id.* at A-137.

270. See *id.* at A-140.

271. See *id.* at A-137.

272. See *id.* at A-30.

273. See *id.* at A-146.

274. See Juergen Killius, *Business Operations in Germany*, 962-2nd *Tax Mgmt.* (BNA), at A-66.

275. See *id.* at A-60, A-64.

276. See Robert Couzin, *Business Operations in Canada*, 955-2nd *Tax Mgmt.* (BNA), at A-51.

277. See *id.*

278. See *id.* at A-45.

279. See Australian Taxation Office, *Individual Resident Income Tax Rates*, at <http://www.ato.gov.au> (last visited Mar. 28, 2001).

280. See *id.*

### C. Reduction in the Lowest Marginal Rate

Congressional members have the authority to determine whether they should enact legislation to adjust the rate structure as a result of economic or social conditions affecting the country. However, there are several reasons why any restructuring of the tax system should conform to the progressive tax principle. IRS statistics establish that upper income taxpayers have been retaining a larger share of their after-tax income than taxpayers in lower income brackets. As a result, our tax system has become less progressive than it has been in the past. It is likely that this pattern will continue based on the various congressional tax proposals. Congress needs to improve its method of distributing tax benefits and reapportioning the budget surplus. In reversing the erosion of the progressive tax system, it is not necessary to limit the tax benefits afforded to the wealthy, but tax benefits to the lower income taxpayer need to be enhanced. The use of deductions and nonrefundable credits is inadequate. In order to balance the tax benefits allocated to the lower income taxpayers and the upper income taxpayers, the lowest marginal rate should be reduced. The alternative approach of increasing the tax costs of the wealthy is less appealing.

The most equitable and simplest way to protect the progressive tax structure is to lower the lowest marginal tax rate<sup>281</sup> or to expand the 15% bracket to include higher incomes. Presently, the lowest marginal rate is 15%. The lowest marginal rate should be reduced to 10%.<sup>282</sup> If a single taxpayer had taxable income of \$15,000, that taxpayer's tax would be \$2,250 under the current marginal rate structure. Alternatively, if Congress reduced the lowest marginal rate to 10%, that taxpayer's tax would be \$1,500. This represents an annual tax saving of \$750. The tax liability is 33% lower than the liability under the current rates. By comparison, if you assume that the single taxpayer reported taxable income of \$300,000, under the current rate structure the tax liability would equal \$99,572. If, however, the lowest income tax bracket were lowered to 10%, that taxpayer tax liability would be \$98,467. The integrity of the progressive tax system would be protected as the higher income taxpayer's annual tax saving is \$1,105, but the tax liability is reduced by only 1%. If a taxpayer had \$50,000 of taxable income, the tax liability under the current scheme would equal \$11,127. Alternatively, under the proposed scheme, the tax liability would equal \$10,022. The taxpayer's liability is reduced by 10%. Consequently, the higher income

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281. See Bankman & Griffith, *supra* note 44, at 1905, 1945 (stating that "progressive tax is best implemented through declining marginal rates rather than through increasing marginal rates").

282. President George W. Bush's plan includes a reduction in the lowest rate to 10%, but the income ceilings are \$6,000 for single taxpayers and \$12,000 for married taxpayers filing joint returns. See Pocketbook Politics: How Tax Plans Would Affect You, *Wall St. J.*, Oct. 4, 2000, at C1, C21.

taxpayer will receive an annual tax savings in the same amount as any taxpayer with taxable income of at least \$22,100, but the percentage of tax savings is higher for lower income taxpayers.

#### D. *Viability of Proposal*

Professor Graetz has stated that five principles must be addressed to establish whether a particular tax is viable: Whether the tax is fair, easy to comply with and administer, conducive to economic growth, produce adequate revenue and provide little interference with private economic decisions.<sup>283</sup> In determining whether the proposal to alter the income tax rates is viable, these five principles will be addressed.

1. *The Fairness of the Reduction of the Lowest Marginal Tax Rate.*—As already noted in this article, there is no consistent interpretation of fairness under the tax statute. While an amendment to the income tax laws may be considered fair to one individual, it also may be considered to be a most inequitable amendment to another individual. Any amendment of a tax statute that increases the tax burden of the wealthy in order to reverse the erosion of the progressive tax system would raise issues of fairness. Furthermore, it would provide no tangible tax benefit to the lower income taxpayers. Alternatively, if Congress expanded the earned income tax credit to make it more inclusive, it would not survive the inevitable criticism that it went beyond its intended purpose and unfairly reallocated wealth. A more practical approach of increasing progressivity is to either lower the lowest marginal bracket or to increase the lowest marginal tax bracket to include more lower to middle income taxpayers. While an expansion of the lowest marginal bracket to include a larger amount of taxable income would provide a substantial tax savings to many lower to middle class taxpayers, it would also provide a minimum benefit to upper income taxpayers by a slight reduction in their effective tax rates. The major concern with this proposal is that it would not provide any benefit to low-income

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283. See Graetz, *supra* note 22, at 10. It is difficult to conceive a tax system that is fair but does not conflict with the other 4 tax principles. As Professor Graetz points out:

[b]oth economic efficiency and equity generally support uniform income tax treatment of sources and uses of income. In other circumstances, however, equity and efficiency conflict. For example, tax fairness might support taxing all sources of income when economic efficiency argues for taxing consumption or wages. Likewise, the disincentives for earning income may be greater under a progressive rate structure that applies higher rates to greater amounts of income, but a society's sense of tax justice may demand such progressivity.

See *id.* at 12; see also Paul, *supra* note 33, at 151, 155 (“[c]omplexity is a by-product of a tax regime's reconciliation of the lofty aspiration to distribute tax burdens equitably and the mundane requirement that the tax be susceptible to administration and compliance.”).

taxpayers. This is particularly problematic for the category of low-income taxpayers that are unable to take advantage of the earned income tax credit. Hence, while the increase in the 15% bracket has its advantages, it is not entirely equitable because it prevents a small class of taxpayers from sharing in the benefits. Some scholars might criticize this proposal because the wealthy taxpayers would actually receive a larger annual tax savings than their lower income counterparts. However, the proposal is not intended to reallocate wealth; rather, it is intended to ensure that the percentage of tax savings is higher for the lower income taxpayer than the higher income taxpayer.

Conversely, a reduction of the lowest progressive rate would benefit taxpayers in every income bracket. In reversing the past erosion of the progressive tax system, every taxpayer, irrespective of the taxable income, will enjoy the tax benefits by sharing in the tax cut.

2. *Simplicity and Compliance.*—During 1989, former Representative and House Ways and Means Committee member Barber Conable reflected on his days in Congress and causal forces behind the Code's complexity.<sup>284</sup> He coined the phrase "ABC syndrome" to explain the complexity underlying the tax code.<sup>285</sup> Based on his experience, the ABC syndrome unfolds upon the enactment of a tax provision and the subsequent interaction with constituents complaining about the inequitable impact of the provision. The constituent states "[w]hat you have done in the tax system is fundamentally all right, but I have a very unusual situation, you see, and it is not fair for me to have to be taxed this way just because my neighbor thinks it is all right."<sup>286</sup> Upon reflection, members of the House Ways and Means Committee are persuaded that an exception should be created for all A's who qualify.<sup>287</sup> Subsequently, another constituent, B, approaches a congressional member and expresses concern about the adverse effect of the exception created for A.<sup>288</sup> In recognizing the inequity impacting B and those similarly situated, another exception is created.<sup>289</sup> The phenomenon continues and eventually spirals into tax complexity.<sup>290</sup>

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284. See Conable, *supra* note 78, at 38.

285. See *id.* at 40-41.

286. See *id.* at 41.

287. See *id.*

288. See *id.*

289. See *id.*

290. See *id.* Another factor contributing to complexity in the tax statute is Congress's promotion of social policy. Many tax experts believe that the promotion of social policy thwarts the objective of raising revenue and has made the Code inordinately complex. See, e.g., Sheldon D. Pollack, *The Failure of U.S. Tax Policy: Revenue and Politics* 243 (1996); Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 *Harv. L. Rev.* 705 (1970)

Some scholars have argued that the very nature of progressive taxes complicate the tax system and encourage tax avoidance.<sup>291</sup> Concededly, the progressive tax system is inordinately complex;<sup>292</sup> however, it does not follow that every amendment will be difficult to administer. One advantage to a tax cut in the form of a rate reduction or an increase in the 15% tax bracket is tax simplification. It would be easy to administer, and Congress would circumvent the "ABC syndrome". It is much more practical to reduce taxes by lowering the tax rates rather than enacting additional deductions, exclusions and credits. By simply lowering the marginal bracket, Congress is able to cut taxes without the necessity of a complex set of instructions, schedules and regulations.

3. *Economic Growth.*—One of the criticisms of a progressive tax system is that it results in a disincentive for taxpayers to maximize their income opportunities.<sup>293</sup> If the highest marginal rates are increased, an argument could be made that it impedes income generation and economic growth. The argument revolves around a purported disincentive for taxpayers to increase their earnings because of the graduated tax rates. While this argument is worthy of consideration, the empirical data does not lend support to this theory.<sup>294</sup>

4. *Production of Revenue.*—If revenue production were irrelevant, equity and efficiency would result in the repeal of all taxes.<sup>295</sup> However, the primary purpose of the income tax is to generate income for government operations. The lowering of the bottom tax bracket is not cost prohibitive. Based on the IRS statistics from 1997, the projected annual cost of the rate reduction would be approximately \$36 billion per year.<sup>296</sup>

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291. See Blum & Kalven, *supra* note 25, at 14.

292. This article is not intended to provide a recommendation as to how the tax statute could be reformed to make it simpler. Professor Jonathan Barry Forman conducted an in-depth project on how the taxing statute could be revamped to simplify it for low-income taxpayers. See Jonathan Barry Forman, *Simplification for Low-Income Taxpayers: Some Options*, 57 *Ohio St. L. J.* 145 (1996). Professor Forman stated that it might not be possible to do for all taxpayers, but it was possible to simplify the taxing scheme for low-income taxpayers and outlined several proposals to carry out that objective.

293. See Blum & Kalven, *supra* note 25, at 21.

294. For example, after Congress increased the graduated rates during 1993, adjusted gross income for individuals earning \$1,000,000 or more increased each year after the amendment. See *supra* notes 161-70 and accompanying text.

295. See Kwall, *supra* note 144, at 633-34.

296. During taxable year 1997, the income tax after nonrefundable credits totaled \$729 billion. See Internal Revenue Service, 19 *Stat. of Income Bull.*, Selected Historical & Other Data, at 194 (Summer 1999). Upon reducing the lowest marginal rate by 5%, the income tax would total \$693 billion.

With a projected surplus of \$1.9 trillion for the next ten years, implementation of the proposal would have little impact. Moreover, the projected cost of implementation is substantially less than the projected \$1.6 trillion tax cut proposed by President Bush.

*5. Interference with Private Economic Decisions.*—The Code is replete with numerous provisions designed to encourage desired behavior.<sup>297</sup> It is, therefore, difficult to enact tax provisions that do not interfere with private economic decisions. However, the lowering of the bottom tax bracket or expansion of the bottom tax bracket would not interfere with private economic decisions.

## V. CONCLUSION

When the historic Income Tax Act of 1913 was enacted, Congress implemented a progressive tax structure. The fundamental principle underlining the progressive tax structure is that responsibility for the federal tax burden should be based on an ability-to-pay concept. That principle has continued vitality today. There is considerable evidence establishing that Congress has been eroding the progressive tax structure. This is particularly apparent between the lower to middle income level taxpayers and upper income taxpayers. It is probable that Congress has protected some progressivity between the middle to upper income taxpayers and the wealthiest taxpayers. The middle to upper income taxpayers are readily able to benefit from the numerous tax cuts enacted during the 1990's such as Roth IRAs, educational IRAs, Hope and Lifetime Learning Credits and student loan interest deduction.

The current system fails because it does not adhere to the ability-to-pay principle because many taxpayers' after tax income leaves them with incomes below the poverty level. For taxpayers that do not qualify for the earned income tax credit, they will be able to retain a greater portion of their income that will enable them to move closer to the poverty level. Taxpayers that are in the lower to middle income level who have been unable to share in recent tax cuts undoubtedly will be able to benefit under this proposal.

The proposals submitted by both the frontrunners in the recent presidential election failed to satisfy the concept of fairness. President George W. Bush's proposal was unfair because he targeted the wealthy taxpayers. Former Vice-President Gore's proposal was equally unfair because he targeted the low-

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297. See, e.g., IRC § 1(h) (favorable capital gain rates designed to encourage long-term investments); Id. § 163(h)(1) & (2) (mortgage interest deductible which effectively encourages homeownership over renting), id. § 170 (charitable contribution deduction provides an incentive for charitable giving).

income and middle-income taxpayers. The proposal to reduce the lowest tax rate is fair because most taxpayers will be able to share in the tax cut. In addition, one of the most important aspects of the proposal is that it is consistent with the progressive tax structure that is inherent in the Code.